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FOR DEVELOPMENT POLICIES
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EUROPEAN REPORT ON DEVELOPMENT 2015

COMBINING FINANCE AND POLICIES TO IMPLEMENT A TRANSFORMATIVE POST-2015 DEVELOPMENT AGENDA

Full Report

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Foreword ERD 2015

This year marks a historic momentum for the international community to re-shape the way we live for decades to come, and pave the way for a new relationship between humankind and the planet that is our home. In the words of UN Secretary-General Ban Ki-moon, the post-2015 development agenda provides a unique opportunity “to end poverty, transform the world to better meet human needs and the necessities of economic transformation, while protecting our environment, ensuring peace and realizing human rights”. Indeed, business as usual is not an option, whether in terms of human dignity, equality or sustainability. We have to act, and we have to act now - and together.

The post-2015 development agenda is a major priority for the EU. Our goal is to secure both an ambitious outcome in September 2015 and a clear commitment from all to follow through with its implementation.

The post-2015 agenda will mark a true paradigm shift. At its core, the proposed Sustainable Development Goals (SDGs) will cover the three dimensions of sustainable development – economic, social and environmental – in an integrated and balanced manner, as well as crucial issues such as governance and peaceful and inclusive societies. The challenges of eradicating

poverty and achieving sustainable development are fundamentally interlinked: addressing them together will allow us to adopt a truly transformative approach with real and sustainable impact.

The move towards a universal agenda means that the new goals and targets will apply to all countries: we will all be challenged to achieve progress locally, while contributing to the global effort. Everybody will need to play their part, based on the principles of shared responsibility, mutual accountability and respective capacities.

In this context, the discussion on the Global Partnership to implement the agenda is absolutely fundamental. To succeed, we need to mobilize and use effectively all relevant Means of Implementation, financial and non-financial, public and private, domestic and international. Crucially, these need to be underpinned by sound policies and an enabling environment at all levels.

Independent research has an important role to play in this debate, not least in identifying lessons and possible solutions. This is also the objective of this year's European Report on Development, produced with the support of the European Commission and four Member States – Finland, France, Germany and Luxembourg.

The key message from the report is that policy and finance are crucial to implement a transformative post-2015 development agenda. Based on existing evidence and specific country experiences, the European Report on Development 2015 shows that finance alone is not enough. It seldom reaches the intended objectives, unless it is accompanied by complementary policies. What we need therefore is to deliver a truly transformative post-2015 development agenda with the right combination of finance and policies.

The report puts forward a research-based independent contribution to EU thinking and to the global debate. The wealth and breadth of knowledge contained in this report, together with its findings and analysis, provide a valuable basis for meeting the great ambition and promise of the post-2015 development agenda.



Neven Mimica

*Commissioner for International
Cooperation and Development*

Directors' Foreword

We stand at a critical juncture in approaches to global action. During the course of 2015, governments will come together to agree a new framework on financing for development, adopt a post-2015 development agenda including a set of sustainable development goals, and frame an agreement on climate change. The outcomes of these summits and subsequent actions will have a crucial bearing on prospects for poverty reduction, transformative economic growth, sustainable development and avoiding dangerous climate change. The European Report on Development 2015 is a must-read document for policy makers and others involved in these crucial processes. The authors take an in-depth look at the role of the different types of finance in development. They consider also approaches to the mobilisation of that finance and – critically – policies and for its effective use. As the authors rightly conclude, more finance is not a stand-alone prescription for delivering on a transformative post-2015 agenda. The central message of the report is that policy matters.

We have come a long way since the Monterrey Consensus in 2002 which focused predominantly on the role of aid. As we live in an increasingly interdependent world linked by flows of trade, finance, knowledge and technology, aid has become the small change of international

development. However, many national challenges can be met only through engagement and policy coherence at international, regional and national levels. It is no longer a question of “North” helping “South” but of all countries working collectively to address what the UN now recognises as a universal agenda. Better and more coherent policies and financial contributions of all kinds will be needed.

The data presented in this report suggest we need a more comprehensive approach to financing for development. Domestic public resources have grown rapidly over the last decade and are the largest source of finance for all country income groupings. International public finance has also increased but is declining in relative importance. Domestic private finance has shown the fastest growth but is still low at low levels of income. International private finance has been highly volatile compared to the other flows. Innovative finance is promising but is yet to take off at scale. It is clear that there is a need to think about all types of finance for development and aid is only a small but pivotal source of finance.

On the evidence presented in this report, we urge policy makers to consider and adopt general principles for the mobilisation and effective use of finance. Policy and finance should be seen as enablers of development, and not just as cures

for particular symptoms. A conducive policy environment will be required at the global level as much as national or even local levels. There are no blueprints: different types of finance need to be used strategically, each for what they are best suited and directed to where they are most needed. Policy and regulatory frameworks need to be established to encourage these processes.

If we get this right, it will allow all countries to generate, attract and steer finance from unproductive to productive uses, achieve better outcomes on the same levels of finance and even reduce the need for more finance. It is critical that all the parallel negotiations on financing for development and the post-2015 agenda this year converge into a Global Partnership involving multiple actors and based on the principle of universality, while acknowledging the complementary role of differentiation.

We are delighted that our three institutes and the active collaborators we have found at the University of Athens and within the Southern Voice network of think tanks in Asia, Africa and Latin America have once again been able to work together to produce this European Report on Development and hope that it will make a useful contribution to the debate in this historic year for international cooperation and sustainable development.



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The report is drafted by a team of researchers from the five participating institutions, led by Dirk Willem te Velde (team leader) and other core team members (Debapriya Bhattacharya, Louka Katseli, James Mackie and Peter Wolff). It incorporates contributions from San Bilal, Ingo Bordon, Vivienne Boufounou, Max Büge, Bruce Byers, Alisa Herrero, Marie-Agnes Jouanjean, Nannette Lindenberg, Sebastian Grosse-Puppendahl, Gideon Rabinowitz, Andrew Shepherd, Leah Worrall and others.

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Acronyms & Abbreviations

\$	United States dollar
€	Euro
ACP	Africa, Caribbean and Pacific
ADB	Asian Development Bank
AfDB	African Development Bank
AfT	Aid for Trade
AWF	African Water Facility
BFC	Better Factories Cambodia
BIFFL	Bangladesh Infrastructure Fund Limited
BIOFIN	Biodiversity finance initiative
Bn	Billion
BNEF	Bloomberg New Energy Finance
BoP	Balance of payments
BRICs	Brazil, Russia, India and China
CBD	Convention on Biological Diversity
CDC	Commonwealth Development Corporation
CDM	Clean Development Mechanism
CER	Certified emissions reductions
CGE	Computable general equilibrium
CI	Country Illustration
CIC	Climate Innovation Centre
CL	Commercial banking loan
CO2	Carbon dioxide
COFIDES	Compañía Española de Financiación del Desarrollo
CPAN	Chronic Poverty Advisory Network
CSO	Civil society organisation
CSR	Corporate social responsibility
CTF	Clean Technology Fund
DAC	(Organisation for Economic Co-operation and Development) Development Assistance Committee

DC	Domestic credit
DCFTA	Deep and Comprehensive Free Trade Agreement
DEG	Deutsche Investitions und Entwicklungsgesellschaft
DFI	Development Finance Institution
DFID	(UK) Department for International Development
DIE	Deutsches Institut für Entwicklungspolitik
DRC	Democratic Republic of Congo
DRM	Domestic Resource Mobilisation
EBA	Everything But Arms Initiative
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECA	Export credit agency
ECDPM	European Centre for Development Policy Management
ECOSOC	United Nations Economic and Social Council
EF	Environmental fund
EI	Extractive industry
EIB	European Investment Bank
EITI	Extractive Industries Transparency Initiative
EPZ	Export Processing Zone
EPZDA	Export Processing Zones Development Authority
ERD	European Report on Development
ES	Ecosystem service
ETS	Emissions Trading Scheme
EU	European Union
EU-AITF	European Union-Africa Infrastructure Trust Fund
Ex-Im	Export-Import
EXIM	Export-Import Bank of the United States
FDI	Foreign direct investment
FFD	Financing for development

FIT	Feed-in tariff
FMO	Dutch development bank
FPFD	Finance and Policy Development Framework
FS	Frankfurt School
FSB	Financial Stability Board
FUNDEF	(Brazil's) Special fund for primary education
GAVI	Global Alliance on Vaccines and Immunisation
GCF	Green Climate Fund
GDP	Gross Domestic Product
GEF	Global Environment Facility
GEEREF	Global Energy Efficiency and Renewable Energy Fund
GFC	Gross fixed capital formation
GFSP	Global Fund for Social Protection
GHG	Greenhouse gas
GIZ	Deutsche Gesellschaft für Internationale Zusammenarbeit
GNI	Gross National Income
GNP	Gross national product
GPG	Global public good
GSP	Generalised System of Preferences
GTT	Green technology transfer
GVC	Global value chain
GW	Gigawatt
Ha	Hectares
HIC	High-income country
HIPC	Heavily indebted poor country
HIV	Human immunodeficiency virus
HLP	United Nations High-Level Panel of Eminent Persons on the Post-2015 Agenda
IADB	Inter-American Development Bank
IAM	Integrated Assessment Models
IBRD	International Bank for Reconstruction and Development
IBSA	India-Brazil-South Africa

ICESDF	Intergovernmental Committee of Experts on Sustainable Development Financing
ICOR	Incremental capital-output ratio
ICT	Information and Communication Technology
IDC	Industrial Development Corporation
IDCOL	Infrastructure Investment Development Company Limited
IEA	International Energy Agency
IET	International Emissions Trading
IF	International Futures
IFC	International Finance Corporation
IFD	Innovative financing for development
IFFIM	International Facility for Immunisation
IFI	International Finance Institution
IFPRI	International Food Policy Research Institute
IGFT	Intergovernmental fiscal transfer
IIFC	Infrastructure Investment Facilitation Centre
ILO	International Labour Organization
IMF	International Monetary Fund
IPCC	Intergovernmental Panel on Climate Change
IPP	Independent power producer
IPR	Intellectual property right
IT	Information technology
kWh	kilowatt hour
LAC	Latin America and the Caribbean
LDC	Least developed country
LG	Local government
LGCDG	Local Government Capital Development Grant
LIC	Low-income country
LIMITS	Low climate Impact scenarios and the implications of required Tight emission control Strategies
LMIC	Lower middle-income country
LPG	Liquefied Petroleum Gas
M&E	Monitoring and evaluation

MAMS	MAquette for MDG Simulation	OPEC	Organization of the Petroleum Exporting Countries
MDB	Multilateral development bank	OPIC	Overseas Private Investment Corporation
MDF	Municipal Development Fund	OWG	Open Working Group on the Sustainable Development Goals
MDG	Millennium Development Goal	O&M	Operation and maintenance
MDL	Moldovan Leu	PA	Protected Area
MDRI	Multilateral debt relief initiatives	PBGS	Performance Based Grant System
MDWPP	Multi-donor Water Partnership Programme	PCD	Policy coherence for development
MENA	Middle East and North Africa	PCSD	Policy coherence for sustainable development
MFA	Multi-Fibre Arrangement	PDA	Private development assistance
MIC	Middle-income country	PEP	Public employment programme
Mn	Million	PES	Payment for Ecosystem Services
MNE	Multinational enterprise	PFI	Private finance intervention
MOI	Means of implementation	PFM	Public finance management
MSA	Municipal support agreement	PIDA	Programme for Infrastructure Development in Africa
MSME	Micro, Small and Medium Enterprise	PORT	Portfolio flow
MTEF	Medium Term Expenditure Frameworks	PPA	Power purchase agreement
MW	Megawatt	PPCR	Pilot Program for Climate Resilience
NCE	New Climate Economy	PPP	Public-private partnership *Graphs which measure in US dollars PPP refers to purchasing power parity
NEPAD	New Partnership for Africa's Development	PR	Public revenue
NGO	Non-government organisation	PRSP	Poverty Reduction Strategy Paper
NIF	Neighbourhood Investment Facility	PSA	Project-support agreement
NODA	Net official development assistance	PSC	Public-service contract
NOOF	Net other official flows	PSNP	(Ethiopia's) Productive Safety Net Programme
NPL	Non-performing loan	PV	Photovoltaic
NREGA	National Rural Employment Guarantee Act	RefPol	Reference policy
NRR	Non-resource rich	R&D	Research and development
NTR	Non-tax revenue	RDB	Regional development bank
ODA	Official Development Assistance	REDD+	Reducing Emissions from Deforestation and Forest Degradation, and the conservation and sustainable management of forests and enhancement of forest carbon stocks
ODI	Overseas Development Institute	REKI	Restorasi Ekosistem Indonesia
OECD	Organisation for Economic Co-operation and Development		
OOF	Other official flow		
OOP	Out-of-pocket		

REM	Remittance	UNESCO	United Nations Educational, Scientific and Cultural Organization
RMB	Chinese Renmibi	UNFCCC	United Nations Framework Convention on Climate Change
RMG	Ready-made garments	UNSDSN	United Nations Sustainable Development Solutions Network
RR	Resource rich	UNTT	United Nations System Task Team on the Post-2015 Development Agenda
RWSSI	Rural Water Supply and Sanitation Initiative	UPE	Universal Primary Education
SDG	Sustainable Development Goal	US	United States
SDR	Special drawing right	USA	United States of America
SE4All	Sustainable Energy for All	VAT	Value-added tax
SEZ	Special Economic Zone	WB	World Bank
SGF	(Global Environment Facility) Small Grant Fund	WDI	World Development Indicators
SME	Small and Medium-Sized Enterprise	WEF	World Economic Forum
SOE	State-owned enterprise	WHO	World Health Organization
SREP	Scaling-Up Renewable Energy in Low Income Countries	WWF	World Wide Fund for Nature
SRES	Special Report: Emissions Scenarios		
SSA	Sub-Saharan Africa		
SSC	South-South Cooperation		
SWF	Sovereign Wealth Fund		
TANESCO	Tanzania Electricity Supply Company Limited		
TFP	Total factor productivity		
TNC	Transnational corporation		
TR	Tax revenue		
Tr	Trillion		
TST	Technical Support Team		
TVET	Technical and vocational education and training		
UHC	Universal health coverage		
UK	United Kingdom		
UMIC	Upper middle-income country		
UN	United Nations		
UNCTAD	United Nations Conference on Trade and Development		
UNDESA	United Nations Department of Economic and Social Affairs		
UNDP	United Nations Development Programme		
UNEP	United Nations Environment Programme		

Executive Summary

We need a completely new approach towards finance for development - this is what follows from the lessons learned from the implementation of the Millennium Development Goals (MDGs), the changes in the Financing for Development (FFD) landscape and practical analyses of key enablers of transformative development which combines economic, social and environmental dimensions.



This report analyses the **considerable changes in the FFD landscape since the 2002 Monterrey Consensus**. It notes that the implementation of the Consensus came to focus largely on the role of Official Development Assistance (ODA) and paid insufficient attention to the importance of increasing domestic tax revenue and encouraging private finance. Yet in some of the countries that were achieving the greatest progress in reducing poverty, domestic tax revenue carried the main burden. This calls for adopting a **more comprehensive view of FFD that takes fully into account the crucial role of public finance and private finance, both domestic and international**. This will set the scene for international public finance to be a valuable complement to other flows of FFD.

The **European Report on Development 2015's** main message is that **finance alone will not be sufficient to promote and achieve the post-2015 development agenda. Policies also matter. Indeed,**

they are fundamental. Appropriate and coherent policies will ensure that finance is used effectively to achieve results and that it is not wasted or underused. Good policies will also help to ensure that more finance is mobilised as success breeds further success. The Report identifies many examples of governments that are making effective policy choices in mobilising and using finance for major **enablers of transformative development**, including local governance, infrastructure, green energy technology, biodiversity, human capital and trade.

Given the challenges encountered in the follow-up of the Monterrey Conference, it is crucial to develop an **appropriate system of monitoring and accountability** that covers as many flows of finance as possible and that stimulates the right actions in the finance and policy framework, nationally and internationally. This accountability system must cover both the Sustainable Development Goals (SDGs) and their targets and the finance and policies required to achieve them. It can then guide implementation of the post-2015 agenda in a way that covers finance, policies and partnerships.

Overall our analysis suggests that it is not an overall shortage of funds that will be the constraining factor in achieving a transformative post-2015 development agenda. Rather, it is the way finance is mobilised and used that will determine success in achieving the goals that the agenda enshrines. This in turn will require efforts to improve the effectiveness of each category of financing by drawing on its unique characteristics in support of particular enablers of development, to expand the range of possible sources of finance through appropriate policies and also to combine different flows as effectively as possible. This will call for reform of national finance and policy frameworks, as well as concerted efforts at the international level.

Introduction

This Report addresses ‘combining finance and policies to implement a transformative post-2015 development agenda’. The experience of pursuing the MDGs has provided lessons in terms of countries’ successes and failures that can be applied to using finance and policies to achieve a post-2015 development agenda. This Report draws out some of the lessons that could help to inform a new finance and policy framework for development (FPFD) that highlights the role of both policies and finance in supporting the long-term enablers (or drivers) of sustainable development.

The policy context

The vision of global development is at a critical juncture, and the need to move beyond ‘business as usual’ is stronger than ever. Representatives of the world’s nations will come together in September 2015 to agree on a new post-2015 development agenda. In the words of UN Secretary-General Ban Ki-moon, the post-2015 development agenda ‘offers a unique opportunity for global leaders and people to end poverty, transform the world to better meet human needs, and the necessities of economic transformation, while protecting our environment, ensuring peace and realizing human rights’. It will thus mark a transformative ‘paradigm shift for people and planet’ (UN Secretary-General Synthesis Report, 2014).

The post-2015 development agenda stems from two converging processes: the follow-up to the 2010 Millennium Summit, which mandated the UN Secretary-General to initiate a process to succeed the Millennium Development Goals (MDGs), and the follow-up to the 2012 United Nations Conference on Sustainable Development (‘Rio+20’), which launched the process to develop the SDGs.

In parallel, but closely linked with these processes, two strands on FFD have also converged: the follow-up to the 2002 Monterrey Conference on Financing for Development and the follow-up to Rio+20, which gave the mandate to prepare options for a sustainable development strategy, as set out in the report of the Intergovernmental Committee of Experts on Sustainable Development Financing (ICESDF).

The Third International Conference on Financing for Development to be held in Addis Ababa in July 2015 is expected to discuss ‘an ambitious agreement on policies, financing, technology transfer, capacity-building and systemic issues’ (Financing for Development Co-facilitators’ elements paper, 2015) to underpin the post-2015 development agenda.

The policy challenges

The development agenda is ambitious and the challenges it poses seem enormous. In the post-2015 context, therefore, mobilising additional financial resources to pursue development goals will not suffice. Such efforts need to be complemented with improved national and international regulatory and policy frameworks, along with investments in absorptive capacity in order to make more effective use of FFD. Indeed, finance and policy are synergistic: better policy-making is needed to make the most effective use of finance but also to attract and channel new financial resources to where they are most needed.

The global policy processes for designing and implementing an ambitious and transformative post-2015 agenda are taking place in a context that differs significantly from when the MDGs were agreed. Some policy challenges are well-known, but there are also new ones with respect to public and private finance.

Take the following examples:

- ▶ While domestic tax revenues are growing in all country income groupings, systems of domestic revenue mobilisation (DRM) in developing countries are immature, leading to low or inefficient tax collection, high levels of tax evasion, and capital flight. The key challenge therefore is to **raise domestic tax revenues in a way that can best support sustainable development**.
- ▶ Concessional loans and grants are stagnating (although ODA reached a record high in 2013) and are also selective in where they flow. They do not systematically prioritise the poorest economies, can be unpredictable and are not always as effective as they might be. The challenge is how to **make use of ODA in a more transformative way and to tap into new aid resources from emerging economies**.
- ▶ Private capital, which often appears to be in abundant supply, is highly selective in where it flows, what it funds and on what terms. It favours financial markets in developed countries, fast-growing emerging economies, the extractive sectors and the formal economy, including larger, established firms. It requires large lending margins, and often bypasses small and medium-sized enterprises (SMEs) in productive sectors, and people living in poverty, of which 2.5 billion do not use banking services. Achieving the SDGs will require the mobilisation of resources from private sources including foreign direct investment (FDI), bank loans, bond issuance, equity and other risk capital and private transfers as well as the use of risk-mitigation instruments. **The mobilisation and effective channelling of private resources requires a supportive investment climate and complementary use of public policies and finance**.
- ▶ Developing and emerging economies have been driving global growth over the past decade, but the world economy remains vulnerable to financial shocks, with the risk of volatile and

unpredictable trading conditions and financial flows. While there has been modest progress in developing global trade and climate rules in recent years, the challenge remains to **promote a global and stable financial system that encourages the mobilisation and effective use of global savings** to support sustainable development. Although the global community is placing the spotlight on international tax rules, these remain poorly regulated, with too much scope for tax avoidance, tax evasion and transfer pricing, which permits the extensive use of tax havens. **The challenge is to promote collective action on global tax rules.**

What this Report aims to contribute

In order to formulate actions to overcome the policy challenges, the main research question addressed in this Report is: ‘**How can financial resources be effectively mobilised and channelled and how can they be combined with selected policies to enable a transformative post-2015 agenda?**’ Several academic studies and policy documents have discussed the role of finance in different dimensions of sustainable development. Most of the latter examine these questions from the starting point of finance. By contrast, this Report starts from sustainable development objectives (focusing on the enablers or long term drivers of sustainable development) and then presents a framework on how finance and policies can contribute to achieving them. The Report focuses specifically on the links between finance and policies and aims to encourage these to be discussed jointly. **This approach leads to three contributions to the literature:**

- ▶ First, the Report considers a range of financial flows rather than focusing on ODA alone.
- ▶ Second, it examines the role of selected enablers or long-term drivers of sustainable development.
- ▶ Third, it provides further evidence on the way in which finance and policy are interlinked in contributing to sustainable development.



Evidence used to inform the Report

This Report uses a **wide range of evidence** to examine the research question. It reviews (a) the lessons from the MDGs with regard to FFD, including the importance of the policy context in relation to a range of financial flows; (b) financial flows to different country income groupings from 1990 as well as innovative sources of FFD, emphasising the need to consider a wide range of flows; and (c) the role of domestic and international policy in mobilising and making more effective use of finance in six areas – local governance, infrastructure, human capital, biodiversity, green energy technology and trade - which we analyse in the Report as the key enablers that contribute to a transformative post-2015 development agenda.

A set of **ERD commissioned papers form** a crucial part of the evidence gathered for this Report: **Country Illustrations (CIs), Background Papers and Modelling Studies.**

Country Illustrations were commissioned on Bangladesh, Ecuador, Indonesia, Mauritius, Moldova and Tanzania. These provide country-based evidence on links between finance and policy for selected enablers of sustainable development, and how these affect social, economic and environmental dimensions in a transformative vision of sustainable development.

Background Papers were commissioned to provide further evidence on issues such as taxation and development, the roles of development finance, climate finance, the role of MDGs in low-income Countries (LICs), South-South Cooperation (SSC) and finance for agriculture.

Two types of **modelling studies** were commissioned in order to explore some of the relationships between finance and policies for the selected enablers (e.g. infrastructure) in greater depth: modelling on Bangladesh, Moldova and Tanzania and other modelling exercises based on global models.

The Report's approach to financing for development

Both the lessons learned from the implementation of the MDGs and the changes in the FFD landscape suggest that **we need a completely new approach towards finance for development:**

▶ A range of studies on finance needs supported the implementation of the MDGs. They emphasised financial gaps to be filled with ODA, but this represented only a partial vision of how needs could best be met. Furthermore, the context has since changed, making it necessary to move **from development aid as a 'silver bullet' to considering all available sources of finance.**

▶ The focus on finance needs associated with the MDGs often ignored the crucial role of policy. There is thus a need to think beyond only policies or only finance and **promote discussions that can foster joint thinking on appropriate policies and finance.**

▶ The MDGs successfully attracted ODA for specific social sectors, but in a post-2015 context with proposed SDGs that seek to be more comprehensive and transformative, it is important to consider long-term enablers for such a development agenda. This requires a new way of thinking about the role of different finance sources and a **better understanding of structural transformation and poverty eradication.**

This Report proposes a different way of thinking about finance and policies, based on four elements:



This framework contrasts sharply with the view that it is possible to achieve a transformative post-2015 agenda with finance, and ODA in particular, alone. It also takes the objective of sustainable development transformation as central, with finance flows playing a supporting role.

1 Consider all financial resources

Finance options have changed

FFD options have changed dramatically by country income grouping, and over time. For example, consider the following financial flows (expressed in 2011 constant prices):

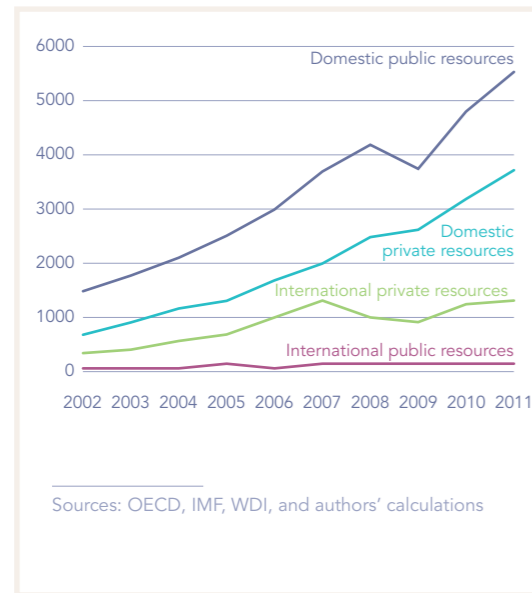
- ▶ Domestic public revenues (tax and non-tax revenues) rose by 272%, from \$1,484 billion (bn) in 2002 to \$5,523 bn in 2011
- ▶ International public finance (net ODA and Other Financial Flows (OOF)) rose by 114%, from \$75 bn in 2002 to \$161 bn in 2011
- ▶ Private domestic finance (measured as Gross Fixed Capital Formation by the private sector, less FDI) rose by 415%, from \$725 bn in 2002 to \$3,734 bn in 2011
- ▶ Private international finance (net FDI inflows, portfolio equity and bonds, commercial loans and remittances) rose by 297%, from \$320 bn in 2002 to \$1,269 bn in 2011

Thus, **since the 2002 Monterrey Consensus, in real terms (2011 dollars) developing countries have had access to an additional \$0.9 tr in private international finance, \$3 trillions (tr) in private domestic finance and \$4 tr in public domestic revenues. Public international finance increased by just under \$0.1 tr** (and the total is now less than 1.5% of the total resources available).

Figure 1 depicts the evolution of finance flows to developing countries.

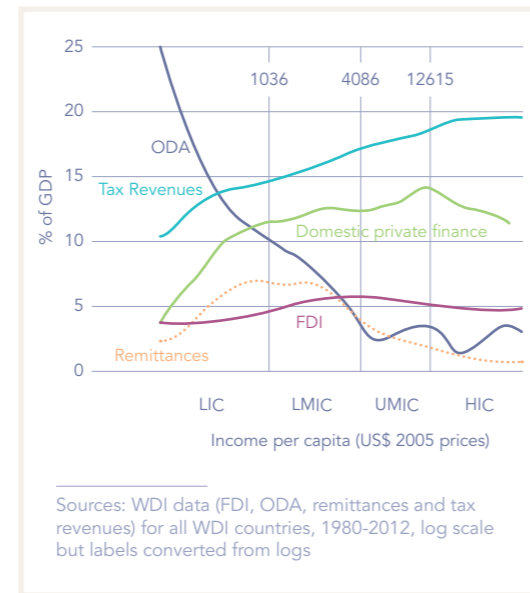


Figure 1 | Trends in finance (\$ bn, 2011 prices)



The data shows that **domestic public resources have grown rapidly and are the largest source of finance for all country income groupings.** International public finance has also increased but is declining in relative importance. Domestic private finance has shown the fastest growth, but is still much lower (as a percentage of GDP) in LICs than in lower middle-income countries (LMICs) and upper middle-income countries (UMICs), with rapid transformations continuing. International private finance has been highly volatile compared to the other flows. Innovative finance is promising but is yet to take off on a large scale. These trends set the context and also present a number of key challenges that need to be addressed in the post-2015 development agenda and FPF. For example, it is clear that there is both a need to think more about public resources 'beyond aid' and also to consider new approaches to ODA.

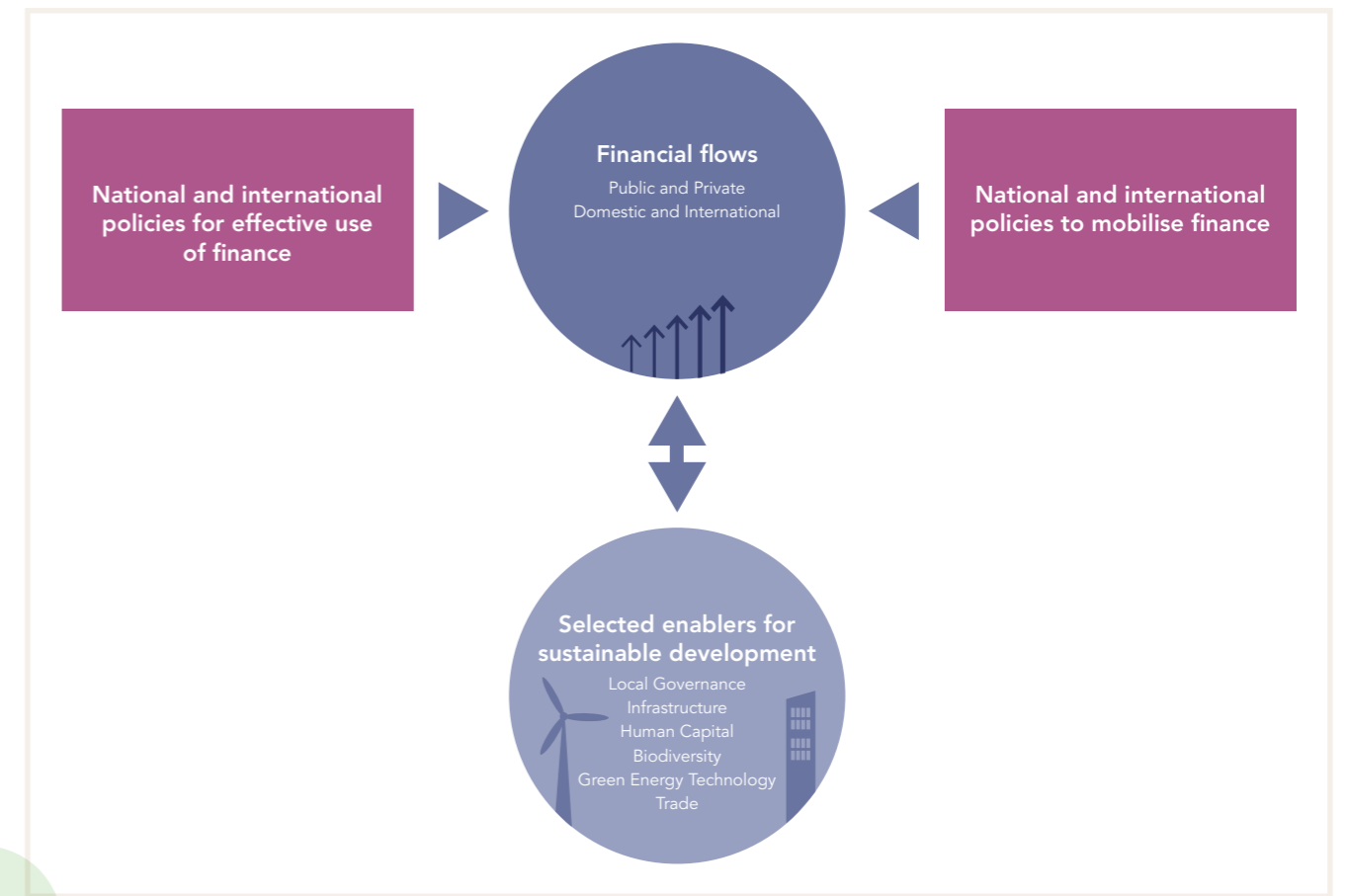
Figure 2 | Financial flows (% GDP) by income level



The composition of finance evolves at different levels of income

Figure 2 shows that as countries move towards higher incomes, they tend to experience: (a) declining ratios of aid-to-Gross Domestic Product (GDP); (b) increasing tax-to-GDP ratios (stabilising when countries approach LMIC levels), and within this, increasing shares of tax from incomes and profits and notably goods and services, but declining shares of international trade tax revenues; and (c) increasing private investment-to-GDP ratios.

Figure 3 | Integrated conceptual framework for finance and policies in enabling a transformative post-2015 development agenda



2 Consider policy and finance together

The Report's framework for assessing the role of finance and policies together

Figure 3 sets out the **integrated conceptual framework that is central to this Report.** It describes the role of financial flows (public and private, domestic and international) in promoting sustainable development. It illustrates how finance flows that are mobilised with the help of policies can promote the enablers. One of the key

messages is that the role of finance in promoting sustainable development needs to be seen in the policy context. This framework is intended to promote the joint discussion of policies and finance (through the illustrative examples of sustainable development enablers, whose selection is explained above).

Policies are crucial for the mobilisation and effective use of finance

The Report demonstrates that **policies matter in financing for development**. Although there is considerable finance available for development at the global level, it does not follow that it is used appropriately. FDI does not reach the most vulnerable and poorer segments of society; tax-to-GDP ratios have changed very little in many LICs; SMEs and infrastructure are starved of capital; and much international public finance does not go to the poorest countries. Indeed, there is a need to overcome a number of market, governance and coordination problems in order to mobilise and channel financial resources to their most effective use. However, appropriate actions can effectively overcome these challenges by addressing market, coordination and governance failures.

The Report identifies a range of **specific policies that help to mobilise finance**. For instance, regulatory reforms (e.g. clear property rights, land titles or cutting bureaucratic red tape for licensing) help to mobilise private-sector resources as well as investment in infrastructure, human capital, trade or technology. The CIs show that **some countries have successfully mobilised more tax revenues (as a percentage of GDP)** by building administrations that limit rent-seeking and curtail the use of tax exemptions, enhancing compliance, renegotiating contracts with major foreign companies, computerising the customs-clearing process, and adopting a broad-based value-added tax (VAT) with a reasonable threshold. In such ways, countries can use policy frameworks to raise domestic finance and address otherwise low and stagnant tax-to-GDP ratios. Low levels of domestic public finance are neither predetermined nor insurmountable and are to a large extent a question of public policy. **Countries can also use policy to attract FDI and use it for development objectives**. The CIs show that when countries adopt better macro-financial policies, the volatility in foreign investment flows is markedly reduced, and that very small regulatory changes can make the difference in attracting foreign investment.

Figure 4 distinguishes between policies for mobilisation and policies for effective use of finance. We summarise the broad **principles for mobilisation of finance**, as follows:

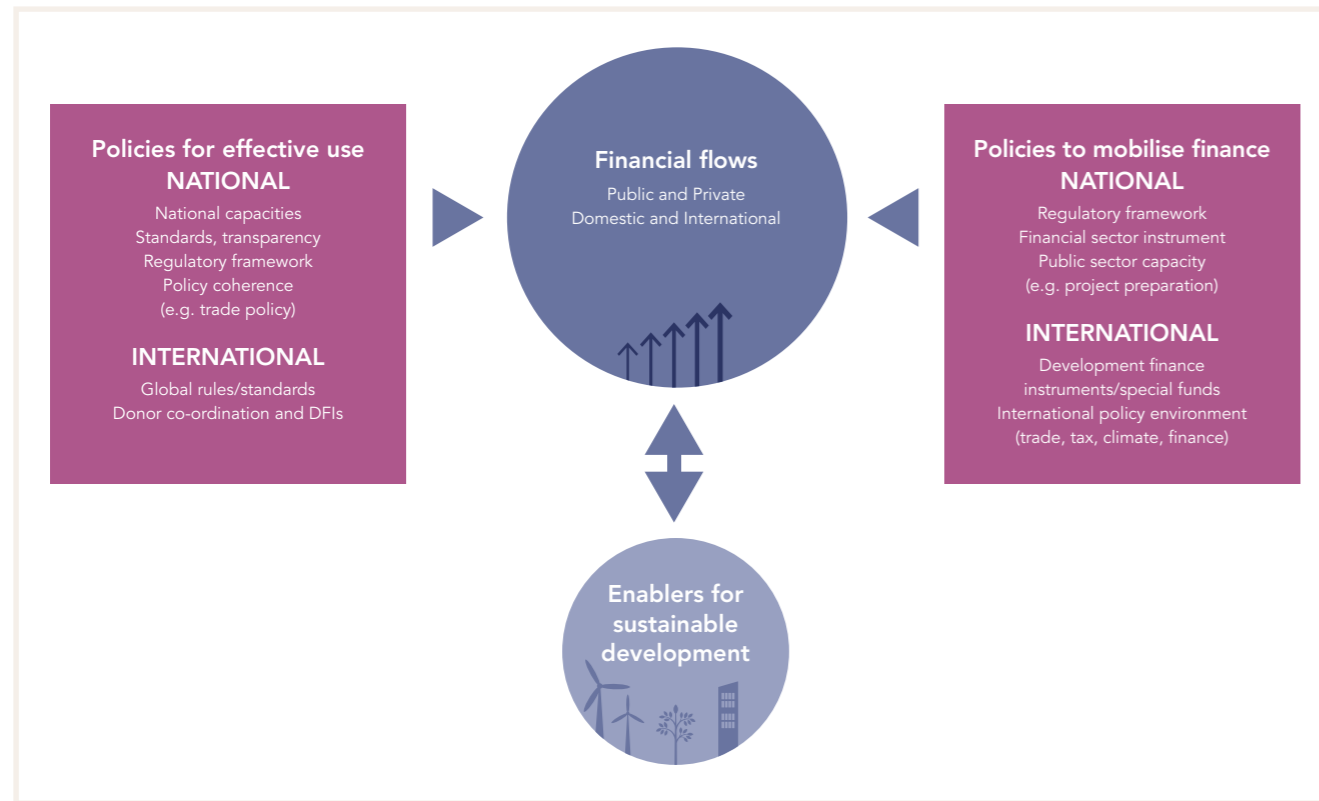
- 1 Finance can promote enablers (for example, **local governance, human capital, infrastructure, green energy technology and trade**), which in turn can also attract more public and private finance. This creates a virtuous circle between the enablers and finance: examples include mobile phone technology for mobile banking services, and human capital for FDI.
- 2 An **appropriate regulatory framework is of critical importance in order to attract private finance**. For example, clear property rights or land titles help to mobilise private domestic finance by providing collateral, and an improved and more transparent and efficient investment climate can unleash more finance. Enhanced competition in transport services and benchmarks in contract provision promote finance for and investment in infrastructure. Rules that create incentives for institutional investors to finance infrastructure in developing countries or green technology, rather than in liquid assets, help to channel international private finance to sustainable development purposes.
- 3 Development of **financial-sector instruments** and the capacity to apply them can mobilise private resources. Blending instruments or public-sector guarantees, for instance, can enhance credit availability, which in turn leverages more private-sector finance.
- 4 **A conducive international policy environment** can be critical in setting the right conditions, e.g. transparent global financial rules and standards for global finance, appropriate trade policies for investment in agriculture in developing countries (abolishing harmful trade distortionary subsidies), tax regulations for tax havens, or appropriate climate-mitigation deals to set a carbon price that will mobilise climate finance.

The Report also identifies five general **principles for the effective use of finance**:

- 1 The ability to implement, manage or facilitate finance effectively requires the presence of **sufficient national and local public capacities**. In domestic public finance, this relates to identifying and implementing sound investment projects (including those with co-benefits across the economic, social and environmental dimensions of sustainable development) and for ensuring that there are good social systems (e.g. health and education) supported by significant expenditure on them.
- 2 The **design and implementation of public and private standards** facilitates the effective use of finance. While standards need to be defined nationally, global coordination and benchmarking can help. Standards can relate to public procurement, accountability in public revenues from natural resources, public financial management, PPP contracts and standards for green technologies or resilience to climate change. Global standards can help in raising standards at the country level.
- 3 An appropriate and **clear regulatory framework** allows competition and provides better incentives for the diffusion of technology in addition to directed finance. Financial and prudential regulation is required to avoid financial crises at the global level, and especially in developed countries. There is also a need for better regulatory frameworks and supervision of banks, more innovation and competition in the banking sector and better regulation of the non-banking sector – such as corporate bonds, stock markets and pension funds – in order to improve the terms on which finance is made available.
- 4 Improving **transparency, information and accountability** contributes to the effective use of finance. For instance, a lack of transparency regarding government taxes paid by investors hampers the quality of public investment. Transparency concerning the large-scale acquisition of land by foreign interests could improve the governance of natural capital.
- 5 Finally, **policy coherence** towards specific development objectives is vital to the effective use of finance. It is important to ensure that policies in different sectors do not undermine policies to promote sustainable development and to take an integrated approach. Lack of policy coherence will lead to wasted finance. Investing in ‘white-elephant’ projects or inefficient productive capacities behind closed borders will not promote transformation in the long run. Financing the development of technologies without building the human capital required to employ them will be a half measure. Providing more capital to development finance institutions (DFIs) or raising credit without the prospect of projects in which to invest can lead to excessive ‘financialisation’ and indebtedness. Improving access to credit without improving the terms on which it is available can still be prohibitive for firms. Policy coherence also applies at the global level, e.g. through the global rules on trade, finance, climate, migration and technology.



Figure 4 | Summary of policies for mobilisation and effective use of finance



Finance cannot be treated independently from policy

Policy is crucial alongside finance to implement a transformative post-2015 development agenda. Poor or adverse policy can stop the potential of finance, but **appropriate policy can:**

- ▶ **Generate, attract and steer finance** - the design of clear policy frameworks for transformation helped Mauritius to attract and steer both public and private finance (CI Mauritius).
- ▶ **Unleash more public and private finance** - reductions in tax exemptions helped to raise public finance in Tanzania, but weaknesses in the energy regulatory framework limited investment from private finance for renewable energy (CI Tanzania).

- ▶ **Increase the stability of international private finance** - an ERD modelling study (Fic, 2015) shows that global banking (Basel III) rules lead to benefits for sub-Saharan Africa (SSA) that are ten times greater than the costs.
- ▶ **Pull finance from less productive to more productive uses** - better tax policies such as reducing bad transfer pricing or tax-avoidance practices can lead to large benefits. The ERD modelling study (Fic, 2015) suggests this could release \$ 3.5 bn in Africa; similarly a relaxation of restrictions on sovereign wealth fund (SWF) investment can lead to more finance for infrastructure in developing countries.
- ▶ **Lead to more results with the same amount of finance** – for example, measures that boost

the productivity of infrastructure by scaling up good practice and making better use of existing infrastructure could help countries to improve infrastructure productivity by 60%, estimated to be worth annual savings of \$1 tr. As another example, better competition policies improve the terms under which banking finance is available. It is estimated that private investors across Africa face additional costs of around \$15 bn (2% of credit extended) compared to the average interest rate spread, simply to obtain finance. More competition and innovation aimed at lowering the interest rate spread in SSA to the average of LICs and MICs would increase the availability of finance by more than 1.2% of GDP and increase investment by 6%.

- ▶ **Reduce the need for finance** - the finance gap for renewable energy is estimated to be between \$400 bn and \$900 bn. This is similar to the current level of fossil-fuel subsidies (more than \$500 bn in 2010), which means that reducing such subsidies could free up finance for other purposes. Lower subsidies are also likely to reduce the need for additional green investment since there would be fewer incentives to use fossil fuels. As a further example, Duty-Free Quota-Free (DFQF) access to the markets of the G20 countries (beyond the European Union, which already provides such access) could increase LDCs' national incomes on average by 0.5% of GDP (World Bank, 2013). This is similar to the \$30–40 bn provided in Aid for Trade (Aft) each year.

3 Focus finance on the enablers of sustainable development

Six selected enablers for sustainable development

The Report argues that action to achieve sustainable development should focus on

the drivers or enablers of change. Sustainable development cannot be achieved without improving and financing **six key areas:**

Local Governance. Governance generally is the most fundamental enabler of development, and we focus on local governance because of its importance in the provision of many critical functions and because few other reports focus on the financing aspects at this level.



Infrastructure, which econometric studies show is important for all dimensions of sustainable development, a conclusion supported by an ERD commissioned study modelling infrastructure scenarios, and by the CIs.



Human capital, whose importance in development is supported by a range of empirical studies, also has a direct link with the eradication of poverty.



Biodiversity is important for all dimensions and most directly for environmental progress. The Report yields new insights with respect to financing because biodiversity is often referred to as a public good.



Green Energy technology and its dissemination lie at the heart of a move from a high-carbon to a low-carbon economy.



Trade, whose importance as an enabler comes out very strongly from the CIs and yields differential insights, especially with respect to the role of private-sector finance.



The Report's focus on enablers contrasts starkly with outdated views that ODA or finance alone can directly achieve sustainable development outcomes.

Figure 5 | Selected enablers for sustainable development



The finance mix varies by enabler

The composition of finance differs markedly by enabler. Finance for institutions and governance seems to be largely public, mainly provided through tax revenues, and international public finance can play a part, particularly in LICs, as shown in the ERD commissioned CIs.

Patterns of finance for human capital vary across education, health and social protection, although all depend heavily on domestic public finance. In the education sector, finance varies by level of education although most comes from public sources, including ODA, for primary and secondary schooling. Private spending by richer households and migrants' remittances is also important. Formal training, such as Technical Education and Vocational Training (TVET) schemes, is financed mainly from private sources, although this approach can be regressive. There is also evidence of public-private partnerships (PPPs) (as in Malaysia) or tax levies for training being allocated and used according to private-sector interests (as

in Mauritius). Funding for health systems comes mainly from public sources, although private out-of-pocket (OOP) expenses can also be critical. While the reliance on OOP expenses tends to make it harder for poorer people to obtain access to health care, this could also create opportunities for private-sector insurance and micro-insurance schemes to complement public funding. Well-designed, publicly funded social-protection systems are essential to safeguard investment in human capital, especially in times of turbulence.

Finance for infrastructure and green technology tends to come from a mixture of public and private sources, although national government expenditure is the principal source for infrastructure. There is a clear progression in the use of private finance, including bond financing, as country income levels rise. Due to the large upfront requirements, large infrastructure or renewable energy projects usually depend on the blending of private finance, ODA grants, technical assistance and OOF. Such blending has increased since the 2007–2008 global financial

crisis in the context of the rising presence of development finance institutions (DFIs) and multilateral development banks (MDBs). Public funding has been used primarily to alleviate risks and attract private investment. MDBs from emerging economies also increasingly use blended instruments. Although significant ODA-backed concessional and non-concessional loans are common in LICs, public grants remain the main source of finance. While private expenditure on research and development (R&D) for green technology is rare in LICs, there is often private investment in renewable energy (generally supported by some form of public finance).

Trade finance is largely provided by private banks through the extension of Commercial Letters of Credit, although this is changing rapidly in the wake of the global financial crisis. In Bangladesh, for instance, exporters of ready-made garments, especially SMEs, are starting to bypass the banking system by developing and negotiating trade directly on 'Open Account' terms with their trading counterparts (Bangladesh CI), and DFIs and MDBs are creating Special Purpose Vehicles to support private-sector development by pooling private and public funds. LICs continue to have very limited access to trade finance and rely on AfT finance to build trade-related capacity.

DFIs are playing an increasing role in leading transformations in key areas such as infrastructure, green energy and trade, by leveraging private finance, supporting the selection of appropriate projects and policies, and providing technical assistance, credit and risk-mitigation instruments and blended finance.

4 Steps towards a Global Partnership to implement a transformative development vision

The UN Secretary-General's Synthesis Report (2014) discusses establishing a new Global Partnership for the post-2015 development agenda at the Third International Conference on Financing for Development (para. 24 ff) in July 2015. This renewed Global Partnership would establish a common foundation and contribute to new ways of thinking about collective action in much the same manner as previous non-binding agreements have done. The Conference outcome could therefore provide a set of common principles on the nature and value of different types and combinations of finance and policy, and how these are best used to enhance the enablers of transformation. There are four steps to consider.

Financing for development as an on-going process

A finance and policy framework under such a Global Partnership would steer global collective action up to 2030 by stimulating domestic and international efforts by all countries, commensurate with their capacities. Moreover, as our analysis shows, private sources of finance that lie beyond the direct control of national governments are gaining in importance, especially at higher levels of country income level. It is important to seek a formula that encourages their engagement and participation in the financing and implementation of the post-2015 development agenda.

Keeping core principles in mind

The post-2015 development agenda is expected to be 'universally applicable' while 'taking into account different national realities, capacities and levels of development', building on the two principles of universality and differentiation (UN Secretary-General Synthesis Report, 2014). Both principles would make the new framework very different from the MDGs and would help to move the debate away from the donor-recipient model, which most stakeholders seek to put behind them.

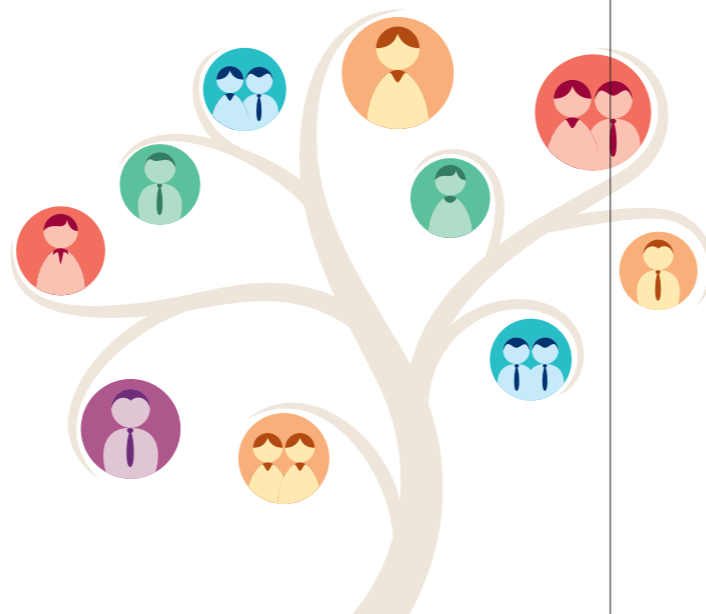
► **Universality** - implies that the new framework will apply to all countries and governments and not only to developing countries. On this basis, each government will be expected to pursue the agreed goals in a manner that is appropriate for their country, and to contribute resources (finance and other means of implementation (MOI)) to the global effort commensurate with their means.

► **Differentiation** - this concept is an important complement to the notion of universality (UN, 2014, para. 84) in that it clarifies that while the new framework should apply to all countries, given the differences in capacities and needs, not all can or should be expected to contribute to its achievement in the same way. This implies firstly, that, although contributions may differ, each is important. All contributions are valued. Secondly that these responsibilities do not apply only to governments, but call for all stakeholders to contribute according to their capacity.

A useful and relatively simple way to distinguish between roles and responsibilities with respect to finance and policies for development is to look at three main groups of countries by income levels: (a) LDCs/LICs and fragile states; (b) MICs; and (c) HICs or developed countries. It also needs to be recognised that small and vulnerable economies face special challenges, which implies that they cannot be easily categorised as LICs or MICs (e.g. some small MICs have very large debts). The broad distinctions between what each of these groupings would be able to do in terms of mobilising and making effective use of finance are identified in Box 1 but further differentiation is possible.

Involving multiple actors

The Global Partnership that is expected to be part of the universal post-2015 development agenda implies that all governments should make an explicit commitment to it. Relevant actors, each with a distinct role and responsibility, include national governments and their various departments, country income groupings, autonomous state bodies (e.g. export credit or export promotion agencies), and non-state actors such as business organisations or associations, financial and non-financial firms, and other national stakeholders such as academic institutions, think tanks, CSOs and labour unions. Multilateral institutions such as the World Bank, the International Monetary Fund (IMF), Regional Development Banks (RDBs) and other DFIs are also key stakeholders.



Box 1 | Illustrative stylised roles and responsibilities of country income groupings

For LICs/LDCs, fragile and small and vulnerable states:

- **Mobilisation** requires an essential, often tough, domestic effort to improve the regulatory environment and administrative capacities, to build up the tax revenue system, combat tax evasion and to start to mobilise private capital flows, including remittances. Ensuring effective regulation and supervision of the financial markets encourages private capital. Well-managed domestic public finance will tend to attract international public finance (including ODA and SSC) to fill development finance gaps. These may also have a catalytic role in helping to reform the domestic revenue system.
- **Effective use** involves focusing domestic budget allocations on transformative priorities and associated enablers, as well as channelling international public resources to invest in human capital, capacity-building and strengthening institutions, and creating specialised facilities or funds to direct public and private resources to specific enablers, most notably infrastructure and networks.

For MICs:

- **Mobilisation** at this level entails greater emphasis on DRM as the major source of FFD. Strengthening the tax effort and extending the tax base are important priorities. MICs can be expected to have a well-developed domestic private finance sector and should also be able to attract higher levels of international private finance (although small and vulnerable MICs face challenges in this area that are similar to those facing LICs). Small amounts of ODA may still be used in a catalytic fashion to stimulate other finance (including tax revenues). Development of stock exchanges and bond markets can mobilise additional private resources, as can PPPs, which might save resources over a project's lifetime. At the same time, as countries move to MIC status they also move into the league of potential SSC providers contributing external financing (international public and private finance) or concessional lending to other countries and to global public goods (GPGs). This effort needs to be acknowledged and encouraged. The UN Secretary-General Synthesis Report (2014) suggests that 'more countries will need to commit to increasing their contribution to international public finance, and set targets and timelines to do so' (para. 111).
- **Effective use** involves, among other things, allocating the domestic budget to transformative priorities and associated enablers, encouraging private investment to support public investment in key enablers such as infrastructure, reducing ODA to a minimum and using it mainly to pursue social or environmental goals and/or enhance leverage of other resources. At the national level, policy coherence for sustainable development (PCSD) and a serious commitment to establish and maintain a supportive international policy framework need to be major policy priorities. MICs can also be expected to play a growing role in global governance in helping to establish such a policy environment and through their willingness to accept and adhere to global standards, as is increasingly the case for the G20 and the UN.

For HICs/developed countries

- **Mobilisation** involves sufficient DRM to finance national efforts towards achieving the goals as well as providing the basis for sizeable ODA contributions and major concessional lending to the countries most in need. Given their developed domestic private finance markets, HICs should be able to attract large volumes of international private finance, although it is important to prevent illicit transfers, which among other things may undermine poorer countries' ability to mobilise finance.
- **Effective use** involves in particular ensuring that resources intended to achieve domestic and international goals are allocated most effectively and making serious efforts to adjust other internal and external policies to ensure greater policy coherence to support development objectives. In their role as major contributors to establishing a conducive international policy framework, they need to ensure by means of proper incentives, rules, regulations and oversight that GPGs – including an open trade regime, environmental sustainability, and financial stability etc. – are provided in a consistent and inclusive manner. Further, domestic policies in areas such as climate resilience and economic development also have important spill overs on other countries.

Introduce a monitoring and accountability framework

Part of the success of the MDGs was that they allowed for specific monitoring and follow-up. Yet in terms of the finance and policy provisions of the Monterrey Consensus it was really only international public finance that was assigned a target that could be monitored. A major challenge for a new finance and policy framework is to establish targets and other measures that can incentivise finance as well as other aspects of financing and implementation in the years ahead. This is not an easy task but it is vital in order to make genuine progress. Equally, it is important in terms of promoting transparency and the full participation of all those whose support will be required to make the framework a reality. A strong effort in this direction is ultimately what will give substance to the term 'global partnership'. Data will be crucial in order to achieve the necessary monitoring and ensure transparency. The main report provides an illustrative example table on what such a finance and policy framework might look like.



Conclusion

Three main findings inform a new finance and policy framework for development

1

The **pattern of finance for development evolves at different levels of income**. A key government objective should be to move the financing pattern to the next level and, as the volume of each form of finance changes, to ensure it is put to best use. This has implications for the mobilisation and use of all types of flow, including, for example, ensuring a more **transformative role for international public finance in the evolving pattern of finance**.

2

Policy matters. Finance is not enough on its own and it is essential to adopt appropriate and coherent domestic and international policies for its effective mobilisation and use:

- ▶ **Domestic policy and financial frameworks** that promote mobilising domestic resources and facilitating their effective use for sustainable development. This includes an effective regulatory framework to govern private sources and adequate capacity to raise public revenues, and applies to developing and developed countries.
- ▶ **A conducive global system** and policy environment that supports the mobilisation of finance and includes supportive agreements on climate change, an improved global trade regime, better global tax rules and the management of the global financial system

3

Accountability and participation. Given the new financing context, and within it the importance of using several different types of finance in synergy (domestic, international, public, private), it is essential to create a framework for on-going dialogue between the various stakeholders involved in each type of finance during the implementation of the post-2015 agenda. Participation in such a dialogue will allow stakeholders to monitor progress, hold each other accountable, jointly manage the evolving pattern of finance and make adjustments as required. The dialogue will need to be informed by real time data from appropriate monitoring and evaluation (M&E) systems, including on finance flows and on complementary policies.



CHAPTER 1.

Introduction

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The vision of global development is at a critical juncture, and the need to move beyond 'business as usual' is stronger than ever. Acting through the United Nations (UN), representatives of the world's nations will come together in September 2015 to agree on a new post-2015 development agenda. This ambitious and universal agenda will reinforce the international community's commitment to poverty eradication and sustainable development, and will seek to integrate in a coherent and balanced manner the social, economic and environmental dimensions of sustainable development (UN, 2013).

In the words of UN Secretary-General Ban Ki-moon, the post-2015 development agenda 'offers a unique opportunity for global leaders and people to end poverty, transform the world to better meet human needs, and the necessities of economic transformation, while protecting our environment, ensuring peace and realizing human rights'. It will thus mark a transformative 'paradigm shift for people and planet' (UN Secretary-General Synthesis Report, 2014).

The post-2015 development agenda is set to include four main components: Declaration; Sustainable Development Goals (SDGs) and targets;¹ Means of Implementation (MOI) and Global Partnership²; and Follow-up and Review.

A key milestone in agreeing a compact for the Global Partnership will be the Third Conference on Financing for Development (FFD) to be held in Addis Ababa, 13–16 July 2015. It will build on the holistic conceptual framework of the 2008 Doha Declaration and the 2002 Monterrey Consensus, and address the comprehensive range of Means of Implementation required to achieve the post-2015 development agenda, including an enabling policy environment and financial resources. Its outcome will make an important contribution to and support the implementation of the agenda.

The post-2015 development agenda is expected to be global in nature and universally applicable. This is fundamental, as universality will require universal commitment and actions, while taking into account different national realities, capacities and levels of development. Universality also implies that achieving the agenda will be a shared responsibility (UN Secretary-General Synthesis Report, 2014). Indeed, the ambitious scope of the post-2015 development agenda will pose unprecedented challenges at both the national and international level. It will require thus require 'a stronger, more accountable and inclusive Global Partnership to mobilise action by all countries and stakeholders at all levels' (European Council, 2014).

As part of this Global Partnership, it will be crucial to address all means of implementation (MOI), including the mobilisation of financial resources from diverse sources – domestic and international, public and private – and ensuring their effective use. But finance alone is not the solution: to achieve the post-2015 development agenda, the Global Partnership will need to address finance and policies together – we refer to this as a 'Finance and Policy Framework for Development' (FPFD). Although MOI is variously defined, it is widely acknowledged to include but also to go beyond financial resources³. The Technical Support Team to the Open-Working Group on the SDGs (2013: 1) describes MOI as 'the interdependent mix of financial resources, technology development and transfer, capacity-building, inclusive and equitable globalization and trade, regional integration, as well as the creation of a national enabling environment required to implement the new sustainable development agenda, particularly in developing countries'. The UN Secretary-General's Synthesis Report (2014) includes under MOI 'Financing our future', 'Technology, Science and Innovation' and 'Investing in capacities for sustainable development' – focusing on finance, technology and innovation and capacity building.

This Report addresses 'combining **finance and policies to implement a transformative post-2015 development agenda**'. While these involve major challenges, the experience of pursuing the Millennium Development Goals (MDGs) has provided lessons in terms of countries' successes and failures in using finance and policies to contribute to eradicating poverty and achieving sustainable development. This Report draws out some of the lessons that could help to inform a new FPDF that includes the role of policies and finance in supporting the long-term drivers

(or enablers) of sustainable development. It also draws on commissioned papers (Country Illustrations, Background Papers and Modelling Studies) to provide further evidence.

This introductory chapter outlines key processes in the post-2015 policy context (Section 1.1), the policy challenges this Report addresses (Section 1.2) and what it aims to contribute (Section 1.3). It then presents the evidence used to inform the report (Section 1.4) and the broad structure of the Report (Section 1.5).

1.1 The post-2015 policy context

The post-2015 development agenda stems from two major and converging processes: the follow-up to the 2010 Millennium Summit, which mandated the UN Secretary-General to initiate a post-MDGs process, and the follow-up to the 2012 United Nations Conference on Sustainable Development ('Rio+20'), which launched the process to develop the SDGs. At the MDGs Special Event in September 2013, the UN General Assembly agreed to bring these together 'in a single framework and set of goals', addressing both poverty eradication and the three dimensions of sustainable development.

In parallel with but closely interlinked with this process, two strands on financing for development (FFD) have also converged: the follow-up to the 2002 Monterrey Conference on Financing for Development and the follow-up to Rio+20, which gave the mandate to prepare options for a sustainable development strategy, as set out in the report of the Intergovernmental Committee of Experts on Sustainable Development Financing (ICESDF). The Third International Conference on Financing for Development scheduled for July 2015, is expected to discuss 'an ambitious agreement on policies, financing, technology transfer, capacity-

building and systemic issues' (Financing for Development Co-facilitators' elements paper, 2015) to underpin the post-2015 development agenda.

The debate on the post-2015 development agenda has been informed by a series of reports making recommendations that should apply to all countries. These include the United Nations High-Level Panel report (HLP, 2013), the United Nations Sustainable Development Solutions Network report (UN SDSN, 2013), the United Nations Global Compact (2013) reports and the report of the UN Secretary-General (2014), *A Life of Dignity for All*. These reports share a broad vision of the post-2015 development agenda (see also Khatun, 2013).

'The Rio+20 outcome document, *The future we want*, inter alia, set out a mandate to establish an Open Working Group to develop a set of SDGs for consideration and appropriate action by the General Assembly at its 68th session' (OWG, 2014b). In response, the OWG proposed 17 SDGs, each with associated targets (see Box 1.1).

¹ In accordance with UNGA resolution 68/309 'the proposal of the Open Working Group shall be the main basis for integrating sustainable development goals into the post-2015 development agenda, while recognizing that other inputs will also be considered'.

² In accordance with UNGA resolution 69/108 the report of the Intergovernmental Committee of Experts on Sustainable Development Financing (ICESDF), the outcome of the Open Working Group (OWG) and the Synthesis Report of the UN Secretary-General will 'serve as important inputs for the preparations' of the Third FFD Conference.

³ In the literature MOI covers both financial and non-financial factors. For example, the OWG (2014b) outlines considerations under the Global Partnership and MOI (Goal 17): finance, technology, capacity building, trade and systemic issues (policy and institutional coherence, multi-stakeholder partnerships and data, monitoring, and accountability).



Box 1.1 | SDGs proposed by the OWG

- 1 End poverty in all its forms everywhere
- 2 End hunger, achieve food security and improved nutrition, and promote sustainable agriculture
- 3 Ensure healthy lives and promote well-being for all at all ages
- 4 Ensure inclusive and equitable quality education and promote life-long learning opportunities for all
- 5 Achieve gender equality and empower all women and girls
- 6 Ensure availability and sustainable management of water and sanitation for all
- 7 Ensure access to affordable, reliable, sustainable, and modern energy for all
- 8 Promote sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all
- 9 Build resilient infrastructure, promote inclusive and sustainable industrialisation and foster innovation
- 10 Reduce inequality within and among countries
- 11 Make cities and human settlements inclusive, safe, resilient and sustainable
- 12 Ensure sustainable consumption and production patterns
- 13 Take urgent action to combat climate change and its impacts
- 14 Conserve and sustainably use the oceans, seas and marine resources for sustainable development
- 15 Protect, restore and promote sustainable use of terrestrial ecosystems, sustainably manage forests, combat desertification, and halt and reverse land degradation and halt biodiversity loss
- 16 Promote peaceful and inclusive societies for sustainable development, provide access to justice for all and build effective, accountable and inclusive institutions at all levels
- 17 Strengthen the means of implementation and revitalize the global partnership for sustainable development

In September 2014, the UN General Assembly 'decided that the proposal of the Open Working Group on Sustainable Development Goals contained in the report shall be the main basis for integrating sustainable development goals into the post-2015 development agenda, while recognising that other inputs will also be considered' (UN General Assembly, 2014). The OWG report builds on the unfinished business of

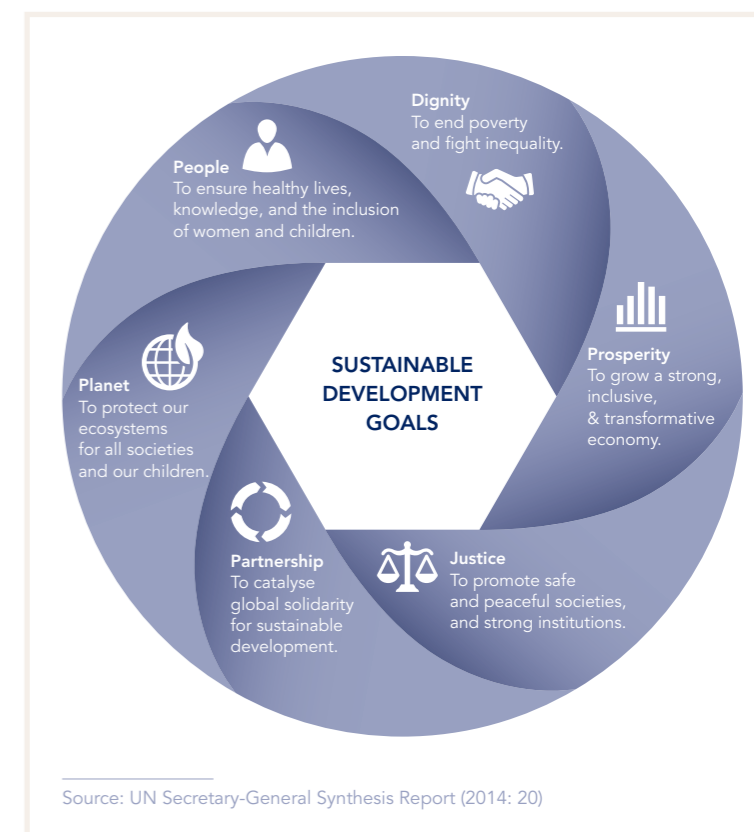
the MDGs but also goes much further, integrating the three dimensions of sustainable development across the agenda and breaking new ground with goals on inequalities, inclusive and sustainable economic growth, industrialisation, sustainable consumption and production, energy, climate change, peace, justice and institutions. The SDGs are also underpinned by the proposed Goal 17 on MOIs and Global Partnership.

The UN Secretary-General's Synthesis Report 'The Road to Dignity by 2030' (2014) integrates the various post-2015 inputs and reaffirms the OWG's report as the 'main basis' for the SDGs. In an effort to 'frame the goals and targets in a way that reflects the ambition of a universal and transformative agenda', it puts forward six 'essential and interconnected elements' – dignity, people, prosperity, planet, justice and partnership – that could help to 'maintain the 17 goals and rearrange them in a focused and concise manner that enables the necessary global awareness and implementation at country level' (see Figure 1.1).

In contrast to the sequence followed for the MDGs – when the 2002 Monterrey Conference took place after the agenda-setting process – the 2015 Addis Ababa Conference will be held two months before the September UN Summit to agree the post-2015 development agenda. The conference outcome is thus set to make a major contribution to the overall post-2015 agenda and in particular to the component on MOI and Global Partnership.

Informed by the work of the ICESDF, discussions have also moved beyond the MDGs' focus on mobilising more official development assistance (ODA) to a broader concern to address implementation comprehensively, including (but not limited to) making more efficient use of different types of finance and the role of policies in this regard. Effective government policies and institutions constitute an essential cornerstone of financing strategies for sustainable development. It is not just about resources but also about how best to use them and to unlock additional resources. The ICESDF (2014) report includes domestic and international policy recommendations to create a national and global enabling environment for financing sustainable development. These recommendations address both the mobilisation of new finance and the effective use of existing FFD.

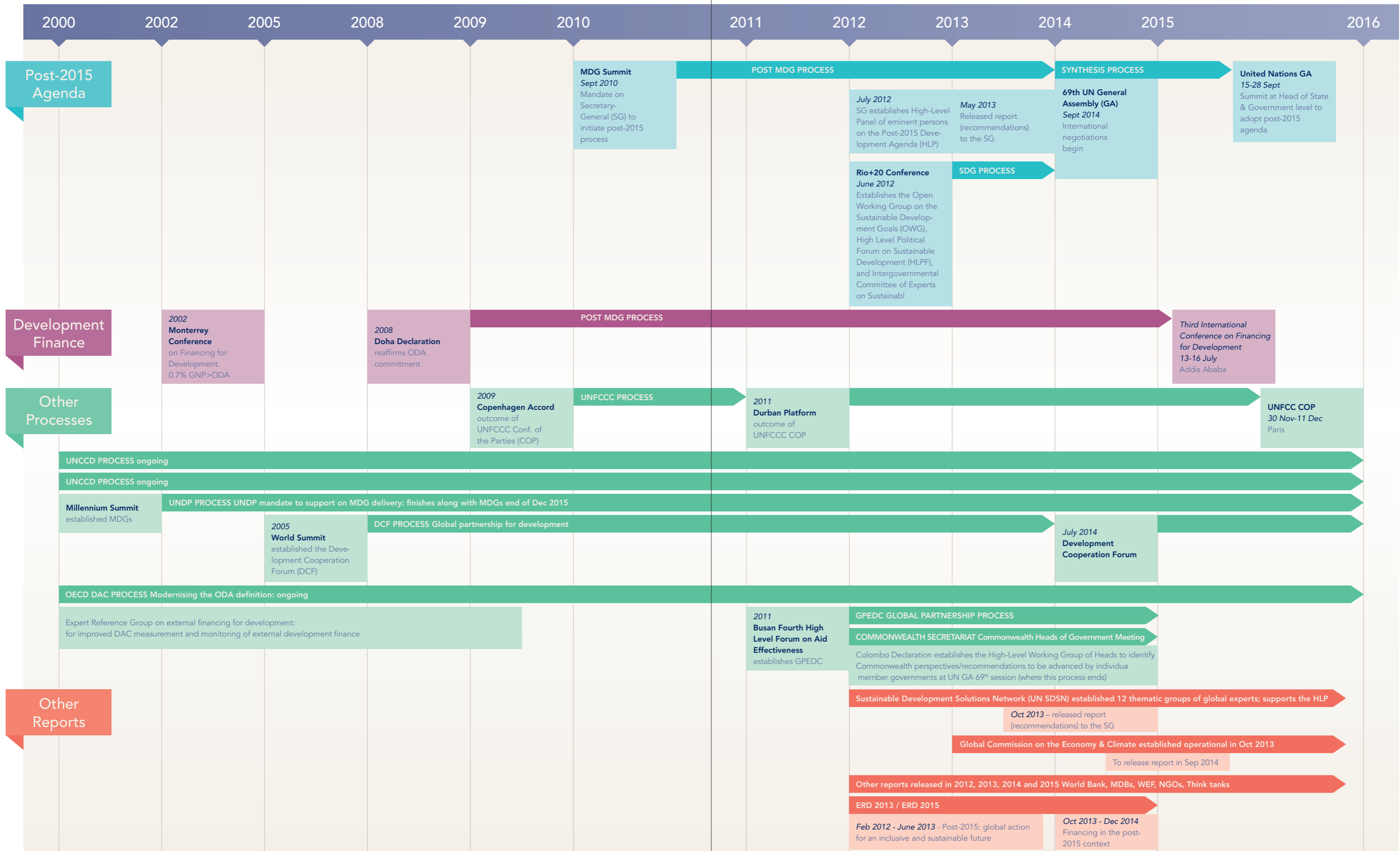
Figure 1.1 | Elements to underpin the SDGs



The UN Secretary-General's Synthesis Report (2014: 89) specifically welcomes these policy recommendations. It also stresses that the outcome of the July 2015 Addis Ababa Conference will help to set the stage for discussions on the United Nations Framework Convention on Climate Change (UNFCCC) due to take place in Paris in December 2015, which will seek to establish a new climate agreement to prevent and reduce dangerous global levels of anthropogenic emissions. The Synthesis Report further stresses the need for coherence and strengthened cross-linkages between the financing frameworks for sustainability and climate change.

Figure 1.2 shows timeline of the present Report in relation to post-2015 processes.

Figure 1.2 | Timeline of the present Report in relation to post-2015 processes





1.2 The policy challenges

The global policy processes for designing and implementing an ambitious and transformative post-2015 agenda are taking place in a context that differs significantly from when the MDGs were agreed. The balance of global economic and political power is shifting, with new state and non-state actors becoming more prominent and better able to support international development, whereas traditional donor countries (largely those belonging to the Organisation for Economic Co-operation and Development (OECD)) have experienced economic setbacks. The world is changing rapidly: forecasts of economic, demographic and environmental trends all point to the urgent need for coordinated and effective global collective action to tackle the economic, social and environmental aspects of development (ERD 2013).

In relation to finance, despite progress in a number of areas, neither the financial system nor the policy environment remain fully fit for purpose, and even less so in relation to meeting future needs. By way of illustration (and these challenges are discussed further in the Report and/or in the commissioned Background Papers):

- ▶ Developing and emerging economies have been driving global growth over the past decade, but the world economy remains vulnerable to financial shocks, with the risk of volatile and unpredictable trading conditions and financial flows.
- ▶ There has been modest progress in developing global trade and climate rules in recent years, but calls to strengthen global financial governance, including regulation of banks and governance of the Multilateral Financial Institutions (MFIs) mean that this issue is attracting greater attention at the global level.

The challenge is to promote a global financial system that encourages the mobilisation and effective use of global savings to support sustainable development.

- ▶ Private capital, which often appears to be in abundant supply – as suggested, for example, by the \$70 trillion (tr) (Kaminker and Steward, 2012) held by institutional investors worldwide – is highly selective in where it flows, what it funds and on what terms. It favours financial markets in developed countries, fast-growing emerging economies, the extractive sectors and the formal economy, including larger, established firms. It requires large lending margins, and often bypasses small and medium-sized enterprises (SMEs) in productive sectors, and people living in poverty, of which 2.5 billion do not use banking services. Achieving the SDGs will require the mobilisation of resources from private sources including foreign direct investment (FDI), bank loans, bond issuance, equity and other risk capital and private transfers. Leveraging more private resources will entail creating a supportive investment climate as well as exploring ways to use public funds in order to combine public and private finance through mechanisms such as blended loans or guarantees schemes.
- ▶ Concessional loans and grants are stagnating (although ODA reached a record high in 2013) and are also selective in where they flow. They do not systematically prioritise the poorest economies, can be unpredictable and are not always as effective as they might be. The challenge is how to make use of ODA in a more transformative way.
- ▶ While domestic tax revenues are growing in all country income groupings, systems of domestic revenue mobilisation (DRM) in developing countries are immature, leading to low or inefficient tax collection, high levels of tax evasion, and capital flight. The challenge is how to raise domestic tax revenues in a way that can best support sustainable development.

- ▶ Although the global community is placing the spotlight on international tax regimes, these remain poorly regulated, with too much scope for tax avoidance, tax evasion and transfer pricing, which permits the extensive use of tax havens. The challenge is to promote collective action on global tax rules.
- ▶ An increasing share of global trade takes place in Global Value Chains (GVCs) coordinated by transnational corporations (TNCs). This is beneficial for those who participate in GVCs, but may make it harder for small businesses from developing countries to integrate easily and expand trade.
- ▶ With some notable exceptions, poor policy, inappropriate regulatory frameworks, weak institutions and/or low absorptive capacities often restrict the ability of poor countries to attract and make effective use of development finance.

In the post-2015 context, therefore, mobilising additional financial resources to pursue specific development goals will not suffice. Such efforts need to be complemented with an improved regulatory and policy framework, both national and international, along with investments in absorptive capacity in order to make more effective use of FFD. Indeed, finance and policy are synergistic: better policy-making is needed to make the most effective use of finance but also to attract and channel new financial resources to where they are most needed.

In order to formulate actions to overcome such challenges, the main research question addressed in this Report is: **‘How can financial resources be effectively mobilised and channelled and how can they be combined with selected policies to enable a transformative post-2015 agenda?’** Further research questions are set out in Box 1.2 below.

Box 1.2 | Further research questions

- | | | |
|---|---|-------------|
| 1 | What does the current literature say about the gaps in finance for achieving specific development objectives, what are its underlying assumptions, and how do complementary policies affect projections and estimates? | Chapter 2 |
| 2 | What financial flows and instruments are available to different types or groups of developing countries to best tackle the domestic and international post-2015 development agenda, and what selected policies might support their efforts in this direction? | Chapter 3/4 |
| 3 | How have financial flows generated by or channelled to developing countries evolved and how is it anticipated that they will change in the future? What are their main differences (e.g. public or private, volatile or sustainable, short or long term, channelled via bilateral or multilateral institutions, grants, loans or guarantees, budget support or sector-specific)? And what are the advantages and disadvantages associated with the principal changes? How are financial flows expected to evolve? | Chapter 3 |
| 4 | How can different countries and partners (e.g. donors of ODA or providers of South–South Cooperation (SSC)) mobilise finance? | Chapter 4/6 |
| 5 | How can financial flows and instruments be effectively used to promote a transformative post-2015 development agenda? How can complementary policies make different financial flows more effective? | Chapter 4/6 |
| 6 | What are the options for the international community (at the global and national level) to adopt an enabling financial and policy environment for the post-2015 development goals? | Chapter 7 |
| 7 | What does this mean for the post-2015 FFD framework? And which institutions should do what? | Chapter 7 |



A principal aim of this Report is to determine under which circumstances policies have made an important impact on mobilising finance and using it more effectively – as well as cases where this has not been achieved – through the use of commissioned Country Illustrations (see Section 1.4) and lessons to be drawn from the global picture.

1.3 What the Report aims to contribute

Several academic studies and policy documents have discussed the role of finance in different dimensions of sustainable development (e.g. ERD commissioned Background Paper Cadot, et al., 2015; Hansen and Tarp, 2001; Galiani et al., 2014; Manning, 2009; Beck, 2013; IMF, 2012; UNCTAD, 2014; OECD DAC DCR, 2014; World Bank, 2013; ICESDF, 2014). Most policy reports (e.g. OECD DAC DCR, 2014; World Bank, 2013; ICESDF, 2014) examine these questions from the starting point of finance. By contrast, this Report starts from development objectives (focusing on the enablers of development) and then presents a framework on how finance and policies can contribute to achieving them. The Report focuses specifically on evidence on the links between finance and policies and aims to encourage joint discussions on them. This approach leads to three contributions to the literature: first, the Report considers a range of financial flows rather than focusing on ODA alone; second, it examines the role of selected enablers or long-term drivers of sustainable development; and third, it provides further evidence on the way in which finance and policy are interlinked in contributing to sustainable development via the enablers. We briefly discuss these in turn.

First, debates on the post-2015 context are moving away from projecting future financial needs or focusing exclusively on ODA to meet identified needs that characterised the implementation of the MDGs. While ODA can play a useful catalytic

role, it is important to consider all financial flows and to emphasise other types of FFD, including DRM, international and domestic private capital flows and SSC.

Second, the Report emphasises that action to achieve a transformative vision of sustainable development must focus on the enablers of change, and not merely on the intended outcomes. Enablers are defined as the key drivers that contribute to a transformative post-2015 development agenda. For example, the OWG (2014a) highlighted technology and infrastructure as ‘enablers’ of sustainable development. Developing infrastructure is an important foundation for achieving other goals. Similarly, the OECD lists access to technology and governance as important enablers for sustainable development (OECD 2014b, 2014c).

Third, there is to date insufficient evidence on the **link between finance and policy** in contributing to a transformative post-2015 development agenda. This Report suggests how these are linked to selected ‘enablers’ in different country contexts, particularly focused on findings from low-income and middle-income countries (LICs and MICs), and offers evidence on how best to promote a conducive global environment for poverty eradication and sustainable development. In presenting this evidence the Report aims to answer the main research question presented above.

1.4 Evidence used to inform the Report

Key evidence used in this Report centres on:

- ▶ The lessons from the MDGs with regard to FFD, including the importance of the policy context in relation to a range of financial flows.
- ▶ A review of financial flows to different country income groupings from 1990 and innovative

sources of FFD, emphasising the need to consider a range of flows, of which ODA is only one.

- ▶ A review of the role of domestic and international policy in mobilising and making more effective use of finance in six areas (i.e. local governance, infrastructure, human capital, biodiversity, green energy technology and trade).

We analyse the above issues in detail and present a unified framework within which to consider them, drawing on examples to illustrate how finance and policies work together to develop selected enablers of sustainable development.

We examine the definition, evolution and challenges in domestic and international, public and private financial flows for different country income groupings. We present a number of graphics, some based on standard techniques and others on more complex, quantitative displays.

We review the empirical evidence on the link between finance and policy, by type of flow and selected enablers. We distinguish between domestic and international policies to mobilise finance and policies to ensure its effective use. In practice, however, policies for the mobilisation and effective use of finance often overlap and both domestic and international policies can support the enablers.

The literature forms the basis for our selection of six crucial enablers across the three dimensions of sustainable development on which to focus: local governance, infrastructure, human capital, biodiversity, green energy technology and trade. We then present a framework in which different types of finance flows and policies contribute to these enablers.

A set of ERD commissioned papers form a crucial part of the evidence gathered for this Report: Country Illustrations (CIs), Background Papers and Modelling Studies.

Commissioned Country Illustrations

ERD Country Illustrations (CIs) were commissioned on Bangladesh (Khatun, 2015), Ecuador (Borja and Ordóñez, 2015), Indonesia (Damuri et al., 2015), Mauritius (Treebhohun and Jutliah, 2015), Moldova (Ghedrovici, 2015) and Tanzania (Lunogelo et al., 2015). These provide evidence on links between finance and policy for selected enablers of sustainable development, and how these affect social, economic and environmental dimensions in a transformative vision of sustainable development, and so provide illustrative examples of the main issues discussed in this Report.

The CIs provide country-level evidence on the types of finance and policies from 1990 to the present that have helped to achieve national development objectives. The evidence includes descriptive observations on finance and policies as well as on development achievements. The CIs are not intended to give a comprehensive overview of links between finance and policies for sustainable development, but rather to offer country-specific examples of finance and policies that have worked or failed in the chosen countries. These include LICs and MICs from the EU, Asia, Africa and Latin America. The countries were also selected for the insights they could provide into the economic, social and environmental dimensions of sustainable development, for instance where they have achieved particularly remarkable structural transformation or social development.

The CI synthesis (Bhattacharya, 2015) summarises the key findings on the role of different financial flows in the six countries. In general, their evolution follows an upward trajectory from international public finance to domestic public finance and domestic and international private finance. Bhattacharya (2015) discusses how tax revenues help to finance infrastructure, social development and green energy technology. Although ODA is declining in relative importance, contributing only a part of the finance flows in



the six countries, it can be particularly important in providing government budgetary support for small-scale and strategic projects. There is also a positive trend in domestic credit for the private sector across these countries, which is a good indicator of economic development. On the other hand, FDI inflows have declined and become more volatile following the 2007–2009 global financial crisis, and infrastructure gaps, low investment security and political instability are among the major deterrents of FDI flows to these countries. In general, Bangladesh, Ecuador, Indonesia, Moldova, Tanzania – and to some extent Mauritius – are characterised by a lack of financial innovation and underdeveloped financial markets, which can be attributed to low demand (e.g. for their industry and services sectors) and difficulties with monitoring and regulation.

Bhattacharya (2015) notes that for the LDCs and LMICs (Bangladesh, Indonesia, Moldova and Tanzania) there are opportunities to increase tax revenues, which is the most sustainable source of finance for critical infrastructure, climate-resilient and social development. Pursuing more public-private partnerships (PPPs) is a promising option for these countries in order to meet infrastructure needs that exceed government budgets. To differing degrees, ODA could continue to play a catalytic role in all six countries, since it is largely directed towards small and strategic projects pertaining to climate resilience, trade finance, health, education and infrastructure. Remittances from overseas migrant workers will continue to be important for Moldova and Bangladesh, and policies to promote this potential could include training programmes for aspiring migrant workers and re-integration programmes for those who return, as well as more available credit for both groups. Improving and supporting FDI is a priority for all six countries and the currently weak inflows indicate the need for improved infrastructure, accountability and transparency, as well as investment security and political stability. Finally, financial innovation and the development of financial institutions are critical, assuming that

these are tailored to local conditions. Despite these common financial trends and ways forward, each country pursues policies suited to its unique context in order to mobilise and make effective use of the different sources of FFD.

Commissioned Background Papers

ERD Background Papers were commissioned to provide further evidence on issues such as taxation and development, the roles of development finance, climate finance, the role of MDGs in LICs, SSC, and finance for agriculture. These inform Chapters 2–6, and each Background Paper is discussed below.

Brun and Chambas (2015) provide an overview of tax transition in developing countries, finding a sharp increase in government revenues between 1980 and 2012 – ‘by reducing the contribution of taxes that were causing the most important distortions (tariffs), tax reforms broadened the fiscal space and increased the optimal level of tax revenues’. They also explore the types of tax pursued in developing economies (including direct and indirect taxation), and comment that opportunities opened up by the post-2015 development agenda include the potential for tax law and building the capacity of tax administrations.

Büge et al. (2015) find that when international biodiversity programmes and instruments are carefully aligned with broader development objectives, synergies between biodiversity conservation and economic development can be achieved and trade-offs minimised. Efficient use of finance relies on a sound and coherent policy framework, with financing also required for creating and implementing appropriate supporting policies. Current biodiversity financing is aimed at about \$50 billion (bn) per year (of which less than half is spent in developing countries), but the finance needed to halt biodiversity loss is estimated to be six to eight times higher than this. Beyond financing, a better understanding of the cycle of biodiversity conservation financing can help in

addressing country- or region-specific bottlenecks and in designing adequate supporting policies.

Cadot et al. (2015) test whether ODA is targeted at sectors which are bottlenecks to productivity elsewhere in the economy. Controlling for various factors, they find evidence of weak targeting of ODA to such sectors, with effects dependent on the type of donor, mode of delivery and the income level of the recipient country. They conclude that focusing ODA on weak links in order to remove obstacles to productivity growth would not involve a radical rethinking of donor policies but would require stronger and more explicit targeting of spending.

FS-UNEP (2015) find that new investment in renewable energy has waned since 2011, since it has been negatively affected by policy uncertainty and retroactive reductions in public support. In 2013, almost 75% of total investment was in the country of origin, indicating a preference for familiar projects as they are perceived to be less risky. They conclude that domestic policy frameworks are important for unlocking greater climate finance flows. They further note the key role for the public sector in mitigating the risks associated with providing low-cost capital for investors and setting up national climate finance institutions.

Griffith-Jones et al. (2015) discuss the challenge of encouraging the financial sector to serve the real economy, by enhancing its role in intermediating savings for funding enterprises and households in a sustainable way. It discusses the role of strong and effective regulation in (i) raising the solvency and liquidity of banks, (ii) reducing the amount of financial activity of a more ‘speculative’ kind, such as many of the activities of unregulated ‘shadow banking’, and (iii) encouraging sustainable financing for the real economy. It argues that a greater involvement of the users of finance (e.g. non-financial corporations, consumers, trade unions) in designing such rules may be a useful way forward. This can be achieved by open and

transparent dialogue among financial institutions, regulators, policy-makers and other stakeholders on financing sustainable development.

Rahman et al. (2015) argue that LICs’ national policies and public expenditure, as well as ODA, have responded to the MDGs. This degree of response varies across countries and sectors. There is a growing tendency in LICs’ policy documents to deal with MDG-related areas and address these in a more comprehensive manner. In the key social sectors (such as education, health and social protection) public expenditure in LICs overall increased significantly as a share of GDP compared with the pre-MDG period. The absolute amount of ODA received doubled in the post-2000 period compared with the previous decade. A key constraint the authors found in preparing the paper is the need for more reliable data, which needs to be addressed as part of the post-2015 agenda.

Sarris (2015) finds that agricultural transformation entails considerable financial needs due to the demands to improve productivity, requiring capital upgrading and short-term financing for production inputs. The lack of financing could potentially be a constraint on agricultural development and poverty reduction. Government expenditure and other investments in agriculture are inadequate in most developing countries. The bulk of financial flows to the sector are private, while public flows are at very small levels and there are considerable fluctuations in ODA commitments. The paper recommends that most agricultural transformation and poverty reduction should be based on smallholder models of development, and explores five alternative growth pathways through different models of rural financing.

Uneze (2015) examines SSC, including ODA, trade, FDI and remittances. In many instances, most official assistance either goes to countries within the donors’ or providers’ region and is focused on economic infrastructure or is concentrated in resource-rich countries, as well



as being used to promote trade and investment among recipient countries. SSC has increased the financial investment in MDG-related sectors, although the impact of such flows remains low. SSC does, however, promote domestic ownership and the adoption of new technology and helps to reduce aid uncertainty. It will be important that SSC becomes more coordinated in order to improve its effectiveness, with more standardised and transparent data recording, good governance and improved engagement with the private sector.

Commissioned Modelling Papers

Two types of modelling studies were commissioned in order to explore some of the relationships between finance and policies for the enablers (e.g. infrastructure) in greater depth: modelling on Bangladesh (Kinnunen, 2015), Moldova (Levin, 2015a) and Tanzania (Levin, 2015b) and other modelling exercises (see Table 1.1)

Fic (2015) models the impact of global economic policies, including the withdrawal of quantitative easing (QE), implementation of Basel III and tackling tax evasion in developed and developing countries and across different regions. The NiGEM modelling indicates that QE withdrawal is accompanied by a substantial rise in bond yields and interest rates, and substantial macroeconomic impacts in developed countries compared to developing countries. Implementation of Basel III rules show the associated GDP costs are several times less than the benefits of higher capital and liquidity. Policies to tackle tax evasion and transfer pricing would increase output in developing countries.

Kinnunen (2015) uses the MAMS model to explore the potential evolution of the Moldovan economy until 2030 using a set of external and domestic shocks and policy changes. The study finds that market-related reforms are beneficial but do not necessarily benefit the whole population in the absence of government measures to redistribute the gains of growth. There are differences across

sectors in reaction to different policy changes – for example, industry does not seem to depend on transport infrastructure as much as primary production. Increased FDI and improved access to finance are more important constraints for primary production and services than for industrial production, for which external demand is most important. For infrastructure, it is more beneficial to obtain foreign sources of investment (assuming the necessary administrative and absorptive capacity to handle a surge in external resources).

Lenhardt (2015) finds that baseline projections using the International Futures (IF) model would not be sufficient to eradicate extreme poverty in LICs by 2030 – with a different mix of finance and governance reforms necessary in different country contexts. There are, however, some common trends. For example, if OECD countries met the 0.7% ODA target this would reduce the proportion of people living below \$1.25 per day by a further 8% from the baseline, which if combined with increased LIC government effectiveness would decrease poverty by a further 3%. Combined with increased government effectiveness, FDI resulted in a decline in extreme poverty in lower middle-income countries (LMICs) by 7% (compared with 10% in the baseline) and was nearly eliminated in upper middle-income countries (UMICs) by 2030 (using a rate of change of FDI to GDP of 1.4%).

Levin (2015a) MAMS modelling finds that fewer financial resources are required to meet the MDGs in Tanzania by 2015 than in 2025, requiring an average of 8% GDP in ODA disbursements (2005–2025), which is lower than current levels. Higher productivity growth has a higher impact on MDG1 (to eradicate extreme poverty and hunger). The study also finds a trade-off between spending on infrastructure and on sectors relating to human development, such as education and health. Further GDP growth, FDI and total factor productivity growth could make it easier to achieve the MDGs.

Using the MAMS model, Levin (2015b) finds that the financial needs to achieve the MDGs in Bangladesh are not overwhelming, and that these could be achieved by 2021 with a combination of reforms such as deepening of tax reforms and reallocation of public spending towards primary education, as well as foreign borrowing. External shocks, including terms

of trade, FDI and remittances have potentially strong and significant macroeconomic effects, and so could be detrimental to achieving the MDGs, particularly when they are combined. On the other hand, a combination of favourable shocks would make significant contributions towards achieving the MDGs.



An overview of all the commissioned papers is presented in Table 1.1.

Table 1.1 | Overview of commissioned papers

COMMISSIONED PAPERS	OUTLINE
Country Illustrations	
Borja, I. and Ordóñez, A. (2015) <i>Ecuador</i>	Finance and policies for enablers of sustainable development transformation in respective country contexts.
Damuri, Y., Setiati, I., Atje, R. and Santoso, B. (2015) <i>Indonesia</i>	
Ghedrovici, O. (2015) <i>Moldova</i>	
Khatun, F. (2015) <i>Bangladesh</i>	
Lunogelo, H. et al. (2015) <i>Tanzania</i>	
Trebbhoohun, N. and Jutliah, R. (2015) <i>Mauritius</i>	
Background Papers	
Bhattacharya, D. (2015) <i>Synthesis of the Country Illustrations to the European Report on Development 2015</i>	Synthesises the findings of the CIs.
Büge, M., Meijer, K. and Wittmer, H. (2015) <i>International financial instruments for biodiversity conservation in developing countries - constraints and success stories</i>	Examines international programmes and financial instruments for biodiversity conservation.
Brun, J.-F. and Chambas, G. (2015) <i>How do tax systems evolve as countries achieve structural transformation?</i>	Focuses on the transition of tax systems with income growth, and opportunities for the post-2015 agenda to promote DRM.
Cadot, O., Engel, J., Jouanjean, M.-A., Ugarte, C. and Vijil, M. (2015) <i>Is ODA targeted at weak links?</i>	Explores the correlation of ODA targeting to upstream productive services sectors with productivity in downstream sectors.
Griffith-Jones, S., Katseli, L. and te Velde, D.W. (2015) <i>A world financial network - bringing financial institutions into the development debate</i>	Explores opportunities for dialogue between financial institutions and policy-makers on financing sustainable development.
Frankfurt School-UNEP Centre (2015) <i>Financing for sustainable energy systems in developing countries and emerging economies</i>	Examines sustainable energy finance global trends and developing country case studies and instruments.
Rahman, M., Khan, T.I. and Sadique, Z. (2015) <i>Impact of MDGs on public expenditures in LICs in the context of post-MDGs</i>	Provides an overview of the impact of MDGs on LICs national policy and public expenditure (including ODA flows).
Sarris, A. (2015) <i>Financial tools for agricultural development and transformation pertinent to low-income and low-middle-income countries</i>	Examines the process, financial needs, and financial tools for agricultural transformation.
Uneze, E. (2015) <i>Impact of South-South Cooperation in achieving MDGs in LICs</i>	Reviews trends, impacts and future prospects for SSC.
Modelling studies	
Fic, T. (2015) <i>Global economic policies and developing countries: NiGEM scenarios for the post 2015 Agenda</i>	Models global Basel III implementation, quantitative easing and tackling tax-evasion shocks.
Kinnunen, J. (2015) <i>The role infrastructure, finance and FDI in boosting growth of Moldova - MAMS-based analysis</i>	Models infrastructure investment, financial sector performance and FDI shocks in Moldova.
Lenhardt, A. (2015) <i>Scenario modelling of improved financial and non-financial MOI of a post-2015 agreement</i>	Models the impact of FDI and ODA shocks in country income groupings, and scenarios for Mauritius to escape the MIC trap by 2030.
Levin, J. (2015a) <i>MDG achievement in Tanzania - is it possible? MAMS-based analysis</i>	Models scenarios for achieving the MDGs in Tanzania by 2025.
Levin, J. (2015b) <i>Policy options beyond 2015 - achieving the MDGs in Bangladesh</i>	Models scenarios for achieving the MDGs in Bangladesh by 2021.

1.5 Structure of the Report

The Report comprises **seven chapters**.



Following this introduction, **Chapter 2** presents a critical review of the literature on development finance needs. In particular, it reviews the FFD agenda following the conclusion of the MDG period. The review points to the importance of moving from a focus on gaps in financing needs to understanding the role of finance in a transformative agenda, and to the role of policies in mobilising finance and making it more effective.



Chapter 3 presents developments in financial flows since the 1990s for different country income groupings. It identifies the distinctive roles of different finance flows in each grouping, while highlighting the need to look at a range of finance flows, including ODA, but also at domestic public flows and domestic and international private flows.



Chapter 4 reviews the empirical evidence on the role of policies that can help to mobilise and use financial flows effectively. This underlines the crucial role of policies in a Finance and Policy Framework for Development (FPFD).



Chapter 5 presents the Report's methodological framework, linking financial flows, policies and selected enablers for achieving sustainable development. It then explains the selection of six enablers that are used in Chapter 6 to analyse the role of finance and policies.



Chapter 6 examines how finance and policies contribute to the enablers (infrastructure, trade, green energy technology, biodiversity, human capital and local governance), including reviews and new evidence based on the background and modelling papers, as a means to answer the main research question.



Chapter 7 summarises the main conclusions from Chapters 2–4 and synthesises the links between finance and policy set out in Chapter 6. It argues that two main pieces of evidence are crucial to the post-2015 development agenda. First, sources of finance evolve by level of income and vary by the various enablers, and it is important to think about the ways in which the range of finance flows in different contexts and to be alert to how the flows interact, e.g. the role that international public finance can play in being more catalytic. Second, there is a crucial role for policy, which includes national policy and finance frameworks and the global system.

CHAPTER 2.

Main lessons from studies on MDG finance needs

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Main Messages

The lessons learned from the implementation of the MDGs suggest that we need a **completely new approach towards finance for development**. This chapter draws three main messages from a review of the studies on MDG finance needs:

- ▶ A range of studies on finance needs supported the implementation of the MDGs. They emphasised financial gaps to be filled with *aid*, but this represented only a partial vision of how needs could best be met. Furthermore, the financing context has since changed with other flows, private and domestic public, becoming much more important. We need to move **from aid as a 'silver bullet' to considering all available sources of finance**.
- ▶ The focus on finance needs associated with the MDGs often ignored the role of *policy*, which is crucial. There is therefore a need to think beyond either 'only policies' or 'only finance' and instead **promote discussions that can foster joint thinking on appropriate policies and finance**.
- ▶ The MDGs successfully attracted ODA for specific social sectors, but in a post-2015 context with an agenda that seeks to be more comprehensive and transformative, it is important to consider long-term *enablers* for such an agenda. This requires a **new way of thinking about the role of different finance sources and a better understanding of structural transformation**.



The way in which the role of finance for development is conceptualised matters a great deal – and there is a need to think about it in a different way in the post-2015 context than was the case for the MDGs. The adoption of the MDGs in 2000 was followed by various studies to estimate the financial needs required to reach them. It was often implicitly assumed that ODA would fill the gap between the available and necessary finance – and this was the prevailing view on how to finance development. Certainly, more ODA was directed towards the social sectors and progress was achieved. Other financial flows (e.g. domestic resources) received less attention, as did the context within which finance affects development. This must not be ignored again in the post-2015 context.

This chapter reviews the lessons drawn from studies on finance needs that were intended to support the implementation of the MDGs. Reviewing the finance needs and understanding their lessons underpins this Report's approach to finance and policies for development.

The chapter is structured as follows. Section 2.1 reviews a range of studies on financial needs, looking at the intellectual origins of the framework that defined the MDG approach in which a shortage of savings and investment was viewed as the main barrier to progress, which ODA was supposed to overcome. The section also summarises different approaches to finance needs studies. Section 2.2 discusses estimates made in selected studies. This section does not aim to be comprehensive (other accounts include, for example, the ICESDF report and background paper and supporting UNTT reports), but rather to show how the scope of the studies has changed from considering mainly social goals (e.g. health and education) that characterised the MDGs to issues such as infrastructure or limiting the increase in global temperature, currently under discussion. Section 2.3 relates the lessons learned from past studies that inform the approach taken in this Report.

2.1 Reviewing the basis of the studies on MDG finance needs

This section reviews the intellectual underpinning of the studies on finance needs that were undertaken in the MDG context and the methodologies used in order to calculate them. The review reveals a range of unrealistic assumptions that often underpinned these studies that were largely ignored in making the case to scale up ODA in order to meet the MDGs. One assumption that we consider critically throughout the Report is that finance - and ODA in particular - will automatically (with fixed multipliers) lead to development outcomes without considering other finance flows, policies, or required structural changes. This chapter also discusses cases where modelling studies have improved upon or learned from the past.

2.1.1 The intellectual underpinning of the MDG approach to finance needs studies

The studies on finance needs tended to regard ODA as a means to fill a finance gap similar to the 'take-off' and 'big push' literature developed by economists such as Arthur Lewis (1954), Walt Rostow (1960) and Paul Rosentstein-Rodan (1943, 1961), with the underlying idea that ODA could help to 'unlock' growth in developing countries. In this vein, the Harrod–Domar model was extensively used to calculate the finance required to achieve the MDGs, in particular the eradication of extreme poverty. In this line of thinking, the lack of capital accumulation and investment is a key constraint to economic growth. External finance, in particular ODA, can launch a 'take-off in self-sustained growth'.

Drawing on this, Chenery and Strout (1966) developed the **two-gap model** used to justify ODA and still widely used in estimating finance needs. This model identifies two constraints to economic development that could be addressed by ODA: the first is between import requirements

for a given level of production and foreign-exchange earnings and the second, the most important gap in the finance needs literature, is the amount of investment necessary to attain a certain rate of growth, taking into account available domestic resources. One important feature of this model is the 'incremental capital-output ratio (ICOR)', describing the additional capital required to obtain one unit of output. Various features and assumptions of this model have been criticised, particularly within the literature on endogenous growth. The important characteristic of the two-gap model is that ODA (or concessional finance more broadly) is seen as the way to fill the gap. The underlying logic is that ODA should increase investment that in turn should increase growth.

William Easterly (2001) challenged the empirical validity of the model by testing the impact of ODA on investment and the impact of investment on growth in 88 countries. He found evidence of a correlation between ODA and investment in only six countries. Among them, Hong Kong and China have only a small share of ODA in the economy with respectively on average 0.07% and 0.2% of GDP over the period 1965–1995. Only four countries passed the second step of the impact of investment on growth, and only Tunisia passed both. The model is still, however, used in many studies on finance needs both because of its simplicity and because it has not been replaced by any other model linking ODA and growth.

Such models do not take into consideration why there is a shortage of finance in the first place. Indeed, if there is too little investment due to a capital market imperfection in a situation that otherwise has an enabling investment climate, it is reasonable to consider that ODA could potentially overcome this. But if the constraint is a poor investment climate (governance failure) that offers little incentive to invest in the economy, in particular in fragile states, Easterly (2003) argues that ODA may not necessarily result in more investment since it would not alleviate the main constraint on incentives to invest, but would rather

tend to finance consumption. In such a case, there is no link between ODA and growth because aid does not alleviate the constraint on investment.

The importance of considering policies and governance became central to the discussions on ODA that surrounded the 2002 Monterrey Conference on Development Finance, with politicians and the media making use of results of a body of research highlighting their relevance to aid effectiveness. Burnside and Dollar (2000) argue that aid has a positive impact on growth in developing countries that have good fiscal, monetary, and trade policies, but has little effect in the presence of poor policies. Many other studies made variations of this analysis, some confirming and others rejecting their results (e.g. Hansen and Tarp, 2001; Dalgaard and Hansen, 2001; Guillaumont and Chauvet, 2001; Collier and Dehn, 2001; Lensink and White 2001; Collier and Dollar, 2002; Jensen and Paldam, 2003; Brumm, 2003). Mavrotas (2003) further argues that the effects depend on the type of aid. Recent assessments of ODA are more positive: in 1994, an article in *The Economist* concluded that 'Aid [goes] Down the Rat hole', but 20 years later it published an article 'Aid to the Rescue', citing a World Bank study (Galiani et al., 2014) and Brückner (2013), both of which find strongly positive and significant effects of ODA on growth. In general, the relationship is sensitive to econometric specification estimation methods as well as to the definitions of what constitutes 'aid' and 'good policy': without a strong theoretical model underpinning such analyses, each specification is ad hoc. Nonetheless, 'taking into account the policy environment, [Burnside and Dollar, 2000] seemed to have found the missing link between the micro-success and the macro-failure of aid' (Harms and Lutz, 2005: 18). Although the discussions on aid effectiveness have taken into account the policy and institutional context within which ODA is provided, and while the estimates made in some studies are contingent on certain scenarios or contexts, most studies on finance needs still ignore the policy context.



A major objective of the MDGs was to broaden the development discourse beyond the focus on economic growth. Consequently, they served to push ODA away from the broader emphasis on economic growth even though the overall approach was still aid-centred. The debate on aid effectiveness became a lively issue, as embodied by two economists: **Jeffrey Sachs supporting the argument for increased aid based on the 'big push' argument, and William Easterly criticising the MDGs' 'one-size fits-all' and comprehensive approach to development, in particular the over-reliance on ODA.** Debates on the MDGs have too often been caricatured as opposing 'growth', 'aid' and 'governance' (Vandemoortele, 2011), although all three seemed to be components of the same package.

2.1.2 Methodological steps needed in finance needs studies

Many studies estimate finance needs and gaps either by 'sector' (e.g. health, education or the environment) and/or by objectives (such as the MDGs whether globally or at the country level). We have reviewed these and there has been a proliferation of global estimates. As Box 2.1 describes, there have also been different types of country-level studies to estimate the cost of achieving the MDGs. We refer to these studies throughout the chapter and in particular to country-based MAMS modelling commissioned for this Report.

Estimates of finance needs and gaps are based on underlying assumptions and vary widely according to the context and definition of a target. They also depend on the policy context and on how efficiently existing financial resources are used. The term '**cost**' refers to the volume of finance as opposed to 'needs'. This suggests that those supplying the finance make interventions, with the implicit assumption that they will be involved in seeking and providing resources to achieve a target. Embedded in the literature on the finance gap for the MDGs is the assumption that ODA will fill it. Talking about

financial need offers more flexibility regarding the sources that could fill the gap.

According to the UNTT a finance gap represents the '*difference between the current situation and a desired situation*' in relation to a goal or target, or the difference between the available and required finance to meet a specific objective (UNTT, 2013a: 33). The definition of a gap also depends on what is assumed to be available. Some consider that available resources refer only to domestic resources while others (e.g. OECD, 2011) include external financing – another source of inconsistency across studies.

Studies on finance needs take important methodological steps in five areas: choosing a target; mapping the means by which it can be reached; choosing a scenario; choosing an estimation method; and other considerations. While the resulting approach can lead to new insights, each step also comes with a set of problems that need to be addressed if the underlying assumptions are unrealistic. It further explains why these studies are not strictly comparable.

Box 2.1 | Approaches to costing the MDGs at the country level

There have been three approaches to costing the MDGs at the country level:

UNDP country studies: In the early 2000s the United Nations Development Programme (UNDP) piloted country-level costing exercises in Cameroon, Malawi, Uganda, Tanzania and the Philippines. The models focused on six MDGs: income poverty, primary education, child mortality, maternal health, HIV/AIDS and water. The methodology used differed across targets and countries and identified key interventions for each objective.

The Millennium Project: In 2005, the Millennium Project (directed by Jeffrey Sachs for the United Nations) published *Investing in Development: A Practical Plan to Achieve the Millennium Development Goals*. It was based on a number of country case studies to identify major 'interventions' required to achieve all eight MDGs in each of these countries. Expert task forces developed 'MDG needs assessments', compiling lists of technical interventions and associated investment plans to attain the MDGs. In education, for example, the list includes providing more schools and teachers, ending tuition fees, and providing books and uniforms. Countries included Bangladesh, Bolivia, Cambodia, Ghana, Malawi, Tanzania and Uganda. Local counterparts collected information on the unit costs of the interventions. The linear 'scale up' of interventions and investments in each sector was summed in order to estimate resource requirements and develop a financing strategy. The study did not consider policy or institutional reforms.

World Bank: In the early 2000s, a World Bank project focused on the following countries: Benin, Burkina Faso, Ethiopia, Madagascar, Mali, Mauritania, Tanzania and Uganda; Bangladesh, India, Indonesia, Pakistan and Vietnam; Bolivia, Honduras; Albania and Kyrgyz Republic. Its approach gave priority to the macroeconomic policy objectives (such as the containment of inflation, budget deficits and current account deficits) emphasised in the respective Poverty Reduction Strategy Papers (PRSPs), and asked how, given these priorities, the MDGs could best be achieved.

The World Bank also developed a CGE modelling approach. The MAMS models (MAquettes for MDG Simulations) developed by World Bank researchers (Bourguignon et al., 2008) and since used extensively by UNDESA, provide a general equilibrium framework for countries to simulate the effect of different financing sources (e.g. ODA grants, foreign borrowing, and domestic taxation) on different MDGs. The models also take into account the effects of progress in one MDG on progress in others and include issues of absorptive capacity related to large finance inflows.

Sources: Bourguignon et al. (2008); Millennium Project (2005); Reddy and Heuty (2006); Sánchez et al. (2013)

2.1.2.1 | Choice of target

The first step is to identify a relevant target, e.g. specific MDG targets such as food security or access to safe water. While it is important to use appropriate, common descriptions of a target, this is often not the case. Moreover, different studies may cover a similar target but include different countries, again making most of them not strictly comparable.

2.1.2.2 | The choice of means by which to reach a target

A second step is to identify the means by which to reach the target. Often, there are several

strategies and means available. Depending on country characteristics, there could be various options for how to attain the same target, each with a different cost. For example, some might emphasise the potential of organic agriculture to reduce poverty, while others highlight the advantages of investing in chemical inputs or domestic seed banks. Some suggest promoting school enrolment by providing mid-day meals, others by reducing the distance pupils have to travel to school. Often such strategies could be complementary.

As described in Box 2.1, the 'Millennium Project' (2005) mapped out the major policy steps and



investments necessary to achieve the MDGs in selected countries. Researchers identified a set of key interventions to support the achievement of the targets. For each target and country the methodology was to first examine the existing gap and its geographical distribution, in particular distinguishing between urban and rural areas. This made it possible to identify the investment needs and costs of the interventions by which to reach the target.

Unfortunately, many models of MDG finance needs offer only one option, even if is not the most efficient, rather than considering a range of alternative means and approaches. This is particularly the case for global studies that examine the achievement of MDG1, where ODA is linked to aggregate investment, aggregated growth and then aggregated poverty, thus losing valuable detail on different and more efficient ways to reduce poverty. There are exceptions, as we shall discuss in this Report, most notably those studies that use MAMS CGE modelling (see e.g. Box 2.4, Box 2.5 and Box 2.6), and also some global estimates that differentiate among different sectors (IFPRI, 2008).

2.1.2.3 | Choosing a scenario

Most early analyses are based on status quo or 'all other things being equal' scenarios. This can be unrealistic, however, and shocks can have a large impact. Reddy and Heuty (2006) point to the impact of the AIDS epidemic on health targets, which severely affected estimates of finance needs. Further, the literature on climate change highlights the fact that various projections and sensitivity analyses yield very different finance needs. For example, infrastructural needs differ markedly depending on whether climate change is included in the scenarios.

The choice of scenarios relates to the assumptions underpinning the chosen methodology. For example, estimates based on the 'back of an envelope' and descriptive econometric models

use past experience to define indicators or multipliers in order to predict the future. This means that they might not take account of dynamics over time. Other models, such as CGEs, allow for building dynamic scenarios to account for degrees of shock on various trends. An example of this is the World Bank's application of CGE models, initially designed to evaluate the distance to be travelled in order to reach the MDGs (Bourguignon et al., 2008). While CGE models are calibrated according to past experience, they can introduce new parameters, although the estimates rely on an accurate choice of parameters and assumptions.

The IPCC-SRES (IPCC-SRES, 2000: 23) defines scenarios as follows:

Scenarios are images of the future, or alternative futures. They are neither predictions nor forecasts. Rather, each scenario is one alternative image of how the future might unfold. A set of scenarios assists in the understanding of possible future developments of complex systems. Some systems, those that are well understood and for which complete information is available, can be modelled with some certainty, as is frequently the case in the physical sciences, and their future states predicted. However, many physical and social systems are poorly understood, and information on the relevant variables is so incomplete that they can be appreciated only through intuition and are best communicated by images and stories. Prediction is not possible in such cases. (IPCC-SRES, 2000:23)

2.1.2.4 | Choosing an estimation method

Three main methods have been used to estimate the finance necessary to reach the MDGs:

1 **Unit-cost-based analyses or 'back of an envelope' estimates:** An average unit cost of action is identified in relation to the means selected to reach the target. It is then multiplied to reach the size of the targeted population. Most such studies are country-specific and sector-specific and rely on the availability of micro-data. An example of using unit costs is Delamonica

et al. (2001), who divide countries' current expenditure on primary education by the number of pupils in order to obtain a cost per pupil. This 'unit cost' is then multiplied by the incremental number of children who need to attend primary school in order to meet MDG2 by 2015. The Millennium Project (2005) uses this approach, producing an aggregate estimate of the cost of meeting the MDGs at the country level, based on the preliminary needs assessments carried out in Bangladesh, Cambodia, Ghana, Tanzania and Uganda.

Reddy and Heuty (2006) highlight the lack of consistency regarding the concept of unit cost in the financial estimates for reaching MDGs. Unit costs may change, for example, in relation to potential economies or diseconomies of scale over time and across countries. Marginal costs can change and exogenous factors such as the development of new technology or institutions can also have a major influence on the cost of achieving the objective. Unit costs also vary by location, casting doubt on the possibility of aggregating detailed unit costs for certain locations into national or regional, let alone global, unit costs.

The problem posed by using unit costs can also be seen by comparing them across a range of studies for the same country. In the case of education, this shows that a major source of variation in estimates of finance needs lies in the estimated cost per pupil, which could differ by a factor of five even in the same country (Uganda) at a similar time: \$13 (UNICEF, 1998), \$27.50 (World Bank, 2003), \$46 (EPRC, 2001) and \$63 (Millennium Project, 2005).

2 **Growth models,** most of which are backed by the standard Harrod-Domar model, estimate a target (e.g. growth rates) and, by making assumptions about several macro trends based on historical evidence, calculate the finance need 'backwards'. A number of studies use this theoretical framework to assess the resources needed to

achieve the level of growth that would, in theory, make it possible to achieve the MDGs. One of the most cited examples is Devarajan et al. (2002), but more recent analyses such as Atisophon et al. (2011) and OECD (2011) also adopt this approach. Section 2.1.1 sets out a critique of this two-gap model. In addition, each individual link can be criticised. For example, Reddy and Heuty (2006) highlight the implausibility of using the same growth to poverty elasticity's across all countries, given that the poverty elasticity of growth varies by country and over time, depending in part on economic structures, complementary policies and institutions.

3 **CGEs** such as the MAMS models (see Box 2.1) developed by World Bank researchers (Bourguignon et al., 2008), and used extensively by UNDESA (Sánchez et al., 2013), are macro models that include a cost-minimising government as the main agent acting on different sectors (health, education etc.). CGE models aim to reconcile the standard micro-based needs assessment with macroeconomic modelling. They capture micro-macro spillovers via fluctuations in wages. Moreover, by introducing intermediate goods that can be bought on foreign markets, these models allow for the effects of exchange-rate fluctuations. An important feature is the inclusion of decreasing marginal returns on additional government spending, meant to capture the 'absorptive capacity' threshold in a more satisfactory way than in other costing methodologies. The MAMS methodology focuses primarily on the education and health-related MDGs. It also takes into account the fact that there may be cross-sectoral spillovers, on which the effectiveness of government spending depends: for example, spending on education becomes more effective if at the same time there is an improvement in health conditions, because absenteeism is reduced, or if infrastructure improves, and vice versa. This 'joint production' of MDGs is not incorporated in the global sectoral estimates that use unit-cost approaches based on



simply adding up separate sector estimates. This suggests that the country-level MAMS models improve on the earlier estimates and constitute an important point of learning.

2.1.2.5 | Other conceptual issues across all models

While models have become more sophisticated, the estimates share common conceptual and implementation **limitations**. **One issue relates to data reliability and robustness of estimations**, especially in data-intensive models such as MAMS, but also in more straightforward calculations such as ICOR growth models. All these methodologies rely on estimates of unit costs, which are sensitive to data-collection issues, and the models' predictive capacity relies on the relative fit of existing data to reality. This may be problematic in the context of countries where the accuracy of data, especially at the aggregate economic level, may be far from comprehensive or reliable. Nonetheless, estimates at the country level tend to be sounder than estimates at the global level.

Another issue relates to **aggregation, double counting, and the consideration of spillover effects** across the targets. Interdependency among targets, double counting, and trade-offs are only partially addressed by the most recent models, such as CGEs. The literature on cost includes various scales of analysis, from one target in a sub-sector in a single country to multiple global targets. As highlighted by Devarajan et al. (2002), the estimated finance gap to achieve MDG1 should not be added to sectoral estimates of other MDGs but should be compared, since they are two estimates of the additional global ODA necessary to achieve the MDGs, based on the underlying assumption that achieving MDGs 2–7 is one way to achieve MDG1.

In addition to these concerns, the existing models have not really taken into account the role of 'soft' skills, such as good **governance and institutions**, in defining the relative effectiveness

of finance, which is crucial to costing. Widespread corruption, for example, may jeopardise the effectiveness of additional ODA, and limit the country's ability to mobilise domestic resources or to undertake fiscal reform. These variables, which authors as Devarajan et al. (2002) stress are crucial to the achievement of development goals, are not taken into account by existing models, other than through relative 'productivity' parameters or residuals in econometric estimations. This key criticism is developed in this Report and relates to the importance of complementary policies (addressed in Chapter 5).

Those issues, and particularly the issue of double counting, spillovers and institutional environment, are often mentioned in relation to the **scale of the cost estimates**. There is general consensus on the limits of costing methodologies at the global level, with a call for more country-focused analyses because these address some of the shortcomings. A more disaggregated level of analysis makes it possible to tackle concerns about country-specific capacity and needs, although it is still subject to many other caveats. A country-level approach does, however, make it easier to identify accurate targets and pathways to reach them, and makes it possible to take into account the institutional environment, thus providing more refined estimates of unit and marginal costs and benefits of action. Recently, a number of MAMS applications have built country-level models (e.g. Sánchez et al., 2010).

In conclusion, researchers sometimes (have to) make unrealistic assumptions and follow methodologies that may be subject to criticism, but could still be improved upon by examining the issues in greater depth and giving more detailed consideration to the role of context for the effective use of finance. There has been learning in the development of country-level MAMS modelling, which offers some advances over global estimations. In particular MAMS models can take into account country-level specificities; address the linkages across individual MDGs; and

compare different types of financing for the same objective, e.g. domestic versus foreign. Although MAMS models offer a promising route, they have not to date fully assessed the importance of context (Box 2.4 describes two commissioned MAMS studies that aim to do this: Levin 2015a, 2015b). Better data and more disaggregation might solve some of the problems associated with the finance needs studies, but would not address the need for an alternative FFD vision that explicitly considers the policy context and the role of finance for the enablers of sustainable development transformation – a Finance and Policy Framework for Development (FPFD).

Three MAMS modelling studies were commissioned for this Report to consider the role of finance and policy in the context of the MDGs. MAMS modelling for Tanzania and Bangladesh simulates whether it would be possible to achieve the MDGs in an extended timeframe (2025 and 2021 respectively) (commissioned modelling papers: Levin, 2015a, 2015b; Box 2.5). MAMS modelling for Moldova simulates infrastructural investment (commissioned modelling paper; Kinnunen, 2015). It finds that market-related reforms will lead to greater benefits for the population and inclusive growth when public measures are taken to redistribute the gains of growth (see Chapter 6). Modelling was also undertaken on the impacts of Basel III implementation, quantitative easing and tackling tax evasion, using the NiGEM Model (commissioned background paper; Fic, 2015) and on the beneficial interaction between government effectiveness and the effectiveness of ODA and FDI flows, using the International Futures Model (see Box 4.3; commissioned modelling paper, Lenhardt, 2015). The results clearly demonstrate the importance of the policy context and are further explored below and in Chapter 4.

2.2 The scale of finance required: comparing MDG and post-2015 contexts

Many studies have followed the methodological steps identified in the previous section to calculate the scale of finance needed to achieve MDGs. This section presents a few examples for the MDGs that are frequently covered in these studies. The aim is to provide some order of magnitude, bearing in mind the questionable assumptions on which some of the estimates are based. In the context of the post-2015 development agenda, the SDGs under discussion are more comprehensive than the MDGs and include environmental and economic objectives. The scale of finance required to meet a wider set of post-2015 goals is therefore likely to be far greater than for the MDGs. Given the difficulties to be overcome in order to make cost estimates, which depend on many assumptions such as the policy context, we do not offer new estimates since these would risk reviving the outdated belief that finance alone could solve all the problems. Rather, we focus on examining different finance flows and the link between finance and policies in enabling development goals.

2.2.1 Finance needs to meet objectives in the MDG context

The studies on MDG finance needs focused on estimating what would be required to meet a range of mainly social development goals. The estimates varied for the reasons summarised in Section 2.1. Of the many studies we reviewed, we select those that have been most frequently cited in relation to halving global poverty and reaching health and education targets (for other reviews see, for instance, Reddy and Heuty, 2006, and Reddy and Heuty, 2008). The review illustrates many of the points raised in the previous section, e.g. that these studies are based on simplistic assumptions without considering the policy and institutional context.



The finance gap that needed to be bridged in order to **halve global poverty** by 2015 ranges from an additional \$20 bn (Zedillo, 2001) to \$62 bn (Devarajan et al., 2002) each year. Zedillo (2001) calculates the cost of achieving the MDGs, of which MDG1 is one. The calculations are based on the costs of achieving individual goals already identified and ad hoc estimates when there are no available costings. Further, the sectoral estimates (based on unrealistic assumptions, as discussed above) did not refer to a common cost concept (e.g. total cost, total public cost, or total cost to donors) and excluded goals for which were no readily available estimates. The figures presented by Zedillo (2001) therefore represent only 'the order of magnitude' of the additional finance required to achieve the MDGs (Reddy and Heuty, 2006). The estimate of the financing gap for halving poverty was based on UNCTAD (2000) and Collier and Dollar (2000) studies. The former suggested that halving poverty would require additional ODA of about \$10 bn a year to increase economic growth in Africa to 6% a year, which Zedillo (2001) doubled to allow for a parallel effort in the lower-income countries outside Africa.

The more detailed study by Devarajan et al. (2002) (and most other studies examining poverty goals) uses the Harrod–Domar growth model. To estimate the additional ODA needed to halve poverty between 1990 and 2015, the authors use a '**two-gap' growth model** where growth depends on the level and efficiency (measured through ICOR) of investment. The rate of poverty reduction depends on the level, growth and distribution of per capita GDP. Working backwards from the existing poverty level and distribution of income, the average rate of growth required to reach MDG1 by 2015 determines the additional investment needed. In principle, the need can be met by ODA, domestic savings or non-aid flows, but for poor countries it is **assumed to be met by ODA**.

The **range of estimates within studies**, let alone across them, is quite large. Some studies, such as Zedillo (2001) and Pettifor and Greenhill (2002)

produce rather different estimates of the finance gaps (varying between \$20 bn to \$46 bn a year). Other studies, such as the much-cited Devarajan et al. (2002), suggest a smaller range (\$54–62 bn), which is of the same order as the more recent estimates by Atisophon et al. (2011), who suggest that the upper range of the distribution between Zedillo (2001) and Devarajan et al. (2002) is more likely – they estimate an additional \$37 bn to \$62 bn a year is needed to halve global poverty by 2015 in LICs (an MDG cost estimate for those countries where a financing gap exists).

Some studies consider in more detail than aggregated growth the **means and pathways through which poverty can be reduced**. For example, IFPRI (2008) estimates the finance required to achieve the MDG1 through agricultural growth by first calculating the required agricultural growth rates using country-specific elasticities of poverty reduction with respect to agriculture, and then estimating the necessary financial resources using growth with respect to expenditure elasticity. Because growth in the non-agricultural sector also contributes to poverty reduction, either directly or indirectly through growth linkages with agriculture, it also considers the additional poverty-reduction effects from that sector. IFPRI (2008) estimates an annual financing gap for 30 SSA countries of \$33–39 bn from 2005 to 2015.

There is also a large range of estimates for the finance gap in relation to meeting **education (MDG2) and health (MDG4–6) objectives**. There are two important features of these estimates. First, is the link between MDG1, MDG2 and MDG4–6. While Devarajan et al. (2002) provide separate estimates for MDG2 and MDG4–6, they argue that poverty reduction (MDG1) achieved through increased growth could sufficiently increase the demand and supply of health and education services to ensure the achievement of the respective MDGs. A separate calculation in Devarajan et al. (2002) focuses on the costs of achieving the health and education goals separately. A resulting increase in human

development could then affect incomes, thus ensuring the achievement of the income-poverty goal. The second feature is that most of these studies use the unit-cost approach.

Estimates of the finance gap to achieve **MDG2** range from about \$7 bn a year (Delamonica et al., 2001) to \$27 bn a year (Devarajan et al., 2002). Delamonica et al. (2001) and Atisophon et al. (2011) estimate the cost of achieving universal primary education (UPE) based on an estimation of the country-specific unit cost of reaching a 100% net primary enrolment ratio by 2015. The additional expenditure required to achieve UPE is the total number of additional children multiplied by the unit costs.

Estimates of the finance gap to meet **MDG4–6** (the health-related goals) are also based on unit costs. In general terms studies such as Devarajan et al. (2002) or Atisophon et al. (2011) estimate the total per capita costs required for health treatment (e.g. the World Health Organization (WHO) argues that ensuring access to the types of interventions and treatments needed to address MDG4–6 requires on average a little more than \$60 per capita annually by 2015). Health-related costs in the best-case scenario are estimated at around \$6 bn (Atisophon et al., 2011) and between \$20 bn and \$25 bn by Devarajan et al. (2002). Other recent estimates, such as WHO (2010), are much higher even when focused only on LICs. The comparability of these estimates is clearly limited since they focus on different geographical areas and sectors, and should not be interpreted as precise estimates.

2.2.2 Finance needs to meet economic and environmental objectives in the post-2015 development agenda

While the literature on the finance needs related to the MDGs focused on reaching social development goals, the post-2015 context would require taking into account estimates of financial needs that relate to economic (infrastructure, trade finance) and environmental objectives.

Examining these more comprehensive goals suggests two main issues: (a) finance needs vary greatly depending on the underlying assumptions and scenarios, as suggested in Section 2.1; and (b) finance needs appear far greater in the economic and environmental spheres than in the social context. A further feature is that the new studies do not assume that ODA should fill the entire finance needs.

The global scale of infrastructure investment needs is immense, with a shortfall of \$1 trillion (tr) for the 2008–2015 period for developing countries (Yepes, 2008) and \$2.5 tr annually up to 2030 for global investment (McKinsey, 2013). Other studies, such as the IEA (2013) estimate that an additional \$2–2.5 tr a year is needed simply to maintain and upgrade the transport sector, depending on different climate-change scenarios. The Global Commission on the Economy and Climate estimates that a low-carbon pathway has incremental infrastructure requirements (across all sectors) of \$4 tr between 2015 and 2030, an increase of 5% from baseline levels. Box 2.2 provides further details on finance needs in the case of infrastructure and shows how different scenarios, in particular the need to include the effects of climate change, might affect the estimates.

In addition to the studies on the infrastructure gap, there have been similar studies on **finance for SMEs and trade**. According to the World Bank's enterprise surveys, some 24% of firms in SSA (and 17% across all LICs and MICs) cite access to finance as the biggest obstacle to doing business, and 43% in SSA (31% in all LICs and MICs) cite it as a major constraint. The IFC (2014) finds that SMEs in developing countries find it difficult to obtain credit, which makes it harder to achieve economic development. In LICs and MICs as a whole, there are between 360–440 million formal and informal micro, small and medium enterprises (MSMEs). Around a half (45–55%) of the 200–245 million MSMEs in developing economies are either underserved or not served at all.



This represents a gap in credit finance for such MSMEs of \$2.1–2.6 tr. A survey by the Asian Development Bank (2013) found an unmet global demand for trade finance of \$1.6 tr, with the need for additional trade finance in Asia alone to be around \$425 bn.

Box 2.2 | Estimating infrastructure finance needs

The McKinsey Global Institute (2013) projects a global need for investment in infrastructure of around \$57–67 tr by 2030, depending on estimations. This amounts to around 3.5–3.8% of global GDP. Most of these investments are needed in road infrastructure (\$16 tr), energy (\$12 tr), water (\$11.7 tr), and telecommunications (\$9.5 tr). These are conservative estimates since they depict only the money needed to maintain current expenditure trends: there are large infrastructural shortfalls, especially in LICs and MICs, indicating that the scale of the investment challenge is potentially much greater than these estimates suggest. Developing countries face the largest needs for investment in infrastructure, especially where many have little access to basic facilities.

ODI (2013) reports that, globally, 768 million people lack access to safe drinking water and that 2.5 billion have no access to improved sanitation facilities; the authors also report that in a business-as-usual (BAU) scenario, about 30% of the world's population will lack access to cooking fuels by 2030, and that 12% have no electricity. These are all relevant to planning development finance in the post-2015 context. The bulk of the costs in infrastructure in the next 40 years will be for transport, particularly road transport, as estimated by McKinsey (2013) and Yepes (2008). The 2013 IEA report predicts that by 2050, non-OECD regions will account for nearly 90% of the increase in travel at the global level, and 85% of additional projected infrastructure, including 90% of new roads worldwide.

As UNTT (2013a) reports, most of the costing methodologies regarding infrastructure rely on engineers' assessments, which vary by country and sector. This raises comparability issues as it is hard to obtain precise global estimates of the overall costs and benefits of developing infrastructure. Although global estimates rely mostly on standard growth projections (McKinsey, 2013) or econometric methodologies (World Bank, 2005), which exhibit the same limitations discussed in the context of the MDGs costing strategies (e.g. relying on historical data and linear predictions), some sector-specific models use scenarios, e.g. in relation to climate change.

An example is the 2013 IEA report, which examines road infrastructure needs by 2050. It looks at different climate-change scenarios associated with different estimations of the necessary maintenance and building costs. For this, the report uses the IEA Mobility Model (MoMo), a global transport model that contains detailed historical data and projections for the transport sector to 2050, including energy and greenhouse gas (GHG) emissions. Two possible scenarios are considered: a 4°C rise in temperature (where the world is heading now, assuming that policies in the pipeline are successfully implemented); and a more optimistic 2°C rise in temperature by 2050 (assuming the implementation of additional policies). The authors emphasise the limitations of their model, particularly data constraints and the fact that it is impossible to introduce the feedback effects of transport infrastructure, such as increased travel. Nevertheless, the scenario-based estimates provide a range of cost estimations to build road infrastructure that is sensitive not only to growth in population and needs, but also to climate change and exogenous shocks based on assumptions about the effect on infrastructural needs in developing countries.

For example, the construction of roads needed in non-OECD economies by 2050 is estimated to require about \$46 tr in the 4°C scenario and \$37 tr in the 2°C scenario. This large difference cannot be captured in methodologies that do not use scenarios to introduce flexibility in setting targets. The costing methodology itself depends on average cost assumptions (i.e. dollars per kilometre of road), specific to broad heterogeneous geographical areas (e.g. 'Middle East', 'Latin America'). The methodology seems close to a standard 'back of an envelope' calculation, with estimations inferred from multiplying a unit cost by projected infrastructural needs.

Sources: as cited

Estimates of the finance needs for a green transition vary, depending on scenarios, but generally point to the need for significant additional financing. The International Energy Agency (IEA) (2012) estimates that a green transition would require cumulative investment in green infrastructure of about \$36–42 tr between 2012 and 2030, which is approximately \$2 tr per year (compared to current annual investment of \$1 tr). For the coming years, and focusing only on the power sector, the IEA projects that \$6.35 tr in total investment will be required from 2010 to 2020 in order to halve energy-related CO₂ emissions by 2050 compared to 2005 levels; and that by 2020 about \$24 tr investment would be required. The World Economic Forum (WEF, 2013) refers to additional, incremental investment needs in clean-energy infrastructure, low-carbon transport, energy efficiency, and forestry of at least \$0.7 tr per year to limit global warming to 2°C. The World Resources Institute (WRI, 2013) indicates that in order to reach the 2°C target developing countries will need \$531 bn yearly until 2050 for additional investments in energy supply and demand technologies. The most recent IPCC (2014) report indicates annual investment needs in low-carbon energy (such as solar, wind and nuclear power) of \$147 bn per year until 2030 in order to meet the 2°C target, but would also require investment in fossil-fuel energy to be cut by \$30 bn per year – resulting in a \$117 bn per year net increase in energy investment. Box 2.3 shows how different assumptions and different scenarios can lead to different estimates of finance needs for sustainable energy. In particular, it shows that assumed future energy demand can result in major variations in finance needs. This suggests the need for current modelling estimates to become more sensitive to the need to incorporate different scenarios and different contexts (e.g. reduced fossil-fuel subsidies free up resources and also reduce the finance needs).

Various estimates have also been produced for **biodiversity finance needs**, sometimes overlapping with climate-change needs, for example in the case of forests. To implement the Convention on Biological Diversity (CBD), the CBD Secretariat (2012) estimates that between \$74 bn and \$192 bn per year is needed, while the High-Level Panel on Global Assessment of Resources for Implementing the (CBD) Strategic Plan for Biodiversity 2011–2020 estimates \$153 bn to \$436 bn per year. The United Nations Forest Forum (2012) estimates that global finance needs for sustainable forestry management alone would be from \$70 bn to \$160 bn per year. The UNDP Global Environment Facility (2012) estimates the finance need for oceans at \$35 bn per year, including reducing nutrient over-enrichment of coastal areas, making shipping more energy-efficient, protecting coastal carbon sinks, reducing unsustainable fishing practices and reducing aquatic species transfer through fouling of ships' hulls.



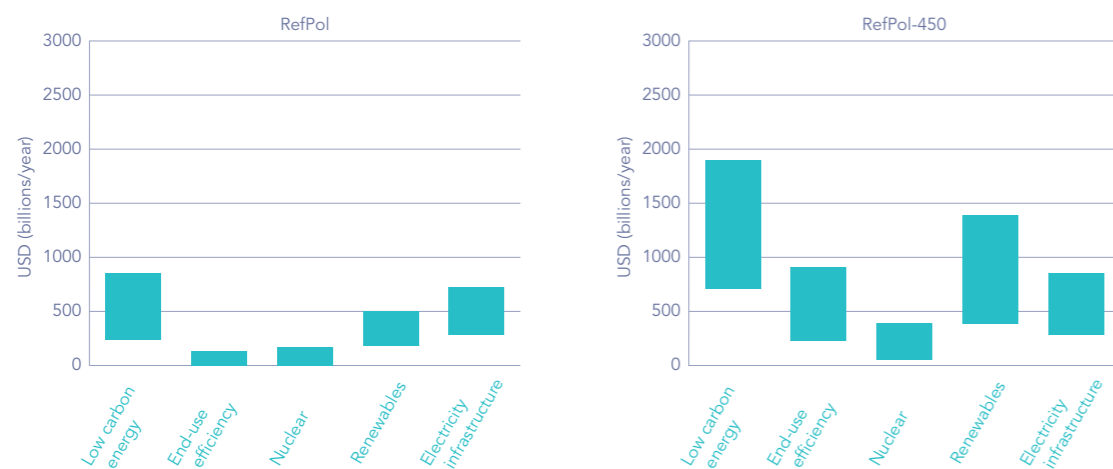
Box 2.3 | Estimating sustainable energy finance needs in different scenarios

In projecting future sustainable energy finance needs, model outputs will produce varying estimates based on the assumptions, parameters and scenarios adopted. Estimates are based on Integrated Assessment Models (IAM) for energy and emissions scenarios, which typically adopt process-based approaches, focusing on the detailed physical processes that cause climate change (van Vuuren, 2007). A range of IAMs, called LIMITS (Low climate Impact scenarios and the implications of required Tight emission control Strategies) models, assess energy investment needs in two scenarios:

- RefPol, which uses current and planned climate policies
- RefPol-450, which adopts climate policies consistent with a 2°C climate target

The energy-investment needs produced by the various LIMITS models (including IMAGE, MESSAGE, REMIND, TIAM-ECN and WITCH) over the 2010–2050 period are presented below (see McCollum et al., 2013). The bars indicate the variation across models (maximum and minimum investment needs). The bar on the left is the sum of the four bars on the right.

Figures 2.3B1 & 2.3B2 | Energy investment needs produced by the various LIMITS models over the time period 2010–2050



Source: McCollum et al. (2013)

These models are based on different assumptions about resources, future energy demand, the substitution of elasticity, and technological parameters – including unit investment costs, efficiencies, growth rates and learning rates. In generating projections they adopt either linear programming algorithms with perfect foresight (i.e. based on a specified policy pathway), a recursive-dynamic framework, or a decision-making algorithm based on agent-based approaches (with assumptions about how agents will react). The use of different assumptions and scenarios leads to large differences in projected energy-investment needs.

For example, low-carbon energy needs is estimated at \$250–600 bn a year in the RefPol scenario and at \$700–1900 bn a year in RefPol-450. Estimates of annual end-use efficiency finance needs range from \$30 bn to \$115 bn (RefPol) or from \$225 bn to \$700 bn (RefPol-450). The lowest projections produced across RefPol and RefPol-450 arise from models that build in greater reductions in energy demand in response to increases in energy prices – with the introduction of policies increasing the share of renewables in energy portfolios, which increases the cost of energy and hence reduces demand and therefore supply-side investment needs. There is also a substantial inter-regional variation in investment needs, projected according to future energy demand and climate policy scenario (RefPol and RefPol-450), based on current infrastructure and the macroeconomic environment.

Sources: McCollum et al. (2013); van Vuuren (2007)

2.3 Finance needs studies: achievements and lessons for financing post-2015 development goals

Studies on finance needs served a clear purpose in relation to efforts to achieve the MDGs, but new thinking is required in order to make a more effective contribution to the debate on finance and implementation in the post-2015 context. Here, we set out what is needed and how this Report engages with this debate. First we discuss the success of the finance needs studies. The MDGs successfully catalysed development efforts in MDG-related sectors, but they were also linked to the increased mobilisation of ODA for developing countries and the allocation of public expenditure to MDG-related sectors. Although it remains difficult to establish causality, we explore positive correlations below (commissioned background paper, Rahman et al., 2015).

2.3.1 The MDG achievement: mobilising aid and influencing public expenditure

The finance needs studies for the MDGs largely met their aims, which were to estimate the scale of the financial constraints facing many countries and to encourage an increase in ODA and assist negotiators in the process (see also Sánchez et al., 2010). The first major success was the 2002 Monterrey Consensus on the financing of the MDGs, with the UN declaring that ‘a substantial increase in ODA and other resources will be required if developing countries are to achieve the internationally agreed development goals’ (UN, 2002).

There is some evidence that the **MDGs helped to mobilise an increase in ODA for the social sectors**, as the global level and composition of aid has changed dramatically since the early 1990s (commissioned background paper; Rahman et al., 2015; Chapter 3). There was a sharp increase in ODA from 2000 and a higher share devoted to

the social sector, in particular social infrastructure and services (more spending on education, health and population programmes, although not on water and sanitation) (ERD, 2013). Rahman et al. (commissioned background paper, 2015) recorded a doubling of ODA disbursed to LICs (in absolute terms) between 1990–2000 and 2000–2010. Some MDGs, notably in relation to HIV/AIDS, have shaped the allocation of ODA (although, according to Fukuda-Parr, the global HIV movement had a prior and independent effect). The increase is not observable in sectors less directly connected to the MDGs. In fact, Fukuda-Parr et al. (2013) find evidence that the MDGs led to distorted priorities. Nonetheless, finance needs studies in relation to the MDGs may have contributed to a rise in ODA for the social sectors overall. Bilateral ODA allocated to these sectors doubled in the 2000–2008 period from about \$20 bn a year to over \$40 bn a year, while spending on productive sectors remained static. At its peak in 2009, social spending accounted for 43% of total ODA commitments (\$45 bn). Although this is not evidence of causation, authors on the topic tend to agree that the MDGs and related cost studies contributed to raising ODA for the social sectors.

Many analyses that examine aggregate ODA (e.g. Alesina and Dollar, 2000; Berthélemy, 2006; Dollar and Levin, 2006) find that aid allocation and effectiveness vary according to the needs of recipient countries as well as donor interests. Thiele et al. (2007) test whether bilateral and multilateral donors prioritised ODA in line with the MDGs, finding that most donors’ sectoral aid composition appears to follow a multidimensional objective rather than narrowly focusing on economic growth. There are some noticeable trends towards greater expenditure per capita on MDG priority sectors, such as health and education (Kenny and Sumner, 2011). The share of government spending on education in developing countries has also increased significantly.



That having been said, the MDGs appear to have influenced the political discourse more than the actual allocation of domestic resources. Manning (2009) examines (a) whether the MDG paradigm has led to increased *attention* to those areas it covers (he suggests: variable, but donors increased aid to basic education); (b) whether increased attention has led to any observable changes in the *allocation of resources or the policy framework* (he finds that the HIPC framework freed up resources for poverty reduction); and (c) whether increased allocation of resources or changes in the policy framework have led to any observable changes in *results* (he argues for a broad interpretation of the MDGs following Wood (2004, 2007)). Wood (2007), in a talk entitled 'Taking the MDGs Seriously but not Literally', argues that, while the MDGs themselves are desirable, the time-bound targets risk setting up distortions, and that 'to avoid bad and/or inefficient outcomes, don't tie individual incentives to the numerical targets – and ensure people never lose sight of the broader goals'. Fukuda-Parr et al. (2013) hold that the application of the targets to country-level planning is problematic from a technical standpoint and that 'the ability to estimate costs and policies necessary to meet the targets was probably overstated from the start'. Rahman et al. (commissioned background paper, 2015) argue that LICs' adoption of the MDGs was reflected in a growing tendency to deal with these issues in policy documents in a more comprehensive and targeted manner, although many of them were already being addressed before the MDGs were adopted.

There is **less evidence on whether finance needs studies and MDGs have affected domestic budget allocation** and domestic policies (although as Chapter 6 argues public resources for education and health have increased). Rahman et al. (commissioned background paper, 2015) find that public expenditure in LICs in MDG-related sectors, such as education and health, has increased significantly as a share of GDP compared to the pre-MDG period. For example, in 2000 the

share of education expenditure was 2.9% of GDP but increased to 4.2% of GDP in 2010; for health, the average share for 1996–2000 was 1.5% of GDP, rising to 2% of GDP in 2001–2012. There was also acceleration of public expenditure in these sectors in most LICs, although the overarching trends conceal significant differences. There was also evidence of increased share of expenditure in LICs on social and environmental protection, albeit based on very small sample sizes due to a lack of data (commissioned background paper; Rahman et al., 2015).

Although there has been less discussion on how the implementation of the MDGs has affected national spending (although ODA obviously tends to be much smaller than national spending), some insights can be obtained from examining the impact of debt relief, which was a fundamental part of the MDG debate (MDG8). The evidence suggests that debt relief allowed some increased expenditure on reducing poverty. Debt relief under the combined heavily-indebted poor country (HIPC) and multilateral debt relief initiatives (MDRI) and from the Paris Club lowered debt-service requirements, which in turn enabled an increase in poverty-oriented expenditure (as mandated by the HIPC framework). For the 36 post-decision point countries, spending on efforts to reduce poverty increased between 2001 and 2012, while debt-service payments declined (Figure 2.1). Figure 2.2 further suggests that the debt relief associated with the MDGs may have helped to increase the proportion of government spending on tackling poverty (as defined in the PRSPs). We have also commissioned a paper on the impact of MDGs on public expenditure in developing countries (see Rahman et al., 2015).

Figure 2.1 | Shifts in government spending in post-HIPC countries (percentage of GDP) 2000–2018

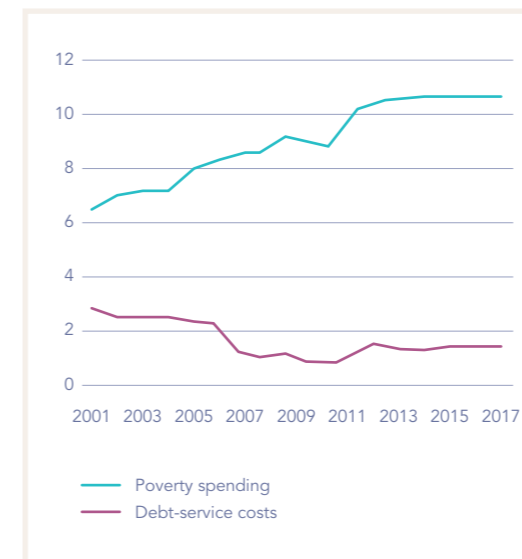
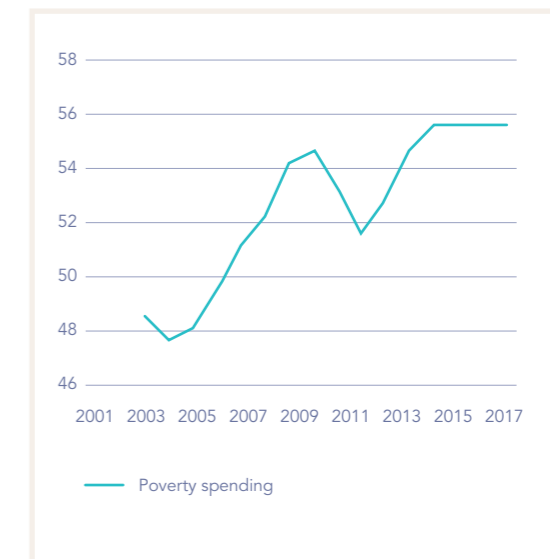


Figure 2.2 | Poverty spending in post-HIPC countries as a percentage of total government spending (percentage of GDP) 2001–2018



Source: IMF (2013). Data refer to government spending in 36 post-HIPC decision-point countries, debt-service costs refer to costs paid up to 2012, and costs due afterwards. Poverty spending is defined in the PRSPs (it includes health and education plus additional items that vary by country, and follows the IMF categorisation used in its regular update: changes over time in the definition affected the 2001–2003 period), and refers to the average over the past three years (so 2010–2012 for data shown in 2012), actuals up to 2012 and thereafter IMF forecasts.

Despite the considerable problems in the underpinning assumptions, finance needs studies have steadily improved. For example, experts suggest a difference between finance needs studies (e.g. by the UN Millennium Project, described in Box 2.1) that established aid requirements by simply adding up estimates per sector, and those studies that modelled different policy options to achieve different outcomes, identifying trade-offs and synergies among the MDGs (e.g. based on MAMS models, discussed above, and in Chapter 4). In estimating finance needs, the former studies may have supported negotiations with donors and multilateral financial institutions in order to ensure adequate DRM (Sánchez et al., 2010), but the latter were better integrated in national policy debates and able to influence the debate on trade-offs and spending

priorities. Further, these studies took into account synergies across the MDGs, and non-linearities in the effectiveness of policy interventions and macroeconomic trade-offs. Recent finance needs studies for reaching infrastructure goals, for example, are more sophisticated and take different scenarios and assumptions into account.

The discussion in this section suggests two important lessons for the future. First, *effective policy signalling or policy coordination attached to the attainment of specific targets can produce tangible effects*; the MDGs' clear focus on poverty reduction has had some impact on budget allocations and channelling of finance to MDG targets. This suggests that a post-2015 development agreement may have important signalling effects.



Second, despite the conceptual challenges, recent modelling studies tend to be more useful either by providing country-level detail (e.g. MAMS modelling, described in Box 2.4) or incorporating details relating to scenarios (infrastructure needs with and without climate change).

2.3.2 Three implications for the post-2015 discussions on finance for development

As stated, although the finance needs studies met the function of mobilising more ODA, while some important lessons have been learned, others have been assimilated only partly or not at all. The discussions on post-2015 FFD will benefit from three intellectual shifts that follow from the review of these studies and are reflected in the approach outlined in Chapter 5. We also discuss how the rest of this Report addresses this new thinking.

(i) From aid as a 'silver bullet' to considering all available sources of finance

While the earlier models on finance needs assumed that ODA would fill any gaps in reaching the MDGs, various recent modelling studies have moved on from the reliance on ODA and provide evidence of the potential of better managed and increased domestic tax revenues as well as private capital flows to contribute to the achievement of the MDGs and their post-2015 successors, the SDGs. While the original MDG needs estimates sought an increase in ODA, more recent analyses emphasise the importance of other means, from increased DRM, following the Accra Agenda for Action (2008), to private capital flows. The OECD (2011) replicates Devarajan et al. (2002) in order to stress the importance and potential of domestic resources and redistributive policies in achieving the MDGs. It acknowledges the simplicity of the approach linking public expenditure to service delivery and social outcomes, but highlights the relative importance of and capacity to mobilise domestic resources as a sustainable way to achieve the MDGs. Recent modelling studies also analyse the potential impact of different scenarios

and policy choices on various outcomes, from poverty reduction to climate-change mitigation (see e.g. Boxes 2.2 and 2.3).

Hence, finance needs studies should highlight how the contribution of a combination of stakeholders selected according to their comparative advantage could reduce the average unit cost of supplying an additional unit of demand. Does each type of finance – DFIs, FDI, private sector, ODA etc. – have a different impact on structural transformation? Is one type of financing more efficient than another in achieving development targets? While the public sector needs to coordinate the provision of public goods, the private sector may play a role in their sustainable use and financing. A combination of stakeholders might be better able to identify targets, with a view to switching from a supply-driven to a demand-driven approach to FFD.

MAMS modelling for Moldova finds that the type of finance used does affect development outcomes (commissioned modelling paper, Kinnunen, 2015; see Box 6.7). Box 2.4 shows a number of simulations using MAMS for a range of developing countries, examining how much public finance would be needed to reach the MDGs and how this varies depending on the source (ODA, foreign borrowing, domestic borrowing and taxation). It thus considers a range of public-finance strategies and examines which flow is more effective rather than just assuming that ODA or other sources of international public finance must and will fill the gap. While these models have the major advantage of attempting to think 'beyond aid', the disadvantages are that they tend not to give adequate consideration to the role of private finance options or policies. Recognising the importance of the need to think 'beyond aid', this Report considers a wide variety of finance sources (see Chapter 3).

Box 2.4 | Different finance options for reaching the MDGs

For some years, the Development Policy and Analysis Division of the Department of Economic and Social Affairs of the United Nations (UN-DESA) has coordinated a range of country analyses in an integrated macro-micro modelling framework including three analytical elements. At its core lies the *Maquette for MDG Simulations* (MAMS), a dynamic recursive computable general equilibrium (CGE) model (see Technical Appendix for a more detailed explanatory note). MAMS was developed from a standard CGE framework and has been improved in various country-specific analyses. Its salient feature is an additional module, which covers the main determinants of MDG achievement through the impact of public expenditure on MDG-related infrastructure and services. MAMS accounts for specific targets for the achievement of UPE (MDG2), the reduction of under-five and maternal mortality (MDG4–5) and increased access to safe water and basic sanitation (MDG7a and 7b). While MAMS constitutes the integral part of the macro-micro modelling framework, the second analytical pillar comprises microeconomic and sectoral analyses of determinants of MDGs' outcomes in the country context, providing an adequate calibration of the MAMS MDG module. The third part of the framework entails micro-simulations for poverty and inequality indicators that allow for an assessment of the poverty-reduction target (MDG1). Therefore, labour-market outcomes of MAMS simulations are imposed on household and survey data to represent the entire distribution of income in the country in question, since economy-wide CGE models such as MAMS usually cover a certain number of representative households.

Taking as a reference the achievement of the MDGs by 2015, the analyses for nine countries from Africa, Asia and the Middle East examine among other things the question of the cost of different financing scenarios to meet the targets. To that end, a baseline (or BAU) scenario serves as a benchmark for each country. The BAU scenario replicates the actual economic performance and the impact of policies implemented during the period between the base year, usually 2005, and 2010, and projects the overall trends until 2015. Although the assumptions underlying the reference scenario necessarily vary by country, the impact of the global financial crisis on GDP growth has been accounted for in most cases.

Building on MAMS estimates for the full achievement of MDGs in 2015, the comparative study provides an assessment of 'additional MDG-related public spending'. The differences between the estimates for total spending on MDG-related public services under the respective financing strategy scenario and the estimate for total spending on MDG-related public services under the BAU baseline scenario are reported in columns 5–8. For the MDG-financing scenarios it is assumed that government spending becomes endogenous, and thus expenditures are increased to meet the defined targets, if they are not already met under the baseline scenario. The resulting fiscal deficits can be financed by through seeking more ODA (column 5), increased domestic or foreign public borrowing (columns 6 and 7) and increased taxation (column 8). For the majority of the countries analysed, the estimates indicate that the additional MDG-related public spending ranges between 5% and 10% of annual GDP. Although countries that would make steady progress on the path towards achieving the MDGs under the BAU scenario, such as Kyrgyzstan or the Philippines, while the former would have completely achieved MDG1 and to a large extent MDG 2 and 7a, they would also need to considerably increase public spending to achieve the entire set of targets.

The financing strategy is of significance for the estimates of required MDG-related spending. Using domestic resources through borrowing or taxation tends to increase the total cost of the respective strategy because of crowding out private spending, although tax financing appears less costly compared to domestic borrowing (except for the Philippines and Egypt, with a pronounced 'consumption-compression' effect of increased taxation). Naturally, not all financing strategies will be universally feasible and the cost implications of different scenarios cannot be the only criterion. Rather, debt sustainability and the feasibility of raising taxation need to be accounted for in addition to cost. By taking a broad view in terms of the feasibility of different financing scenarios, many country studies recommended domestic financing (increasing tax revenues) to avoid debt-sustainability issues (in the case of domestic borrowing) or exchange-rate appreciation (in the case of external borrowing). In some countries, however, domestic taxes cannot be increased rapidly, while in others the large increase in ODA required can pose a great challenge.



Table 2.4B | MDG related public spending as a percentage of annual GDP

	PERCENTAGE ANNUAL GDP (%)					
	Base year	BAU scenario	Additional spending under different financing scenarios			
			Foreign aid	Foreign borrowing	Domestic borrowing	Taxation
Egypt	1.48	1.50	0.26	0.26	0.27	0.28
Kyrgyzstan	5.58	4.88	7.83	7.83	n.a.	8.21
Philippines	2.21	2.00	6.30	6.30	7.17	7.41
Senegal	6.66	7.18	8.04	8.04	n.a.	n.a.
South Africa	5.91	3.07	n.a.	n.a.	n.a.	9.08
Tunisia	5.28	5.09	5.56	5.56	6.10	6.09
Uganda	3.89	4.24	6.73	6.73	9.47	9.21
Uzbekistan	5.94	6.28	n.a.	4.76	4.81	4.62
Yemen	5.37	16.04	10.39	10.39	18.76	17.39

- 1 MDG-related public spending is defined in Sánchez and Vos (2013). For most countries, the year of the simulation is on or around 2005 (2004 for Yemen, 2006 for Kyrgyzstan and the Philippines, and 2007 for Egypt and Uganda).
- 2 Lack of detailed information on all MDG-related public spending in the corresponding sectors as required for the Social Accounting Matrix used, MAMS, may have caused the base-year MDG-related public spending to appear low in some countries, notably Egypt and the Philippines.
- 3 Annual average of the period from base year to 2015, unless otherwise indicated.
- 4 Results are not available (n.a.) for financing scenarios considered unfeasible in the country studies.

Source: Sánchez and Vos (2013)

(ii) Promote joint thinking and implementation of finance and policies

The post-2015 discussions on implementation will need to address finance and policies together.

Finance needs studies are weak at including policy considerations, although some MAMS models have included efficiency of spending or productivity increases. Although model-based discussions have tentatively begun to address the link with policies, the post-2015 framework will need to strengthen the shift in focus from mobilising more finance, to the quality of investment and effective use of existing finance. MAMS modelling commissioned for this Report represents an important step for modelling the role of policies (commissioned modelling papers: Levin 2015a, 2015b; Kinnunen,

2015). Box 2.5 below provides an overview of two of these modelling exercises for Tanzania and Bangladesh, and Box 6.7 includes some findings from the Moldova exercise.

There is a danger that the SDGs in the post-2015 finance context will be considered in isolation from policies, in much the same way as in the follow-up to the 2002 Monterrey Conference on Financing for Development. This finance-based, supply-driven approach is increasingly out of date; indeed, several authors stress the harmful effects of too much finance, pointing to crises and misallocation of resources (e.g. IMF, 2012; Beck, 2013) or the 'Dutch disease' effects of ODA (Rajan and Subramanian, 2009). In some cases, finance is the (main) answer. For example, in a good policy

and business environment, investment might be constrained simply by market failures (e.g. in the case of externalities, public goods, asymmetric information, moral hazard and transaction costs). In such cases, finance might be an appropriate solution. In other cases, however, there is a lack of investment because of weak policies and a weak institutional environment. Recent decades have seen efforts to identify the most binding constraints to growth at the country level – whether finance or other constraints. The growth diagnostics framework (Hausmann et al., 2005) focuses on two key factors behind growth: investment and the cost of financing it.



Box 2.5 | Analysing development goals in Bangladesh and Tanzania using a scenarios analysis of public finance and other policy options

Both Bangladesh and Tanzania are largely on track to meet most MDGs by 2015 apart from MDG2 (100% primary completion rate). Two commissioned modelling studies use the MAMS model to examine how all MDG targets could be reached within an extended time period (2021 and 2025 respectively) (commissioned modelling papers: Levin, 2015a, 2015b). They examine different public finance options and other policy options and find that additional public financing required to meet development goals are not particularly large (in part because of the assumed growth rates) and extended targets could be achieved through domestic tax, increased foreign borrowing (in the case of Bangladesh), ODA, or a reallocation of public spending towards education targets. Moreover, the studies simulate scenarios that go beyond public finance and include more remittances (especially important in Bangladesh), different trade prices, increased FDI, or productivity increases. They show that these non-public finance scenarios could also help to attain development targets, including MDG2.

For Bangladesh, the analysis provides a comparison of the base scenario and alternative financing scenarios for foreign borrowing and tax revenue that increase average expenditure as a share of GDP by approximately one percentage point annually (commissioned modelling paper, Levin, 2015b). In the foreign borrowing scenario this implies that external debt rises from 27% of GDP in 2005 to 37% of GDP in 2021. The alternative tax-financing scenario assumes that the tax-to-GDP ratio is increasing on average by one percentage point annually, with roughly half of the increase from higher income taxes and half due to higher indirect taxes such as value-added tax (VAT). In a third scenario it is assumed that government expenditure is halved and transferred to the primary education sector, while the rest of the public sector retains the same level of spending as a share of GDP. Overall, a combination of reforms including further deepening of tax reforms and reallocation of public spending towards primary education would be important components for a policy strategy towards achievement of development targets in 2021.

The study on Bangladesh also analyses whether additional non-financial shocks (e.g. policy changes) could reduce the revenue requirements identified in the tax-financing scenario in order to achieve MDG2. The impact of an annual productivity increase of 1.5% compared to the baseline scenario across the private sectors (agricultural, industry and the services sector) leads to achieving all MDGs in 2021. Moreover, the financing requirements would be 1.7 percentage points (as a share of GDP) lower than the tax-financing scenario. Thus adding total factor productivity growth to the finance scenarios leads to accelerated progress towards the targets and a further reduction in the resource requirements to achieve MDG2. In fact, the resource requirements would be even less compared to the baseline scenario and are close to the current (2005) spending, which further underlines the importance of policies that complement finance.

In the case of Tanzania the MAMS modelling study uses the end of the country's long-term strategy 'Vision 2025' as the target date for achieving the MDGs (commissioned modelling paper; Levin, 2015a). Comparing the baseline scenario with scenarios that assume ODA and tax financing, additional resources are needed to achieve the MDGs. On average over the whole period (2005–2025) annual ODA disbursements of around 8% of GDP would be required, which is less than actual disbursements. Within an extended timeframe, and a less ambitious agenda, i.e. keeping the same targets, the aid-financing gap would be cleared by a 25% increase in finance compared to the baseline scenario. In addition, the macroeconomic impacts of a tax-financed scenario would lead to slightly lower average growth and hence slower poverty reduction and higher unemployment. This study also analyses whether private-sector productivity increases in agriculture, industry and services could lead to a more ambitious agenda to achieve the MDGs before 2025. Such productivity increases can be induced by complementary policies and involve government intervention to overcome market failures. The simulations assume a 1% annual growth of total factor productivity. The productivity shocks have a stronger impact on overall GDP for larger sectors in terms of GDP share, i.e. for the agriculture and services sector in the case of Tanzania. The study finds that in an agenda that does not necessarily include additional ODA but involves reforms to enhance private-sector productivity, the achievement of the MDGs can be brought significantly closer than in the baseline scenario. The re-allocation of public spending across different categories is another important determinant for achieving the MDGs.

The modelling studies on Bangladesh and Tanzania thus highlight that non-public financing can also contribute to achieving the MDGs within an extended timeframe. Supporting policies that lead to productivity increases in the private sector, attract FDI and remittances and increase export revenues help to reduce additional financing needs and could be a key part of a more ambitious agenda to meet the MDGs.

Sources: commissioned modelling papers by Levin (2015a, 2015b)

But even when finance is a constraining factor, a country may not be able to absorb significant increases. Weak absorptive capacity will lead to diminishing returns to ODA, for instance, and declining marginal impacts of additional finance (e.g. more ODA). **The efficiency of interventions depends on the institutional and policy framework, specific to each country.** Not only might large ODA increases have negative macroeconomic impacts, but they can also be a disincentive to building strong domestic institutions to mobilise resources. There is important literature on the 'Dutch disease' effects of ODA, (e.g. Rajan and Subramanian, 2009), although the effects tend to be lower than for natural resource revenues. Moreover, as Easterly (2003) has highlighted, without the proper capacity, additional ODA might serve to increase consumption and reallocation of public resources rather than bring about a real increase in public investment. Non-productive use of financial inflows can lead to price distortions and indebtedness without any long-term welfare benefits. Weak institutional and policy structures might result in waste, leakage and corruption due to poor planning, and poor resource-management systems, as well as weak transparency and accountability.

In many instances, therefore, in order to be effective, ODA depends on reforms of the institutional and policy framework. Reforms can increase the absorptive capacity and the ability to reduce the amount needed to reach a development target by improving the efficiency of each dollar spent. **There is ample evidence confirming the importance of context for effective finance.** For instance, the impact of Aid for Trade (AfT) is greater in the presence of effective governance and trade strategies in the recipient country and/or an open regime on the part of trading partners (Basnett et al., 2012). Climate finance is less efficient but needed more when countries continue to subsidise fossil fuels and so distort prices. Less expensive water infrastructure is needed when virtual water that

is embodied in agricultural products is imported (ERD, 2011/2012). Bruns et al. (2003) find that finance is not a sufficient condition for improving completion rates since other factors are also important, such as low unit costs (e.g. teachers' salaries) and the efficacy of education systems.

The World Bank (2013) argues that the cost of achieving any development goal depends on how efficiently it is pursued, taking into account the quality of underlying policies and practices. For example, the shortfall in infrastructure in developing economies was estimated at \$1 tr per year until 2020, with an additional \$200 bn to \$300 bn per year required to ensure green infrastructure. These costs could be reduced by making more efficient use of existing infrastructure and by improving project quality and management. A range of practical steps can often boost the productivity of infrastructure by 60%, thereby lowering necessary spending by 40% (World Bank 2013). The importance of policy context of financing infrastructure is discussed in detail in Chapter 6.

While these issues have begun to influence the post-2015 discussions on FFD, more work is required. For example, the World Bank (2013: 17) cites post-2015 UN proceedings which underline 'the pitfalls of trying to assess financing at the recipient country level from a "needs" approach without also considering policy changes, institutional improvements, and other parts of the development strategy. Instead, financing must be understood as one component of a strategy that includes private sector efficiency and public sector efficiency and public sector productivity improvements'. Efforts to achieve the MDGs focused on public finance on the assumption that private investment would follow. The successors to the MDGs are likely to focus more on public-private interaction (e.g. Public-Private Partnerships (PPPs)), domestic and global policies to stimulate private investment, institutions, capacity, and so forth, in addition to considering the role of ODA. The World Bank (2013) and



UNTT (2013b) have begun to focus on new ways to mobilise the private sector. The recent ICESDF report lists a range of principles for the effective use of finance.

(iii) Understanding the links between structural transformation and poverty reduction

The focus of the MDGs on social development supported a move towards achieving development outcomes beyond economic growth or long-term development efforts. This led to difficulties when it was assumed that ODA could address current poverty by providing finance to the social sector and failed to take into account the challenges in linking ODA to the attainment of social objectives. Moreover, achieving social progress in the long run is dependent on structural transformation, which includes a combination of economic transformation (UNECA, 2014; IMF, 2014), reductions in carbon intensity and preserving natural capital, the eradication of poverty and a reduction in inequality.

While there have been some changes in thinking (e.g. on finance needs) achieved by seeing the issue through the lens of the aid-growth-governance nexus, almost all existing models on the MDGs (regardless of whether they include policies) are based on static economies in which the technological parameters of the underlying economic models are fixed. This begs the question of their relevance to achieving structural transformation, which is based on the assumption of the need for technological progress and hence a change in the parameters. The UNTT (2012, Annex 2) acknowledges that ‘in the global debate, **the MDGs led to overemphasising financial resource gaps to the detriment of attention for institutional building and structural transformation**’, which are longer-term challenges.

Previous models were designed to assess the finance needed to meet the MDGs, some of which were expressed in tangible targets (e.g.

the construction of schools), and for which it was possible to conduct a cost analysis (taking into account the caveats previously mentioned). How could the same models inform environmental sustainability and structural transformation, which are essentially dynamic processes? Structural transformation calls for changes in technology and in resource allocation, with consequent spillovers throughout the economy, not for static technologies and structures. But such developments are not immediate and depend on capacity-building and fundamental changes in the way the economy, institutions and society are organised. **Finance could facilitate these long-term changes.**

Here we might learn from the modelling exercises that examine what it takes to achieve a green-energy shift. Cost estimates for the adoption of green energy depend on the cost reduction associated with specific technological learning curves as well as other savings (e.g. lower energy consumption; see Box 2.3 for a description of modelling studies and their findings). Thus, the investment requirement for a low-carbon energy transition should not be equated with its costs (German Advisory Council on Global Change, 2011: 158). Additional investments can also be offset by savings on fossil fuels. Furthermore, when climate models are linked with economic models (‘integrated assessment models’), global GDP can be estimated with and without climate-related policies, the difference reflecting the cost of mitigation policies. The results of integrated assessment models depend strongly on the underlying assumptions with regard to technological development, with endogenous technological change leading to lower cost. This does not take into account any potential co-benefits through employment creation and poverty reduction, which can possibly be reflected in appropriately designed models.

This Report contributes to the intellectual shift required for the implementation of a post-2015 development agenda. Chapter 3 discusses trends

in a **range of sources of finance available to countries** and Chapter 4 includes a general review of the link between policies and finance on the basis of econometric studies, **contributing to the intellectual shift towards considering policies (beyond finance)**. Chapter 5 provides a conceptual framework for thinking about the links between finance and policies aimed at the **enablers** of sustainable development. Chapter 6 provides new evidence on the links between policies and finance for different enablers, seeking to provide as much detail as possible while still drawing out general lessons. The aim is to construct an alternative vision of post-2015 finance for development to the earlier studies on the costs of and finance needs for achieving the MDGs.

CHAPTER 3.

Financing trends and challenges beyond 2015

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3

Main Messages

Since the 2002 Monterrey Consensus, FFD options have changed dramatically by country income grouping, by income levels and over time. The main messages arising from the review of the financing trends and challenges over the past decade are:

- ▶ **Domestic public resources** have grown rapidly and are the largest source of finance for all country income groupings. Given their significant volumes and public goods orientation, expanding domestic public resources further will be critical to achieve the SDGs. A particular focus needs to be placed on the challenges facing low income countries (LICs) and some lower middle-income countries (LMICs), with action also required internationally to ensure the international financial system is effectively supporting these efforts.
- ▶ **International public finance** has also increased but is declining in relative importance. ODA and other forms of international public finance such as SSC remain important sources of financing for most LICs and some LMICs, and can play a critical role. It is therefore important to maintain high ambitions regarding these sources in the post-2015 FFD agenda in terms of their quantity, effectiveness and strategic focus.
- ▶ **Domestic private finance** has shown the fastest growth, but is still much lower (as a percentage of GDP) in LICs than in lower middle-income countries (LMICs) and upper middle-income countries (UMICs), with rapid transformations continuing. **International private finance** has been highly volatile compared to the other flows. There are significant opportunities to expand **private sources of finance**, given their importance to promoting investment, job creation, infrastructure and technological development. Again, the poorest countries face the most significant challenges, including how to attract such finance and in managing volatility.



This chapter describes the changes in finance options in real (volume) terms relative to income, by country income group, level of income and over time (2000–2011). It is structured as follows. Section 3.1 classifies the main financial flows in four categories: domestic and international, public and private. It reviews the basic characteristics of each in order to understand its role in supporting development, and suggests that flows are not substitutable, as Griffith et al. (2014) also conclude. Section 3.2 describes the main historical trends by flow and by country income group (and by individual country, shown in Annex 2). It provides data suggesting that non-ODA flows have grown in relative terms. Section 3.3 examines the future prospects of these flows and Section 3.4 draws out the conclusions.

3.1 Classifying flows of finance

This Report uses a broad definition of finance in relation to the post-2015 development agenda, beyond finance for which achieving development goals is the main explicit purpose, in order to analyse trends across all public and private sources of financing relevant to developing countries. This approach is consistent with the shift of the post-2015 FFD agenda identified in Chapter 2, away from a focus on ODA for achieving the MDGs, towards a broader approach that recognises the contribution that all forms of financing can make to the enablers of sustainable development.

Table 3.1 sets out the four main categories of finance covered in this Report, although they do not represent the full range of sources of financing that are relevant to each category. Where appropriate, we identify relevant financing sources that are not addressed in this chapter and the limitations this implies for the analysis. Note that these flows refer to financial flows (e.g. tax revenues in a given year) and not the stock, or accumulation of flows (e.g. the level of public debt).

There are recognised limitations to the analysis of these sources:

- ▶ Domestic public finance – lack of sufficient cross-country data to explore trends in tax revenues before 2002 and some notable gaps in reporting even for the 2002–2011 period.
- ▶ International public finance – focuses on flows reported to the OECD Development Assistance Committee (DAC), which includes ODA reported by OECD DAC members and an increasing number of non-OECD donors. However, it excludes Brazil, China and India, which provide the vast majority of ODA-equivalent finance in the form of SSC. The analysis of OOF also focuses on trends reported to the OECD DAC, which excludes most South–South OOF, on which there is little detailed reporting.

Table 3.1 | Categories of financial flows

CATEGORY	SOURCES
Domestic public finance	Tax and other public revenues, Domestic debt
International public finance	ODA, Other Official Flows (OOF) and SSC
Domestic private finance	Gross fixed capital formation (excluding FDI) by private sector, private credit provided by domestic banks, market capitalisation
International private finance	International, private transfers (private development assistance (PDA), remittances), FDI and other international private capital flows (bank lending and equity and bond portfolio flows)

- ▶ Domestic private finance – our analysis examines trends in gross fixed capital formation by the private sector, excluding FDI, but we do not know whether this investment was financed domestically or whether domestic finance was used for FDI. Hence, we also discuss private-sector access to domestic credit and stock-market capitalisation, both of which are stock (not flow) variables.
- ▶ International private finance – remittances are thought to be significantly under-reported worldwide in view of the large volume of informal transactions that are not captured by existing reporting systems and analysis; in addition, major discrepancies in the reporting of remittances between source and destination countries affect the accuracy of current estimates. Remittance outflows from LICs are very small. Data on FDI inflows are widely reported, but FDI outflows are under-reported, although tend to be small at low-income levels. Private development assistance (PDA) includes financial support from private agencies such as NGOs, foundations and corporations; but due to limitations in official reporting (especially with regard to geographical coverage) it is difficult to assess the full extent of PDA and to distinguish what additional resources are mobilised beyond channelling ODA. For this reason, the section on ODA only offers a basic and tentative summary of PDA.

The four categories of flows have different characteristics. This means that they are unlikely to be perfect substitutes for each other, but may have elements of substitution and complementarity. It is important to understand such characteristics in order to appreciate the role that each source can play in assisting countries to develop sustainable development enablers, and how they can be best mobilised and managed in order to make the most effective use of finance in the post-2015 context. These empirical characteristics do not prescribe specific roles for public or private actors.

We describe the following characteristics of finance flows:

- ▶ Basic identifying characteristics – main actors involved and who manages the finance (demand and supply)
- ▶ Purpose characteristics – motivations for the finance and sectors in which it is focused
- ▶ Resourcing characteristics – concessionality and servicing costs, volatility and cyclical
- ▶ Broader effectiveness characteristics – channels of development impact; ownership, transparency and accountability

We summarise these characteristics in Table 3.2 and describe them further below.



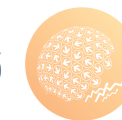
Table 3.2 | Selected characteristics of different sources of finance

	MAIN ACTORS INVOLVED WHO MANAGES	MOTIVATIONS	SECTOR FOCUS
Domestic public flows			
Tax and other public revenues	Raised mainly from domestic transactions (income and consumption), but also from corporate tax, international trade taxes and royalties from resource extraction	Strong focus on public goods and welfare, but also other drivers of resource use (equity, efficiency, growth)	For most developing countries public revenues are the most significant resource for funding national development priorities
Domestic debt	Government borrowing from international and domestic sources	Strong focus on public goods	Mainly used for investments in infrastructure and other economic-related sectors
International public sources			
ODA	Provided mainly by governments and government-owned development finance institutions Managed by a variety of actors (in order of significance) including governments, private contractors and NGOs	OECD/DAC regulations require ODA to be focused on 'the promotion of the economic development and welfare' (OECD, 2014b)	Social and administrative infrastructure (e.g. health, education, water) 37.7%; economic infrastructure 17.2%; humanitarian 8.9%; production 7.6% (OECD, 2014b – % of total bilateral ODA commitments 2011); around 20% of ODA is concessional loans, which are predominantly focused on productive (<50%) and social (30%) sectors (DI, 2013b)
OOF	Provided by a range of bodies, including export credit agencies, government-owned/-directed development finance institutions, multilateral development banks, DFIs Managed largely by private sector, but also by governments	Export credits largely motivated by providers' economic interests; in general OOF more commercially oriented, but with public good/development characteristics	Infrastructure (32.1%), banking and business (14%), industry and trade (13.1%), governance and security (6.6%), water and sanitation (5.8%); Education (3.5%), Health (3.2%) (DI, 2013a – % of total 2011)
SSC	Provided mainly by governments and government-owned/-directed institutions (e.g. development banks) Managed largely by governments, but also by private sector and NGOs	'South-South cooperation is based on the central idea of solidarity and engaging the countries involved in a mutually-beneficial relationship that promotes self-reliance' (RIS/ UNDESA/MEA-I, 2013)	Focused more than ODA on infrastructure and productive sectors (UNDESA, 2008)
Domestic private finance			
Investment by private enterprises	Private enterprises, investing retained profits or finance from other sources	Profit-oriented; often investment for the long run	Varies significantly across countries
Domestic bank lending	Provided by domestic financial institutions to domestic private sector	Profit-oriented, if not development-oriented in case of domestic development banks	Varies significantly across countries
Stock markets	Financing from individuals and institutional investors channelled to listed companies	Profit-oriented	Varies significantly across countries

International private finance			
FDI	Provided and managed mainly by private companies with the aim of acquiring a long-term stake in a company in another country	Profit-oriented; often long-term investment	Varies significantly across countries. Infrastructure (30.1%), other industry and trade (20.9%), metals, chemicals and other physical sciences (17.3%), agriculture (5.8%), healthcare and life sciences (1.5%) (DI, 2013a – % of FDI to developing countries, 2011)
Portfolio equity flows	Provided mainly by institutional investors and investment funds, but also banks. Managed by the private sector	Profit-oriented; often of a short-term nature	Varies significantly across countries
Commercial loans	Provided by banks 75% of long-term loans to developing countries taken on by private institutions (DI, 2013a)	Profit-oriented, short or long term (but maturity in LICs often under 5 years)	Varies significantly across countries
PDA	Provided by NGOs, foundations, faith-based organisations and corporations Managed mainly by non-state actors, e.g. NGOs and private sector	Charitable aims (e.g. welfare, social services and rights issues, but also some sector development)	For corporate assistance humanitarian, health and education dominate; for foundations health is by the largest sector (around 66% of total); for NGOs it is health and social services (DI, 2013a – data for 2011)
Remittances	Provided by family members	To support families in home country (e.g. through financing health, education, housing or business)	Used for a wide range of household consumption and investment activities (OECD, 2005 – are remittances aiding development)

Actors and purpose characteristics: Table 3.2 suggests, first, that government revenues, PDA and ODA are focused more directly on the social sectors than are other sources and therefore contribute more directly to social development. Commercially oriented flows focus more on certain types of infrastructure, the productive sector, financial sector and cooperation with the private sector, and so are more directly relevant to economic development. In principle, different flows are often intended to make a distinct direct contribution.

Concessional and servicing costs: The finance flows differ in their levels of concessionality and therefore their servicing costs. In addition to public finance, the most concessional forms of financing are ODA grants, which by definition incur no servicing costs (although there are significant implementation costs). Over 80% of gross ODA is provided in the form of grants (although this has fallen moderately in recent years), as is most PDA.



Various other financing sources are considered concessional but incur some servicing costs. These are predominantly loans provided at below market rates of interest, and with longer maturities. Other financial assistance provided at concessional rates includes ODA loans, a significant proportion of OOF and some elements of PDA.

Commercial finance – domestic credit and foreign lending – is non-concessional and incurs the most significant servicing costs. Given their levels of revenue and growth, developing countries have to be especially careful about the commercial debt or financial obligations they incur in order to ensure these are sustainable. Inward FDI can also lead to outflows when it finances projects that produce large sales and profits that can be repatriated.

Channels of development impact: A full assessment of the development impact and significance of these sources of financing is beyond the scope of this chapter. Here we discuss broad ways in which these flows tend to have an impact on development. First, due to their more intensive focus on social sectors – such as health and education – as well as their stronger welfare and public-good orientation, sources such as public revenues, ODA and PDA are likely to have a greater direct impact on these priorities and their associated impacts. Such outcomes are by no means guaranteed, however, as a range of complementary factors need to be in place to ensure that they achieve maximum impact. This is discussed in more detail in Chapter 4, but these factors include accountability relating to the use of resources and the effectiveness of their management.

It is also important to recognise that more commercially oriented sources of finance can contribute to social development and welfare outcomes, both directly and indirectly. These sources are important for developing infrastructure, helping to strengthen the financial sector, creating jobs, improving productivity, increasing economic growth and mobilising

tax revenues, all of which are vital to sustaining development progress.

There is no guarantee of such impacts, however. The commercial orientation of these flows means that they can bypass those with the least disposable income unless they are mobilised, used and managed well and market failures are addressed. These flows can also in some circumstances bypass local economies (e.g. investments in enclave sectors or economic zones) or lead to the exploitation of a country's natural and financial resources (e.g. by causing pollution and via illicit financial flows).

Volatility and cyclical: Among the most significant challenges relating to the ability of developing countries to use finance relate to its volatility and cyclical. Volatility refers to the degree to which financial flows change over time. Cyclical refers to patterns by which these flows rise and fall and relate to economic cycles. Flows are pro-cyclical when they are positively correlated with economic growth cycles in the source country,⁴ and counter-cyclical when they are negatively correlated with economic growth cycles in the source country.

The volatility of finance has important implications for its effectiveness in contributing to sustainable development. Volatile financial flows to developing countries can contribute to a range of difficulties, including macroeconomic disruptions in relation to trade, exchange rates and inflation, as well as financial and economic instability and crises (Massa, 2013; Griffith-Jones, 2013), all which can undermine growth prospects. In addition, the volatility of finance that is focused on the social sector, such as domestic revenues and ODA, pose challenges for effectively planning and disbursing government budgets and can also undermine their impact on economic growth (Kharas, 2008).

The cyclical of finance flows also plays a role in influencing economic stability and growth. Where flows of finance are counter-cyclical, they can help

to protect countries from the effects of economic downturns and crises. In contrast, where they are pro-cyclical, they can either exacerbate the effects of economic downturns and crises, or dampen those of economic upturns and booms.

Volatility is relevant in some way to all sources of finance, but as Table 3.3 shows it is most relevant to private sources, especially portfolio equity and commercial loans, while FDI is less volatile as it is generally a longer-term form of investment

(Tyson et al., 2014). Table 3.3 also suggests that domestic private capital sources are subject to higher levels of volatility than public sources, but that these are less volatile than international private sources. Among forms of public finance, international public sources are more volatile than domestic public sources. The volatility of ODA has significantly reduced its real value (Kharas, 2008).

Table 3.3 | Volatility by flow (as a percentage of GDP) and by country income group (1995–2011)

	DOMESTIC PRIVATE	DOMESTIC PUBLIC	INTERNATIONAL PRIVATE	INTERNATIONAL PUBLIC
LIC	0.03	0.06	0.13	0.10
LMIC	0.06	0.05	0.22	0.30
UMIC	0.15	0.05	0.22	0.26

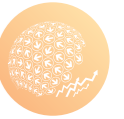
Source: data used in this chapter.

Note: annual volatility measured by coefficient of variation (the ratio of the standard deviation to the mean) based on flow levels as a percentage of GDP.

All forms financing are pro-cyclical to some degree since they cannot be sustained indefinitely in the face of economic contraction. Private financing sources (especially portfolio flows and commercial loans) are the most pro-cyclical, as was seen during the 2007–2008 global financial crisis. International public sources of finance are also subject to notable levels of cyclical, although in both cases this effect tends to be felt after a time lag (Hallet, 2009; te Velde et al., 2011), and recent trends suggest that it is more relevant to ODA grants than to loans (OECD, 2013). Domestic public sources can also fluctuate quite significantly and have counter-cyclical effects, especially for countries producing commodities that are subject to price fluctuations (Guerineau and Erhart, 2011) and for economies more closely linked to the global economy.

Ownership, transparency and accountability: Developing countries have more ownership of their domestic revenues than of other sources of finance, but it is not always clear how far this stretches beyond the government to citizens. Such issues relate directly to questions about the transparency of and accountability for public resources. The 2012 Open Budget Survey reports that while only 25 of the 100 countries surveyed were judged to have published significant budget information, a similar proportion provided little or none. It also found 'that most countries currently provide few opportunities for public engagement' in relation to budgets (IBP, 2012).

⁴ In the case of public revenues the developing country is the source country.



There remain several challenges relating to the ownership, transparency and accountability of international public resources, such as ODA, SSC and PDA. Since 2005, efforts to reform aid have focused on strengthening ownership by the recipient government following intense criticism of practices such as conditionality, by which donors make their aid conditional on the adoption of specific policies or procedures. Although one review found there had been some progress (OECD, 2011), it is far from clear that aid relationships have undergone fundamental change. There have been significant efforts to improve transparency of ODA through the International Aid Transparency Initiative (IATI), to which the vast majority of donors are now signatories and are beginning to observe.

Some of the most significant challenges relating to ownership, transparency and accountability apply to private finance. Governments in developing countries have generally limited powers to direct and regulate such sources, which are by definition driven by private interests. Often there is little official reporting and monitoring of international private flows (although the IMF, World Bank, the Bank for International Settlements and the Institute for International Finance (IFF) provide some data), and some relevant regulatory regimes are voluntary and have only weak enforcement mechanisms. Recent research on 20,000 companies found that 75% report no data on their sustainability practices (STC, 2014).

It is thus clear that the four categories of finance (and sub-categories) used in this Report have different characteristics: they have different motivations, different intended effects, different levels of volatility and sector focus, and different degrees of ownership and transparency. We therefore need to analyse the different flows in different ways.

Before we describe the evolution of finance flows, we explain the country income groupings used in this Report:

- ▶ World Bank's country income per capita classifications (defined in 2012): Low-income Countries (LICs) (annual per capita income below \$1,036), Lower Middle-income Countries (LMICs) (annual income per capita between \$1,036 and \$4,085) and Upper Middle-income Countries (UMICs) (annual income per capita between \$4,086 and \$12,615)
- ▶ Fragile states: we examine development financing trends experienced by the 36 countries which the World Bank classifies as experiencing 'fragile and conflict affected situations' (World Bank, 2014)
- ▶ FDI: we disaggregate the data for resource-rich and non-resource-rich countries, using the IMF listing (IMF, 2012a)

With regard to ODA and OOF we distinguish between static membership of these country groupings over time (i.e. looking at historical trends in the current membership) and a dynamic membership (i.e. looking at historical trends for countries in these groupings each year). The technicalities of and justifications for using both of these approaches for analysing ODA and OOF allocations are discussed in Box 3.4.

3.2 Historical trends in sources of finance

This section explores historical trends in sources of finance across the country income groups commonly used to categorise developing countries. It adds to similar recent research (e.g. EC, 2013; OECD, 2013) by disaggregating sources of finance, looking at long-term trends over the period 1995–2012 and presenting statistical

analyses illustrating the relationship between individual categories of financial flow and country income levels.

The analysis shows that there have been significant changes in finance flows since the 2002 Monterrey Conference, including some positive trends but also some major challenges still to be addressed. Overall resources have increased substantially, with domestic tax revenues representing the largest category and domestic investment growing the fastest; international public finance has also grown significantly, although its relative importance in volume terms is declining. Major challenges are also still apparent, with tax-to-GDP ratios still very low in LICs, while private finance is volatile and selective, often bypassing the poorest countries, as does international public finance. Section 3.2.1 presents an overview of trends in the finance mobilised by developing countries over the 2002–2011 period.⁵ Section 3.2.2 examines finance by country groupings and levels of income and Section 3.2.3 by category. Annex 2 illustrates significant variation of flows across individual countries.

3.2.1 Overall finance trends

Figure 3.1 presents trends in domestic public revenue, net ODA and OOF,⁶ domestic private investment, remittances and international private capital (expressed in 2011 US dollars) mobilised by developing countries between 2002 and 2011.⁷ It shows that in real terms (2011 prices) they have obtained significant levels of additional resources over this period:⁸

- ▶ Domestic public revenues (tax and non-tax) increased by 272%, from \$1,484 bn in 2002 to \$5,523 bn in 2011
- ▶ International public finance (net ODA and OOF) increased by 114%, from \$75 bn in 2002 to \$161 bn in 2011

- ▶ Domestic private finance (measured as Gross Fixed Capital Formation, less FDI) increased by 415%, from \$725 bn in 2002 to \$3,734 bn in 2011

- ▶ International private finance (net FDI inflows, portfolio equity and bonds, commercial loans and remittances) increased by 297%, from \$320 bn in 2002 to \$1,269 bn in 2011

Domestic public sources of finance have been the most significant and have grown rapidly over the period. The growth in tax and non-tax public revenues has outpaced that of international public finance (ODA and OOF), which were equivalent to 5% of domestic revenues across all developing countries in 2002, falling to 3% by 2011. The OECD (2014c) reports that ODA reached a record level of \$135 bn in 2013.

Private finance has also been a significant source for developing countries over the period, with domestic finance generally more important than international finance. In 2011 international private capital flows to developing countries were equivalent to 33% of domestic private investment. This figure had fallen from just over 60% in the period immediately before the 2007–2008 global financial crisis, during and immediately following which international capital flows fell sharply.

For the most part, growth in the sources of finance obtained by developing countries was only moderately affected by global financial crisis and recovered quickly. Domestic public finance fell in 2009, before rising above 2008 levels by 2010 and continuing to grow. Inflows of international private capital fell sharply in 2008 and 2009, before rising again to exceed 2007 levels by 2011. Levels of ODA and OOF combined continued to increase until 2010, but fell by around 10% between 2010 and 2012, followed by a real increase of 6% in 2013. Domestic private finance rose steadily from 2002 to 2011.

⁵ This period is chosen because there is sufficient data on domestic revenue; for the analysis of trends for each source of finance the period 1995–2012 is generally covered.

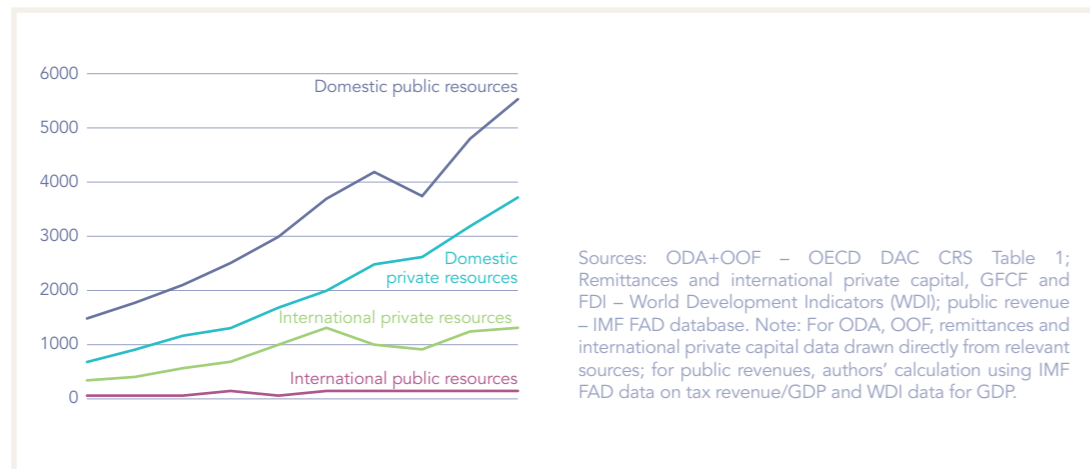
⁶ Focusing only on flows attributable to individual developing countries.

⁷ There is insufficient data on PDA and SSC trends to include in this overview analysis.

⁸ The total volume for such sources has increased by 314%, from \$2.6 bn in 1995 to \$10.8 bn in 2011.



Figure 3.1 | Trends in development finance (domestic public, domestic private, international private, and international public sources) obtained by developing countries (2011 \$ bn), 2002–2011



3.2.2 Finance trends by country income group

This section discusses the evolution of finance flows for each of the income country groupings, analysing their absolute levels in real terms (2011 dollars) and their levels as a proportion of GDP. Domestic public resources have been the most significant source of financing for all the country income groups (especially LMICs and UMICs), immediately followed by domestic private sources. The findings also show the impressive growth in international private sources, with international public sources being the most modest but still of major significance for LICs. Finally, despite significant growth in development finance in LICs, it is dwarfed by the levels in MICs (especially UMICs).

Figures 3.2 and 3.3 illustrate that for the current LICs, in absolute terms there have been similar levels of strong sustained growth across all four categories. The most significant source of financing for LICs throughout the period 2002–2011 was domestic public revenue, which more than doubled from an estimated \$29 bn in 2002 to \$60 bn in 2011. This rise was achieved largely through economic expansion rather than improved

tax efforts, as the average LIC increased its levels of domestic public revenue only modestly over the period. International private finance grew at the fastest rate (from a low base, with the very significant contribution made by remittances), and reached levels equivalent to domestic private finance by 2011. International public finance saw the most modest growth, but more than doubled from \$15bn in 2002 to \$39bn in 2011, and remains a significant source for LICs.

For the current group of LMICs and UMICs, Figures 3.4–3.7 illustrate the sharp growth in domestic public revenue and domestic private investment over the period 2002–2011. These were by far the most significant source for these countries, although both sources remained at similar levels in 2011 for LMICs (just over \$8–900 bn), whereas for UMICs domestic public resources were more dominant. International private capital grew significantly from relatively modest levels in the early 2000s, to reach \$366 bn and \$918 bn in LMICs and UMICs respectively in 2011. In contrast to the other sources, international public finance levels were very modest for the current group of LMICs and UMICs, although ODA increased slightly in absolute levels in recent years.

Figure 3.2 | Trends in development finance obtained by LICs (2011 \$ bn), 2002–2011

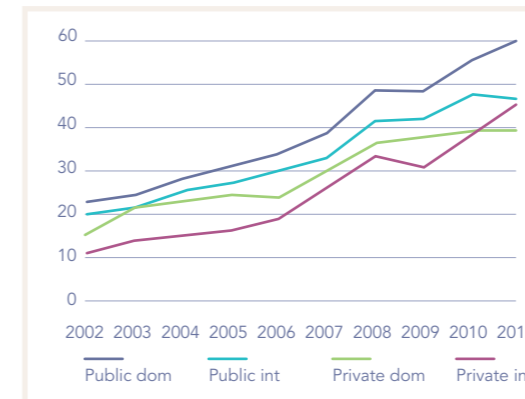


Figure 3.3 | Trends in development finance obtained by LICs (% GDP), 2002–2011

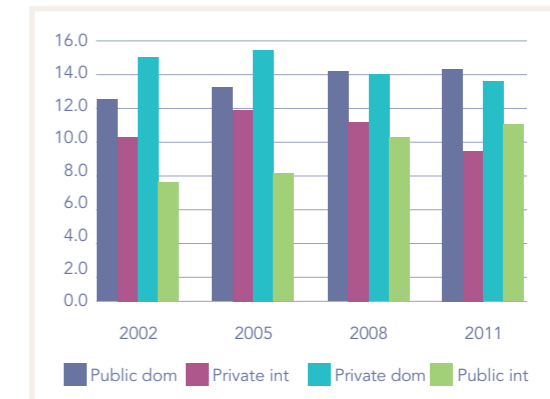


Figure 3.4 | Trends in development finance obtained by LMICs (2011 \$ bn), 2002–2011

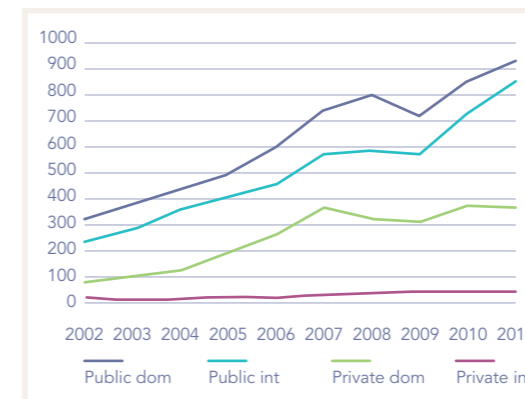


Figure 3.5 | Trends in development finance obtained by LMICs (% GDP), 2002–2011

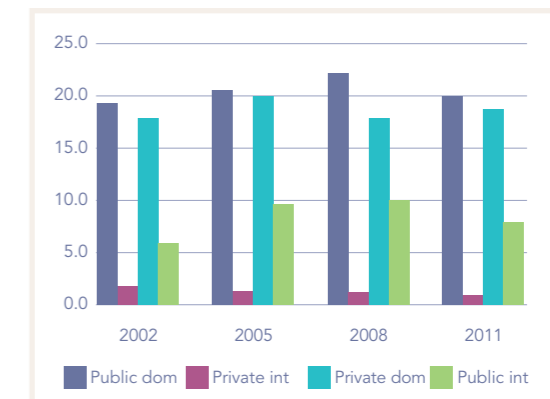


Figure 3.6 | Trends in development finance obtained by LMICs (2011 \$ bn), 2002–2011

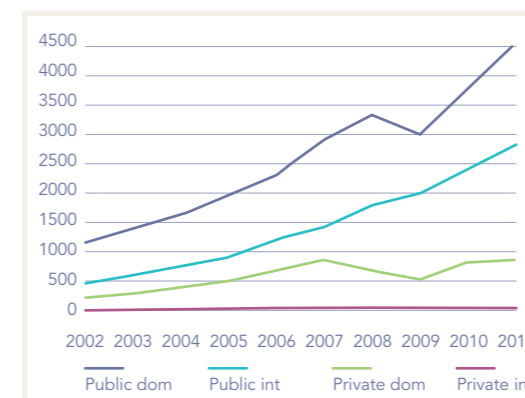
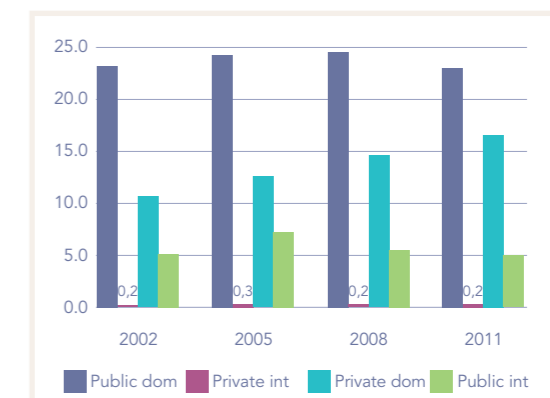


Figure 3.7 | Trends in development finance obtained by LMICs (% GDP), 2002–2011



Sources: ODA+OOF – OECD DAC CRS table 1; remittances and international private capital - World Development Indicators (WDI); tax revenue - IMF FAD database. Note: Absolute data on remittances and tax revenue figures based on applying the weighted average ratio to GDP for countries with data to total GDP levels for each country income group (i.e. projecting data for countries not reporting) because of significant missing data across countries; for all variables share of GDP data is based on weighted averages.



It is also useful to examine the importance of these flows by level of income. Figure 3.8 shows how the main types of finance flows to developing countries have varied by levels of income (based on annual data covering the period 1980–2012). It illustrates that ODA as a share of GNI begins to decrease sharply at very low levels of income, with tax revenues outstripping ODA by the time GDP per capita reaches \$500. In addition, the decline in the ODA-to-GNI ratio as income increases is sharper than the increase in the tax-to-GDP ratio. As a result developing countries experience falling levels of total public revenue as a share of GDP as incomes increase beyond low levels. This means that some countries at very modest levels of GDP per capita may struggle to increase their absolute levels of public financing.

Figure 3.8 also illustrates how private finance generally becomes more significant as country incomes rise. Domestic private finance (measured by gross fixed capital formation by the private sector minus FDI) increases as incomes rise, and exceeds ODA at income per capita of \$1,000–\$2,000. Remittances and FDI exceed ODA at income per capita of \$2,000–\$3,000, albeit at more modest levels as a share of GDP than domestic private investment.

A similar analysis for debt-to-GDP ratios (using data after 2007 - see figure 3.9) suggests it is increasing for countries from the LIC to MIC graduation point so that some public spending is financed through (external) debt around this point. This can pose challenges when debt is not managed well.

Figure 3.10 plots trends in tax revenues plus ODA alongside those for capital formation by the private sector. It illustrates that public finance dominates private finance in developing countries at nearly all levels of income. These trends have important implications for the post-2015 debate on FFD. Public flows (including ODA at low levels of income – see Figure 3.8) are critical sources of finance for all developing countries, but private investment assumes more importance at higher levels of income. This is a key finding of this chapter.

Figure 3.8 | Financial flows (percentage of GDP) by income level

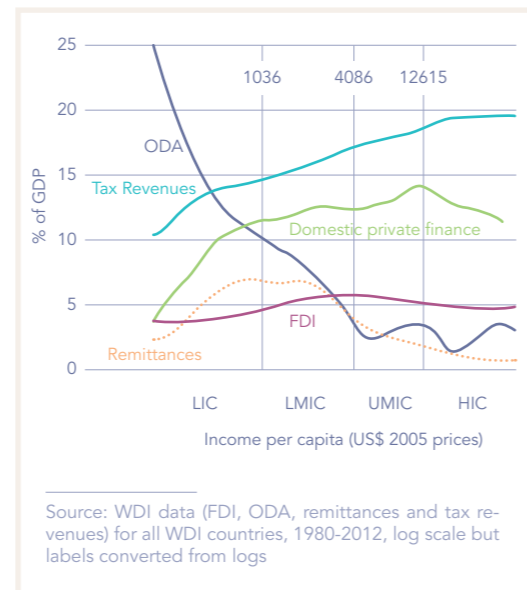


Figure 3.9 | External debt (percentage of GDP) by country income level

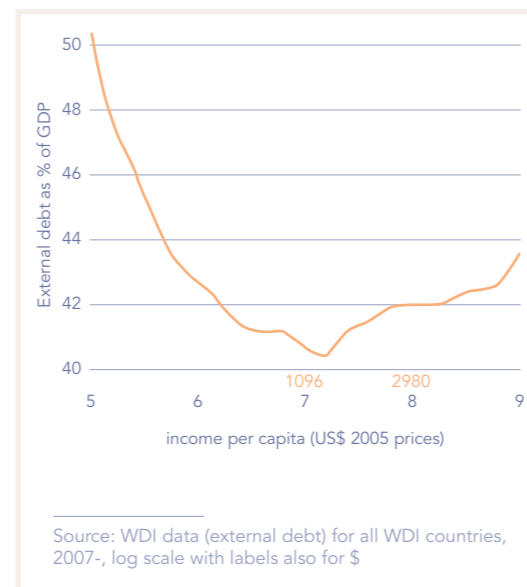
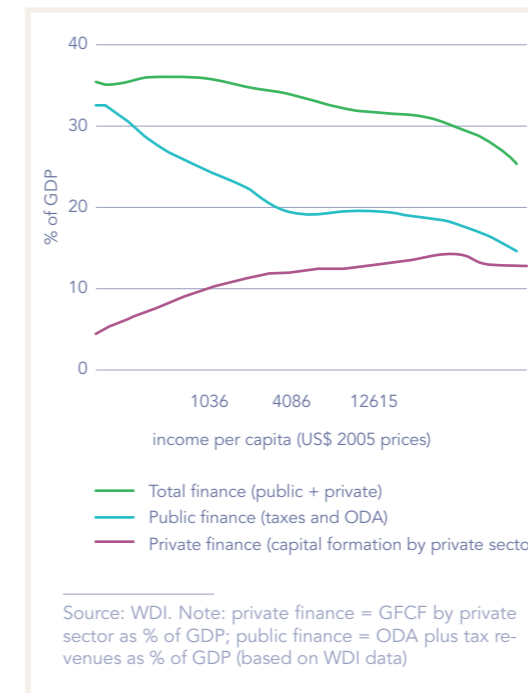


Figure 3.10 | Public and private flows (% GDP) by income level



3.2.3 Trends by category of finance

This section presents trends in finance by category over the period 2002–2011 in view of the lack of data on public revenues before 2002 and for 2012.⁹ It brings out the major achievements and challenges by flow.

3.2.3.1 | Domestic public finance

The focus on total domestic revenues distinguishes between tax and non-tax revenue. Over this period all country income groups achieved very significantly increased levels of public revenue in absolute terms, although the global financial crisis returned LMIC revenues as a share of GDP to their 2002 levels in 2011 and their average levels remained modest. There is significant variation in the levels of public revenue mobilised in MICs, several of which have levels more comparable with

LICs, indicating the need for particular focus on meeting their FFD challenges. In terms of trends in relation to sources of public revenue, non-tax revenues are notably more significant to MICs than to LICs. This indicates that developing such sources may be important for future prospects in LICs, although non-tax revenues seem to be more volatile and sensitive to economic cycles. Figure 3.11 illustrates trends in domestic public revenue as a share of GDP (PR/GDP) across developing-country income groups. It shows that higher-income countries mobilise higher levels of PR/GDP. It also shows that public revenue has been sensitive to the global financial crisis, with notable dips experienced by LMICs and UMICs around this period. A major challenge is for LICs whose tax-to-GDP ratio has been low and broadly constant.

These generally positive trends in PR/GDP have enabled all country income groupings to mobilise increased finance to support their development processes. Across all developing countries public revenues increased from an estimated \$1.5 tr in 2002 to \$5.5 tr in 2011 – an increase of 272% – the largest source of financing for developing countries, including for LICs.

⁹ Before 2002 data was available for only around a third of countries in each income group.

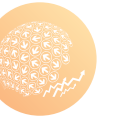
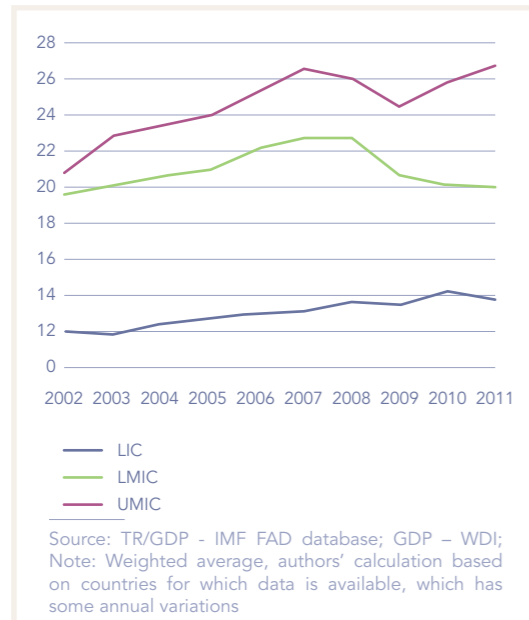


Figure 3.11 | Total domestic public revenues across country income groups (percentage of GDP) 2002–2011



Interestingly, the broadest variation in PR/GDP levels is in the UMICs (from 13.9% for Costa Rica to 57% for Libya), followed by the LMICs (from 11.2% for Guatemala to 42.8% for Ukraine) and then the LICs grouping. (See Annex 2 for an illustration of intra-group variation.) This suggests that there are a number of LMICs and UMICs whose domestic revenues are still modest and are even comparable to those of LICs (as a share of GDP). These countries therefore face significant FFD challenges and there may be a case for providing continued support to them from international public sources.

It is also noteworthy that across all developing countries over the period 2002–2011 the average levels of PR/GDP for resource-rich (RR) countries are generally marginally higher than those mobilised by non-resource-rich countries (NRR) (see Figure 3.12). Following the global financial crisis, the revenues of RR countries have fallen sharply and the gap shrank, and even reversed,

Figure 3.12 | PR/GDP for resource-rich (RR) and non-resource-rich (NRR) developing countries



in 2010. This suggests that revenues from natural resources are exposed to greater volatility, which presents challenges for RR countries.

Figures 3.13 and 3.14 compare trends in tax revenue (TR/GDP) and non-tax revenue (NTR/GDP) – the two main categories of total public revenue – as a share of GDP respectively across country income groupings for the period 2002–2011. Consistent with much of the literature on factors pushing up tax revenues (IMF, 2007, 2012b); Figure 3.13 illustrates that levels of TR/GDP increase by country income groups. Across the period TR/GDP rose modestly in LICs (from 10% to 12%) and only very slightly in LMICs (edging a little over 15%, with a peak of 17% in 2005), but more significantly in UMICs, from 16% to 20%.

As is also clear from Figure 3.13, LICs have faced the most significant challenges in mobilising tax revenues, which is not only a function of their income and economic structure (with large

agricultural and informal sectors) but a range of other factors. These include tax incentives offered to the private sector; tax evasion by TNCs (see Box 3.1); the under-taxation of the wealthy, and of resources such as land and property and sectors such as mining; and weaknesses in tax administration. These challenges affect all developing countries in some way, but are particularly critical for LICs given their low revenue-generation levels. Addressing these issues poses

significant political challenges, which suggests it will take time to achieve significant tax revenue increases (Moore, 2013).

In terms of NTR/GDP it is clear from Figure 3.14 that in most years between 2002 and 2011 this has been much more significant for MICs (on average roughly one third of tax revenues) compared to LICs (on average around one sixth of tax revenues in most years), with NTR/GDP being especially low for LICs.

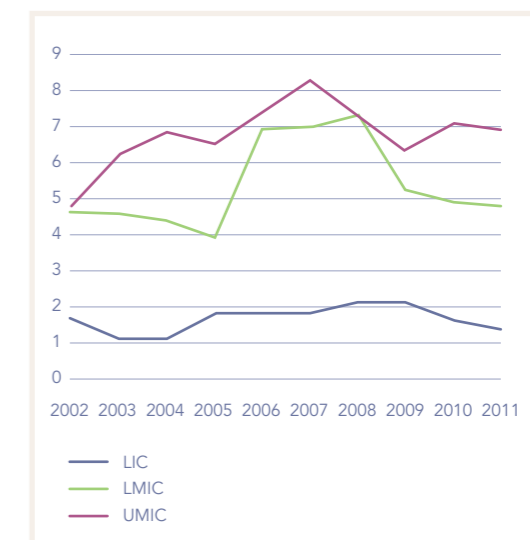
Box 3.1 | Illicit financial flows and their implications for public domestic revenue mobilisation (DRM) in developing countries

Illicit financial outflows (a form of capital flight when money is illegally earned, transferred, or spent), from developing countries amounted to approximately \$542 bn per year on average during the 2002–2011 period. Around 80% of these flows are due to trade mis-invoicing, a practice which undermines government efforts to tax companies. As an illustration of the implications for public DRM, between 2002 and 2011 \$60.8 bn moved illegally into or out of Ghana, Kenya, Mozambique, Tanzania, and Uganda using trade mis-invoicing. This translates into losses in tax revenue estimated at between 7% and 12% of total government revenue for each of these countries over this period (GFI/ADB, 2014). There has been growing international attention paid to these issues in recent years – especially in the G8 and G20 – although steps still need to be taken to address them.

Figure 3.13 | Tax revenues across country income groups (% GDP) 2002–2011



Figure 3.14 | Non-tax revenues across country income groups (% GDP) 2002–2011

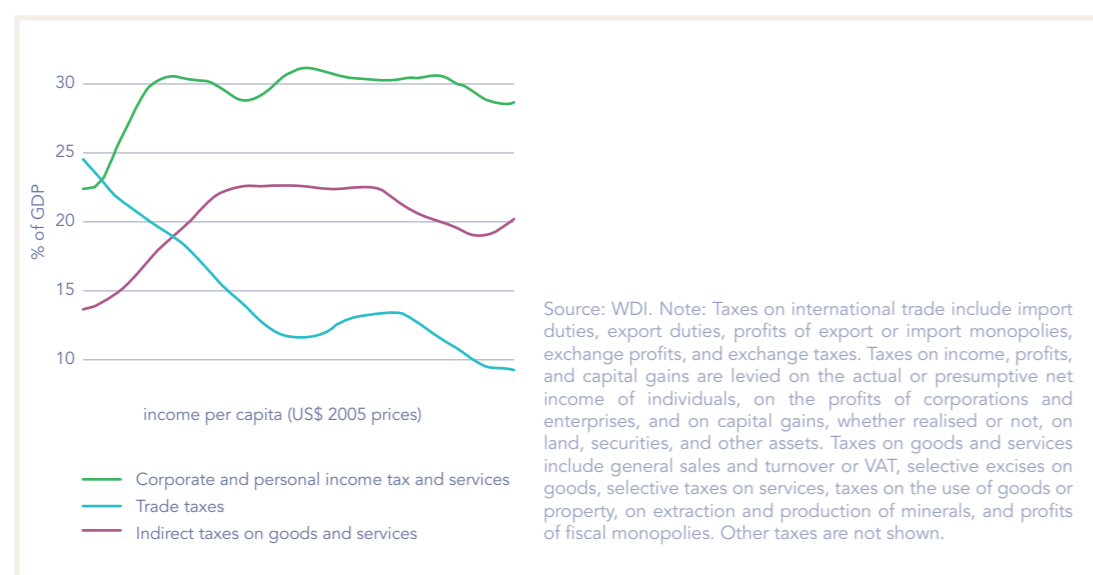




The main sources of tax revenue vary by level of income. Figure 3.15 shows that as income levels rise there is a corresponding increase in the share of tax from incomes and profits and from goods and services, compensating for a rapidly declining share of trade tax revenues. This suggests that as countries undergo economic transformation, they experience gradual increases in tax-to-GDP

ratio but large swings in the underlying types of taxation. For example, the amount of tax revenues collected through VAT increases with income levels (see ERD commissioned paper by Brun and Chambas, 2015). Efforts to raise tax-to-GDP ratios need to take these shifts into account.

Figure 3.15 | Revenues for selected taxes (percentage of GDP) at different country income levels



As illustrated further in Section 3.2.3.4 on international private finance, one of the channels through which developing countries are increasingly mobilising resources for public investment is international private capital markets. The programmes to cancel or reduce debt in the 2000s and improving levels of economic growth have given many developing countries the fiscal space to use these sources of financing without significantly undermining the sustainability of their debt. Their debt levels are rising, however, and developing countries will need to assess their ability to take on additional debt in the coming years. These issues are most relevant for countries

that have recently progressed to MIC status and for which concessional funding sources are less readily available (Prizzon and Mustapha, 2014).

3.2.3.2 | International public finance

This section presents trends across sources of international public finance obtained by developing countries between 1995 and 2012. It illustrates that ODA has increased across all country income groups, although OOF levels seem to have remained relatively modest. It suggests that despite some improvements in allocations of ODA to LICs (for which per capita

ODA has increased rapidly over the last decade) there remain questions about the suitability of allocations of international public finance. Concerns about a weak relationship between the volume of ODA and the income levels of recipient countries remain and are reinforced by recent increases in ODA to MICs. In addition, OOF levels have been very modest beyond UMICs, raising concerns about whether these less concessional but still important flows could be better aimed at LMICs, many of which have less access to ODA (Galiani et al., 2014). The rapid growth of SSC points to it becoming an increasingly significant form of international public financing, although to date there has been limited detailed analysis of its allocation patterns.

Official Development Assistance (ODA)

ODA is currently defined as flows to countries and territories on the Development Assistance Committee (DAC) List of ODA Recipients (OECD-DAC, n.d.) and to multilateral development institutions provided by official agencies (including state and local governments, or their executive agencies) and for which the promotion of the economic development and welfare of developing countries is the main objective and which is concessional in character and convey a grant element of at least 25% at a 10% discount rate. There is extensive debate in the OECD DAC about the application of this definition, especially with regard to defining the required levels and approaches to calculating concessionality. In December 2014 OECD DAC members agreed to adopt some important changes to the definition of ODA, which will be introduced in the coming years (see Box 3.4). Our analysis is based on data reflecting the definition currently in use.

As noted earlier, our analysis includes ODA reported to the OECD DAC from a range of non-OECD countries,¹⁰ which in 2012 contributed around 5% (equivalent to \$6.5 bn) of total reported ODA.¹¹ BRICs, or more accurately the BASIC countries – Brazil, India, China and South Africa (since 2010 Russia reported on its ODA and country allocations to the OECD DAC) – do not systematically report on the levels and geographical focus of their aid. Moreover, the data come from a range of country-level sources with diverse reporting standards, making it impossible to draw accurate comparisons. For this reason SSC is not included in this detailed analysis. However, Box 3.2 presents an overview of the latest research on SSC trends from BASIC countries and an analysis of its characteristics. An important finding from the available data reported in Box 3.2 is that SSC is increasingly rapidly. The trends also illustrate that SSC is an increasingly important source of financing for regions such as SSA.

¹⁰ These countries include Bulgaria, Chinese Taipei, Cyprus, Estonia, Hungary, Israel, Kuwait, Latvia, Liechtenstein, Malta, Romania, Russia, Saudi Arabia, Slovenia, Thailand, Turkey, United Arab Emirates; amongst these providers the largest by some way is Saudi Arabia, with Turkey United Arab Emirates, Russia and Poland also significant providers (DI, 2013a).

¹¹ Non-DAC donors, including those reporting to the OECD DAC, do not apply the ODA criteria to their reporting in the same way as the OECD-DAC members, but use an approximation of the ODA definition.



Box 3.2 | Recent trends and characteristics of development assistance from the BASIC and other developing countries

Figure 3.2B below presents the OECD's latest data on ODA-like flows from the original BRICs countries – Brazil, India, China and South Africa (now termed the BASIC countries). It excludes Russia, which has since 2010 reported on its ODA to the OECD DAC. The data are presented on a gross basis and draws on a range of different country-level sources, with diverse reporting standards, making it impossible to draw accurate comparisons.

Gross ODA-like flows from the BASIC countries were an estimated \$3.2 bn in 2010, with China by far the largest provider (OECD-DCR, 2013). Other studies suggest that development assistance from the BRICS is significantly higher, with total SSC (including from some countries already reporting in some way to the OECD-DAC) estimated at \$16–19 bn in 2011 (UN-ESC, 2014), with the Chinese Government reporting its assistance to have been \$5 bn per year in the 2010–2012 (Sun, 2014).

Uneze (2015) argues that flows from other countries, such as Turkey and United Arab Emirates, have also increased in the period 2003–2012 to LICs in SSA; from \$66 mn to \$2.5 bn in Turkey and from \$926 mn to \$1 bn in the United Arab Emirates. Challenges relating to the categorisation and monitoring of these flows preclude efforts to generate firm and consistent figures on them.

The BRICs and other developing countries have a long tradition of providing development assistance, and have been keen to emphasise that their support is driven by the principles of 'a demand-driven approach; non-conditionality; respect for national sovereignty; national ownership and independence; as well as mutual benefit' (RIS/UNDESA/MEA-I, 2013).

Most SSC is to neighbouring countries, although China's focus on SSA is one exception. Over the period 2010–2012, 52% of Chinese development assistance was provided to SSA, up from 46% in 2009 (Sun, 2014) and China is SSA's largest international partner in relation to infrastructure development (OECD, 2012). Turkey and the United Arab Emirates (UAE) also seem to be providing growing assistance to SSA. These trends illustrate that SSC is an increasingly important source of financing for regions such as SSA.

It is also thought that SSC is more focused than ODA on economic and productive sectors, and is more closely linked to trade and investment (UNDESA, 2008; Uneze, 2015). Moreover, most ODA from traditional donors is in the form of grants, while SSC providers tend to prefer concessional loans (Uneze, 2015).

There is as yet limited collaboration and coordination among SSC providers (Uneze, 2015), but in recent discussions they identified a range of issues regarding efforts to improve the effectiveness of their programmes. These included the need to strengthen evidence on the nature of SSC, improve evaluation, establish platforms to address common agendas and to deepen engagement with regional and multilateral institutions (RIS/UNDESA/MEA-I, 2013).

Figure 3.2B | Gross ODA-like flows from the BASIC countries to developing countries, 2007–2011 (\$ bn)



Figure 3.16 illustrates trends in country-allocable¹² net¹³ ODA (NODA), excluding debt relief,¹⁴ as a share of GDP (NODA/GDP) across country income groupings over the period 1995–2012. The data on which Figure 3.16 is based excludes China and India because their very large economies mean that their NODA/GDP levels are very low and strongly shape trends for the country income groupings of which they have been members.

As noted earlier, the OECD (2014c) reports that ODA levels hit a record of \$135 bn in 2013. Figure 3.16 illustrates that the current LICs have received by far the highest levels of NODA/GDP. These levels fell in the late 1990s, and then rose in the early 2000s, largely reflecting trends in global ODA. NODA/GDP levels for these countries then stagnated between 2004 and 2009, before falling from an average of 10% to 8.7% of their GDP in 2012. This trend is largely due to the strong levels of GDP growth keeping pace with and then outstripping the significant growth in ODA for these countries over the last decade. NODA/GDP levels for the current group of LMICs have fallen steadily since 1995 and been below 2% from 2006. For the current group of UMICs these levels were below 0.5% of GDP throughout the period 1995 to 2012.

Another perspective on trends in NODA across country income groupings for the period 1995–2012 is to analyse such trends on the basis of a dynamic country categorisation, an approach explained and contrasted with a static country analysis in Box 3.4.

The most significant trends in NODA based on an analysis of a dynamic country income grouping emerge in relation to NODA per capita. Figure 3.17 illustrates such trends, again excluding China and India, and shows that since the late 1990s LICs have received the largest and fastest growing levels of NODA per capita (\$47 in 2012), with NODA per capita to the average LMIC and UMIC, excluding China and India, also growing but to lower levels (\$25 and \$17 in 2012).

Figure 3.16 | Net ODA (as percentage of GDP, excluding debt relief) across country income groups (excluding China and India), 1995–2012 (static membership)

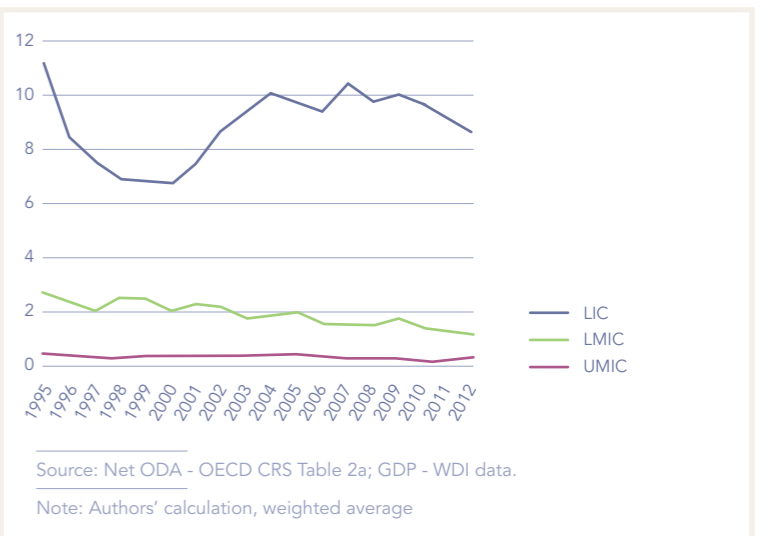
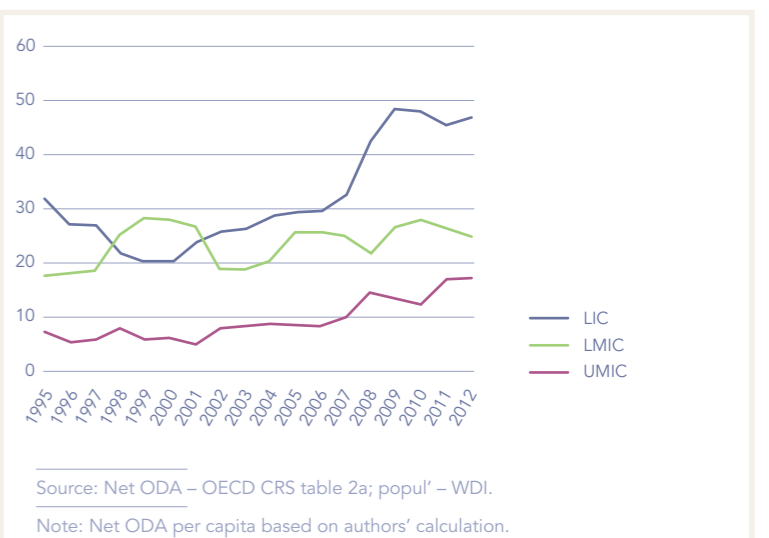


Figure 3.17 | Net ODA per capita (excluding debt relief, 2012 \$ rate) across country income groupings (dynamic membership) (excluding China and India), 1995–2012



¹² This analysis excludes ODA that is not attributed to specific countries; the main categories of such ODA include allocations to regional programmes, administration costs and spending on refugees and students from developing countries who are living in donor countries.

¹³ Net ODA (NODA) is the standard measure for international reporting of ODA, and is equivalent to total gross disbursements of ODA minus repayments on ODA loans; as well proceeds from selling equity stakes that had been purchased using ODA.

¹⁴ The current approach to recording debt relief as ODA tends to overstate the resource transfers to developing countries. This is because the total value of debt principle cancelled, as well as payment arrears and future interest payments forgone, are reported as ODA, even in contexts where there were no debt repayments being made or likely to be made in the future; in such contexts, which are widespread, debt relief does not enable the country to obtain access to increased resources to support its development.



Figure 3.17 also shows that over the period 2010–2012 NODA per capita to LICs stagnated, and fell to LMICs, but rose to UMICs from 2005. This trend compounds concerns that despite ODA allocations becoming more sensitive to a country's development characteristics, such as income levels, over the last decade (illustrated in Figure 3.17; see also Claessens et al., 2009) donors still allocate ODA largely on the basis of political factors (Hoeffler and Outram, 2008), albeit that some donors are more responsive than others to a country's development indicators (Clist, 2011).

It appears that an increasing international focus on mitigating climate change has helped to propel increases in ODA to UMICs, as these countries have received significant increases in ODA to address such challenges over the last decade (ODI, 2014). This trend highlights one of the key questions in current discussions on the future of ODA – namely, the degree to which it should be focused on addressing GPGs and issues such as climate change, rather than on more traditional development and poverty-reduction objectives. Based on commitments made as part of the United Nations Framework Convention on Climate Change (UNFCCC), developing countries have been vocal in calling for assistance on climate change to be additional to ODA commitments. During the 2010–2012 period, an average of \$13 bn of ODA (around 10% of the total) was

principally focused on climate change (OECD, 2012), especially on mitigation activities, for which the priority is often emerging economies.

The characteristics of ODA flows across country groupings have also changed significantly over the period 1995–2012. LICs have increasingly received ODA in the form of grants, which constituted 83% of their gross ODA in 2012, up from 57% in 1995. At the same time LMICs and UMICs have increasingly received ODA in the form of loans, which constituted more than 40% of their gross ODA in 2012, up from below 30% in the early 2000s.

For UMICs (and to some degree LMICs), donors have provided a growing proportion of the ODA loans received in recent years from funds raised on financial markets (OECD, 2013).

In terms of ODA trends in country income groupings, in terms of GDP the LICs have the largest range of ODA levels, within the lowest received by Bangladesh – 1.2% in 2012 – and the highest by Liberia – 54% in 2012. Most MICs receive very low levels of ODA as a share of GDP, with Kosovo being the largest recipient in the case of LMICs – 9.9% in 2012 – and Bosnia and Herzegovina the largest of the UMICs – 3.4% in 2012. (See Annex 2 for illustration of these intra-group trends.)

Box 3.3 | The rising share of ODA allocated to global public goods (GPGs)

Global Public Goods (GPGs) are goods for which the benefits of consumption cannot be restricted and transcend national boundaries. There are diverse views about exactly which types of goods and related interventions belong to this category. This has led to estimates of the share of ODA that is dedicated to GPGs varying significantly: estimates produced range from 3.7% (Anand, 2002) to 25% (Raffer, 1999).

Using the most recent definitions, the share of ODA that supports GPGs and related interventions has been increasing over the last two decades. Based on a relatively narrow definition of GPGs te Velde et al. (2002) estimates that over the period 1980–1998 the share doubled to 9%. A 2009 study, which used three definitions of GPGs to estimate such trends across from 1995 to 2006, found that it rose gradually during from 10–14% to 12–15% (Cepparulo and Giuriato, 2009). The most recent extensive study of these trends distinguishes between bilateral and multilateral ODA and finds that the share of bilateral ODA focused on GPGs rose from just under 4% in 2002 to 8% in 2011, and from 5% to 15% for multilateral ODA over the same period (Davies, 2015).

The 1990s saw environmental priorities resulting in an increase in ODA spending on GPGs (te Velde et al., 2002), with health and communicable diseases (and some notable increases in interventions relating to security and crime) driving these trends during much of 2000s (Cepparulo and Giuriato, 2009) and climate change becoming a significant factor in recent years (Davies, 2014).

Box 3.4 | The OECD DAC's review of its development finance monitoring systems

At its December 2012 High Level Meeting (HLM), the OECD DAC agreed to modernise the definition of ODA, and to develop a proposal for a new measure of development finance beyond ODA - Total Official Support for Development (TOSD). It embarked on this process in recognition of significant changes in the practice of development finance over recent years.

Following extensive technical work and dialogue, at its December 2014 HLM the OECD DAC agreed to reform rules on the reporting of loan concessionality:

- To count only the grant element of concessional loans as ODA (as opposed to the net cash-flow value of the loan currently)
- To calculate the grant element of a loan using a discount rate based on the IMF's 5% plus a risk adjustment factor of 1% for UMICs, 2% for LMICs and 4% for LDCs/other LICs (currently a uniform discount rate of 10% is applied to loans to all countries) (note: the discount rate is not an interest rate)
- To apply a minimum grant element threshold for loans to count as ODA of 45% for LDCs and other LICs, 15% for LMICs and 10% for UMICs (currently a uniform floor of 25% is applied to all)
- To disqualify as ODA any loan whose terms are not consistent with IMF Debt Limits Policy and/or the World Bank's non-concessional borrowing policy

OECD DAC members also agreed to continue work on a range of other areas in order to modernise ODA reporting systems, including:

- **Support to the private sector** - to better account for the public effort that goes into mobilising additional private sector resources for development.
- **Security-related support** - to further explore how support in the area of peace & security could be better reflected in the DAC statistics
- **Total official support for development (TOSD)** - to complement ODA with the introduction of a broader statistical aggregate of international public contributions to development (TOSD), which would provide a more comprehensive account of finance made available thanks to the official sector.

Sources: OECD DAC (2012, 2013, 2014)



Other Official Flows (OOF)

OOF are defined as official financing provided by countries in the OECD's ODA eligibility list but which does not qualify as ODA, either because it is not aimed primarily at development or because it is not sufficiently concessional. The current discussions on redefining ODA may lead to changes in the distinction between ODA and OOFs (see Box 3.4). This Report uses its current definition and therefore treats OOFs separately.

As highlighted in Section 3.1, this analysis is based on an incomplete picture of global OOF given that these are reported in sufficient detail by only a limited number of OECD members (which reported \$29 bn net in country-allocable OOF in 2012). As a result substantial volumes of OOF provided by a number of DFIs and non-OECD agencies¹⁵ are not included in this analysis. Kingombe et al. (2011) examine DFIs that aim to invest in sustainable private-sector projects; maximise impacts on development, while remaining financially viable in the long term and mobilising private-sector capital. Many DFIs are solely owned by the public sector. For instance, the Commonwealth Development Corporation (CDC), the German Investment Corporation (DEG), SwedFund in Sweden, Norfund in Norway, Industrial Development Corporation (IDC) in South Africa, and the US Overseas Private Investment Corporation (OPIC). Proparco (France), FMO (Netherlands), COFIDES (Spain) and SIMEST (Italy) have a mixed public-private ownership structure. The multilateral and regional DFIs have multiple shareholders from various countries. DFIs provide finance (e.g. loans, guarantees, equity investment; often classified as OOF but not always ODA) to the private sector and this type of support has grown rapidly at the global level, from new annual gross commitments of \$15.4 bn in 2003 to \$21.4 bn in 2005 and \$33 bn in 2009. This represents more than a doubling in over six years, equivalent to 25% of ODA. The largest DFIs include the International Finance Corporation (IFC), the European Bank

for Reconstruction and Development (EBRD) and the European Investment Bank (EIB) followed by a number of large bilateral agencies (DEG, FMO, CDC and Proparco) and a long tail of small DFIs. DFIs tend to use loan instruments more than equity instruments, but with large variability across institutions. In terms of geographical distribution, IFC invested 13% in SSA (2010), while in 2009, 52% of CDC's portfolio was invested in Africa (45% in SSA), 17% for DEG and 29% for FMO. It seems that most DFIs avoid the poorest countries, perhaps in part because they need to invest on a commercial basis and ensure repayment.

Figure 3.18 presents trends in country-allocable¹⁶ net¹⁷ OOF as share of GDP (NOOF/GDP) reported to the OECD across country income groups over the period 1995–2012. It illustrates that NOOF/GDP to all developing countries over this period has been very modest and has fluctuated sharply from year to year. The current group of UMICs has generally experienced the highest levels of net OOF/GDP, although these have generally not increased above 0.5% of GDP. For all country groupings there was a spike in NOOF/GDP in 2008–2009, during which additional funding was provided through DFIs to support developing countries to deal with the effects of the global financial crisis. The spike was short-lived and all country groupings have experienced a fall in NOOF/GDP since 2010, and LICs experienced net outflows of OOF in 2011.

As with ODA, another perspective on trends in net OOF across country income groupings is gained by looking at such trends using a dynamic grouping analysis, which provides an opportunity to explore how (if at all) patterns in such financing have changed in response to the changing membership of these groupings (see Box 3.4 for more background on this approach). Figure 3.18 presents trends for net OOF per capita (again excluding China and India). It shows that LICs generally received negligible levels of NOOF per capita in the period 1995–2012. For LMICs and UMICs net OOF per capita has been

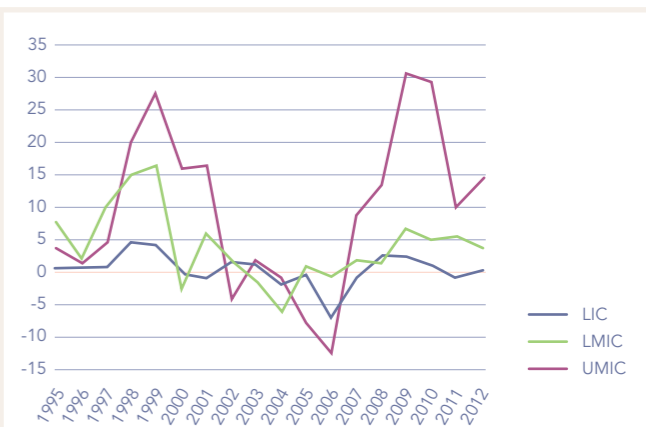
more significant, especially during two noticeable peaks in these flows, during the late 1990s (possibly in response to the East Asian crisis) and the late 2000s (in response to the global financial crisis), although disbursements to LMICs in the latter period were modest. These trends illustrate the role that OOF may have played as a counter-cyclical form of funding for UMICs and (to a lesser degree) LMICs for a short time following episodes of global financial instability.

Despite their relatively modest overall levels, OOF provided by the DFIs have played a significant role in supporting efforts to respond to climate change. DFIs have channelled approximately one-third of total climate financing (CPI, 2013), most of which has been in the form of loans that qualify as OOF.

3.2.3.3 | Domestic private finance

Of the four categories of financing, domestic private finance is the most challenging to measure empirically. This is because measures are often mingled with some of the other categories (especially international private finance). This section therefore provides some indication of the evolution of domestic private finance available to developing countries using three measures to illustrate its different facets. In terms of share of GDP, the current group of UMICs has mobilised the highest levels of domestic credit to the private sector, and the current group of LMICs has the highest levels of domestically financed capital formation and both groups achieved similar levels of market capitalisation. LICs have generally mobilised much lower levels of domestic private finance, and growth in these sources has been more modest than in MICs. Private finance is also volatile and concentrated.

Figure 3.18 | Net OOF per capita (current \$) across country groupings (dynamic membership) (excluding China and India) 1995–2012



Sources: Net OOF – OECD CRS table 2b; Country pop' – WDI.
Note: Net OOF/OOF per capita across country group, authors' calculation; phases of negative net OOF emerge when recipient repayments on OOF loans / returns to providers from OOF investments exceed new provision of finance from OOF sources.

Capital Formation

We first focus on gross fixed capital formation by the private sector less FDI as a percentage of GDP (GFC-FDI/GDP), a measure that attempts to proxy the portion of capital formation financed by domestic sources. Figure 3.19 presents trends in GFC-FDI/GDP across country groupings for the period 1995–2012. It illustrates that the highest levels of GFC-FDI/GDP were achieved by LMICs, following their growth from 13% of GDP in 1995 to 18% in 2012. Over the period 2009–2012 GFC-FDI/GDP levels to UMICs were comparable to those of LMICs following an even sharper increase in their levels, from 8% in 1999 to 18% in 2012. GFC-FDI/GDP levels for LICs fell in the late 1990s, before starting a generally increasing trend from 1999, reaching 13% by 2012.

¹⁵ There is very limited information available on OOF from non-OECD development finance agencies, as these do not currently report such flows to official bodies such as the OECD nor do they apply the same type of distinctions between forms of development finance; these volumes are thought to be very significant but growing fast – for example, recent research estimated that China's total official financing to Africa during 2001–2011 was equivalent to around \$10 bn a year, most of which would be currently categorised as OOF (CGD, 2013).

¹⁶ See footnote 9.

¹⁷ See footnote 10.

¹⁸ Gross fixed capital formation of the private sector minus FDI, domestic credit as a percentage of GDP and market capitalisation as a share of GDP. Gross domestic savings as percentage of GDP was also considered, but this variable does distinguish between public and private sources of savings.



Figure 3.19 | Gross fixed capital formation by the private sector less FDI (as percentage of GDP) across country groupings, 1995–2012

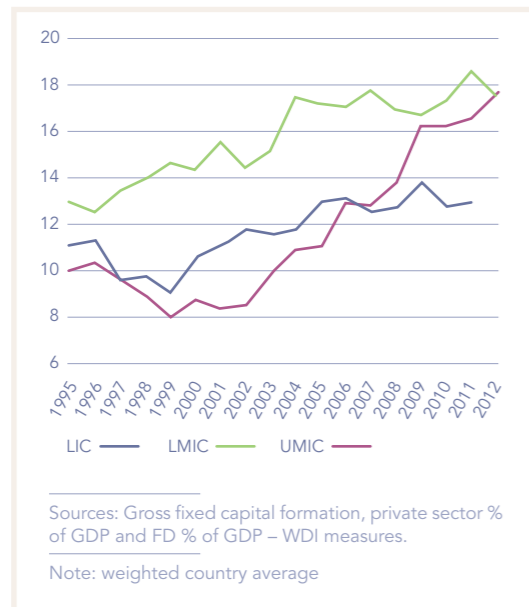
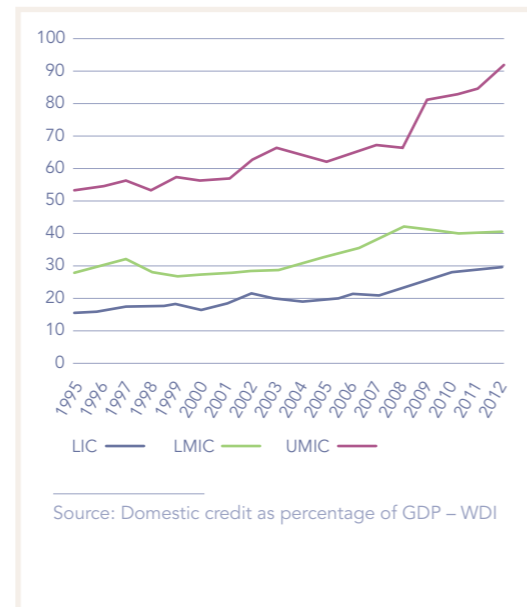


Figure 3.20 | Levels of domestic credit to the private sector (percentage of GDP) across country income groups, 1995–2012



Domestic bank credit

Private financial institutions in developing countries play an important role in generating financial resources to support development. Domestic banks are one of the most significant of this group of institutions, and Figure 3.20 illustrates trends in the credit they provided as a percentage of GDP. In general the higher income country groups have experienced greater levels of and increases in domestic credit over time. These flows have also been volatile for all country groupings, and especially UMICs. The ratio in LICs has doubled since 1995 but is still very low, suggesting the need for major changes in the banking sector.

Stock market capitalisation

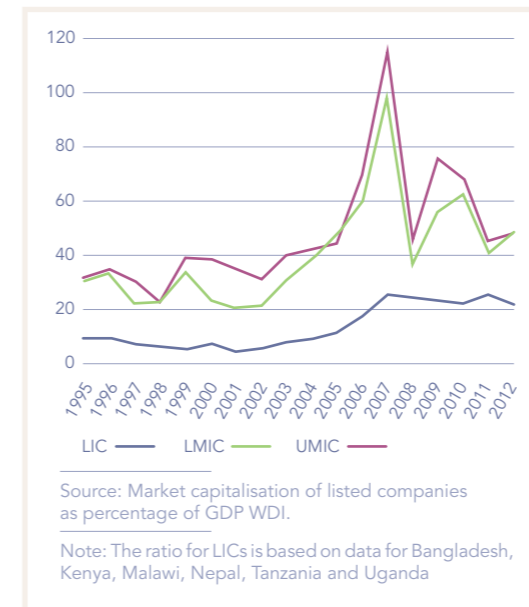
Stock markets help to mobilise and allocate private finance from individuals and institutional investors

towards listed companies. Stock markets are tightly regulated. They are very thin in LICs, with a few companies listed and traded infrequently, but there is a growing number of stock markets in developing countries overall.

Figure 3.21 illustrates trends in stock market capitalisation as a share of GDP (not an annual flow) across country income groups over the period 1995–2012. It shows that capitalisation is much higher in the 2000s than in the 1990s, but that the ratios are quite variable over time (and affected by the global financial crisis). The ratios for LMICs and UMICs broadly track each other; the ratio for LICs is the lowest but is growing rapidly and was least affected by the crisis.

The significance of domestic private finance to developing countries is illustrated by the role this form of financing has played in addressing the challenges posed by climate change.

Figure 3.21 | Market capitalisation of listed companies (as percentage of GDP) across country income groups, 1995–2012



An estimated 81% of climate change-related investments in developing countries come from domestic actors, most funded by the private sector (CPI, 2013).

Other measures of domestic private finance

An analysis of World Bank enterprise surveys provides further insights into domestic private finance. The previous measures (banking sector, equity markets) relate to formal finance involving some intermediation. Table 3.4 below suggests that most investments in developing countries are financed internally. Since there are no systematic data on this mode of financing, the outcome is measured by capital formation.

Other measures would include private equity funds and corporate bonds, and some illustrative examples are included in the ICESDF background materials. Much private finance is present even in LICs, but is concentrated in the countries with more developed financial markets, which are subject to volatility. These challenges need to be addressed in a post-2015 Global Partnership.

Table 3.4 | How is investment financed?

	ALL COUNTRIES	EAST ASIA & PACIFIC	EASTERN EUROPE & CENTRAL ASIA	LATIN AMERICA & CARIBBEAN	MIDDLE EAST & NORTH AFRICA	SOUTH ASIA	SUB-SAHARAN AFRICA
Proportion of investment financed internally (%)	69.2	71.7	63.7	63.2	80.0	66.8	78.3
Proportion of investment financed by banks (%)	16.3	15.0	20.4	20.3	3.2	20.4	9.9
supplier credit (%)	5.1	2.5	5.3	7.5	8.2	1.3	3.9
equity or stock sales (%)	5.0	5.2	7.5	4.3	2.8	6.8	3.7

Source: World Bank (2014), based on enterprise surveys



3.2.3.4 | International private finance

International private finance has grown rapidly across all country income groups, but the allocation is concentrated and volatile. The trends for LICs are perhaps most noticeable, given that they have achieved the highest and fastest growing levels of remittances and FDI as a share of GDP. This FDI is still predominantly focused on the extractive sectors, which poses challenges for linking them to the broader economy. In contrast, flows from private capital markets (portfolio equity and bonds and commercial loans) have been focused on MICs (with similar trends for LMICs and UMICs). These flows have also been the most volatile across all financing sources, and as LICs begin to obtain access to them they will need to manage such volatility very carefully. A post-2015 Global Partnership should also seek solutions to the challenges posed by volatility and the focus on the extractive sectors in LICs.

Private development assistance (PDA)

PDA comes from private philanthropic actors, including NGOs (which provided around 58% of the total from OECD countries in 2011), foundations (16%) and corporations (18%) (DI, 2013a). Due to weaknesses in official reporting and difficulties in disentangling these flows from ODA, the full extent of PDA is difficult to assess and therefore this section provides only a basic summary.

Estimates suggest that total PDA may have been as high as \$45 bn in 2011 (DI, 2013a), or possibly an annual average of \$56 bn between 2008 and 2010 (Kharas, 2012). These levels are reported to have grown rapidly, possibly more than doubling since 2004 (Kharas, 2012). By far the largest source of PDA is the USA (two-thirds of the total), followed by the UK (around 5%) and Germany (1.3%) (DI, 2013a).

In terms of destinations, the most detailed recent research (DI, 2013a) suggests that there

are important distinctions between NGOs and foundations. The largest recipients of PDA from NGOs are generally LICs, of which seven of the ten largest recipients in 2011 were in this group (Haiti, DRC, Somalia, Afghanistan, Kenya, Ethiopia and South Sudan – in order of scale), and two of the ten having recently graduated from LIC status (Pakistan, the largest recipient overall, and Sudan). In contrast, in 2011 five of the six largest recipients of PDA from foundations were India and UMICs (China, South Africa, Mexico and Brazil – in order of scale), with only one LIC among their ten largest recipients that year (Kenya, in third position) (DI, 2013a).

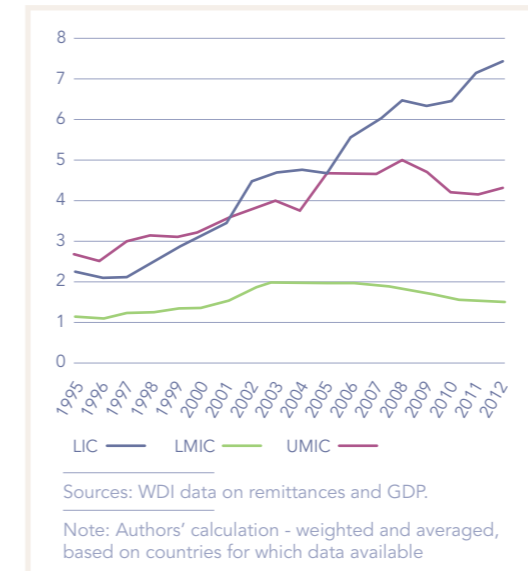
Local donations reportedly dominate international private philanthropy in countries beyond the OECD DAC, and it is estimated that such assistance was equivalent to \$35 bn in Brazil, China, India, Saudi Arabia and South Africa. There is also some South–South PDA (DI, 2013a).

Remittances

Figure 3.22 presents trends in remittances as a proportion of GDP (REM/GDP) across country income groupings. It illustrates that, despite modest absolute levels, remittances have been particularly important and grown fastest for LICs, from 2.2% in 1995 to 7.4% in 2012. Remittances have also been important for LMICs, although these may have peaked at around 5% and have fallen slightly in recent years. Despite their very large levels of remittances in absolute terms, these flows have largely been below 1% of GDP for UMICs. Outward remittances (recorded in the WDI) are too small to report (less than 0.5% of GDP for all country groups since 2000).

It is estimated that between 9% and 30% of total remittance flows are between developing countries (World Bank, 2007). This may be an underestimate, given that South–South remittances are more informal than North–South and North–North remittances, so are more likely to be under-reported. In addition, informal

Figure 3.22 | Remittances (as percentage of GDP) across country income groups, 1995–2012

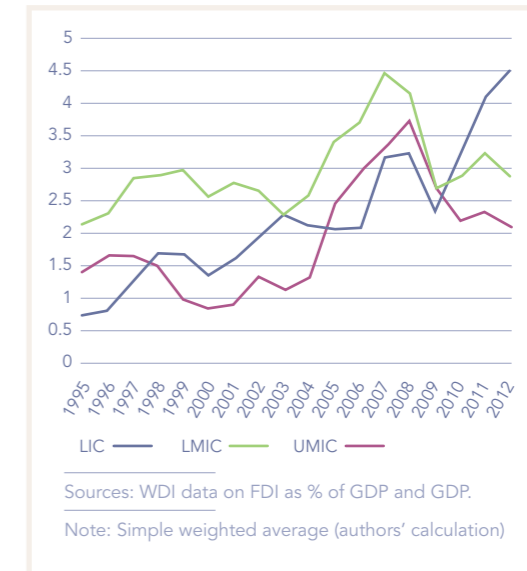


channels may be more significant for lower-income countries, as it is harder for their citizens to gain work in developed countries due to immigration policies and other obstacles (Phelps, 2014).

In terms of variations in REM/GDP within country income groupings, the broadest range is in LICs, followed by LMICs and then UMICs. Average annual REM/GDP during 2010–2012 ranged from a high of 46.6% for Tajikistan to a low of 0.3% for the DRC in LICs; from a high of 24.6% of GDP for Macedonia to a low of 0.4% of GDP for Ghana in LMICs; and from a high of 17.3% of GDP for Lebanon to a low of 0.01% of GDP for Angola in UMICs. (See Annex 2 for illustration of these intra-group trends.)

According to Uneze (commissioned background paper, 2015), 17% of remittances to LICs in SSA originated from developing countries. India, China, Brazil and Saudi Arabia accounted for 30–50% of remittance flows to LICs in their regions. The figures are likely to be under-reported given the prevalence of informal channels, particularly

Figure 3.23 | FDI (as a percentage of GDP) across country income groups, 1995–2012



for South–South remittances, in part because of low competition between transfer operators. Uneze (commissioned background paper, 2015) argues that informal channels could account for as much as 45–65% of remittance flows to LICs in SSA.

Foreign Direct Investment

The period 1995–2012 has seen a dramatic change in FDI flows to developing countries, with their FDI overtaking that to developed countries for the first time in 2012 (UNCTAD, 2013). Although increased FDI was seen in all country income groupings, its scale and character (in terms of sectors and types of FDI) has varied significantly across and within them, with potential implications for development.

Figure 3.23 presents trends in net FDI inflows as a percentage of GDP (FDI/GDP) for each of the country income groupings across the period 1995–2012, and shows quite a diverse picture. The current group of LICs started out with among



the lowest levels of FDI/GDP (below 1%) but following rapid growth, only briefly interrupted by the global financial crisis, ended with the highest levels, at 4.5% of GDP. For LMICs and UMICs much of the impressive growth in FDI/GDP they experienced before 2008 has since been eroded by the impact of the global financial crisis on FDI. By 2012 LICs had higher levels of FDI/GDP than LMICs and UMICs.

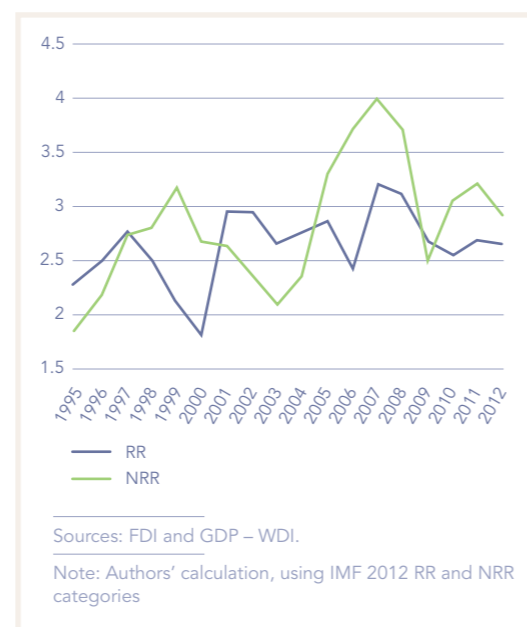
In absolute terms, FDI increased significantly to each of the country income groupings across the period 1995–2012, although the level in LICs was very modest compared to MICs. In real terms (2011 dollars) FDI increased from \$1.8 bn to \$23.8 bn for LICs, from \$22 bn to \$113 bn for LMICs and from \$108 bn to \$477 bn for MICs, which therefore received around 97% of total FDI to developing countries in 2012, with UMICs receiving around 80% of this total.

Within country income groupings there are also significant variations. The broadest range of FDI/GDP levels is in LMICs, followed by LICs and then UMICs. Average annual FDI/GDP during 2010–2012 ranged from a high of 41.4% for Mongolia to a low of -0.5%¹⁹ for Yemen in LMICs; from a high of 24.3% of GDP for Mozambique to a low of 0.1% of GDP for Burundi in LICs; and from a high of 12.3% of GDP for Turkmenistan to a low of -4.2% of GDP for Angola in UMICs. (See Annex 2 for illustration of these intra-group trends.) There is no discernible trend of RR countries consistently attracting higher levels of FDI/GDP than other countries (Figure 3.24).

The character and types of FDI by country income groupings have differed quite significantly, especially for the lower-income countries. There is a strong concentration of FDI flows in LICs (and LDCs) in the extractive sectors (mining, quarrying and petroleum) and related manufacturing sectors, although the dominance of these sectors in LDCs is reported to have fallen over the last decade (UNCTAD, 2013). In contrast, FDI to most MICs is much more diversified in terms of countries and sectors.

The significance of these trends for LICs (and LDCs) is that FDI in the extractive sectors may be less growth-enhancing and have fewer spillovers to the broader economy than FDI in other sectors (Sachs and Warner, 1995; Morrissey, 2012), and may even crowd out FDI to other sectors (Asiedu, 2013). In addition, the concentration of FDI in a narrow range of sectors limits its ability to support these countries to diversify their economies.

Figure 3.24 | FDI/GDP for resource-rich and non-resource-rich developing countries



One of the challenges for LICs (and LDCs) in diversifying and expanding FDI is to create the right conditions for attracting it in the first place. A wide range of factors is thought to determine FDI flows to developing countries. In addition to market size and income levels, which are somewhat beyond the control of policy, these include policy-relevant factors such as macroeconomic stability, trade openness, institutional quality, infrastructure and supply of skilled labour (Asiedu, 2002). FDI to the secondary and tertiary sectors may be especially sensitive to these and other factors (IMF, 2010).

It is also worth noting that the growth of South–South FDI has been an important factor in increased FDI to developing countries and in promoting the relative resilience of FDI flows to developing countries during and since the global financial crisis. It is estimated that the contribution of South–South FDI to total FDI to developing countries increased from 25% in 2007 to 34%

in 2010, and is mainly focused on greenfield investments (World Bank, 2011). Brazil, India and China have been the main providers of South–South FDI. In addition, the continued growth of FDI to LDCs in recent years has been supported by increasing FDI from other developing countries, especially India and China (UNCTAD, 2013). Box 3.5 discusses outward FDI flows.

Box 3.5 | Outward FDI flows

Outward FDI is poorly reported in the WDI, but can be an important means to secure resources, technology and continued profitability. FDI outflows are normally seen as a sign of a healthy economy. Figure 3.5B shows outward FDI flows are insignificant for LICs and much lower than outward FDI for LMICs. UMICs tend to export more capital than they attract, which can be seen as a sign of economic strength. The figures show that inward FDI is much greater than outward FDI for the poorest countries.

The contribution of FDI from emerging economies remains low, but is on the rise. For example, outflows to LICs from China and India have increased 19-fold and four-fold respectively over the period 2003–2009, and it is estimated that 8.4% of FDI to Africa comes from developing economies (commissioned background paper; Uneze, 2015).

FDI outflows need to be distinguished from repatriated profits, although some studies suggest that these are outflows in the same way as FDI inflows. For example, Griffith et al. (2014) claim that developing countries have seen repatriated profits on FDI worth \$420 bn and that such outflows were equivalent to almost 90% of new FDI in 2011. Of course, such profits could have been used to finance investment in the domestic economy. However, while FDI inflows can be used for investment, this could be in projects that generate sales that lead to profits – some or all of which might be repatriated – so this is not a balance of payment (BoP) capital flow category. The same can happen for ODA, of course – it can lead to projects that make large profits, some of which can be repatriated, even if the projects are highly beneficial to the recipient country.

Figure 3.5B | Inward and outward FDI (percentage of GDP) by per capita income levels



¹⁹ This negative net FDI figure illustrates a circumstance in Yemen where disinvestment was greater than investment over this period.

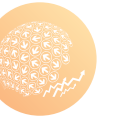
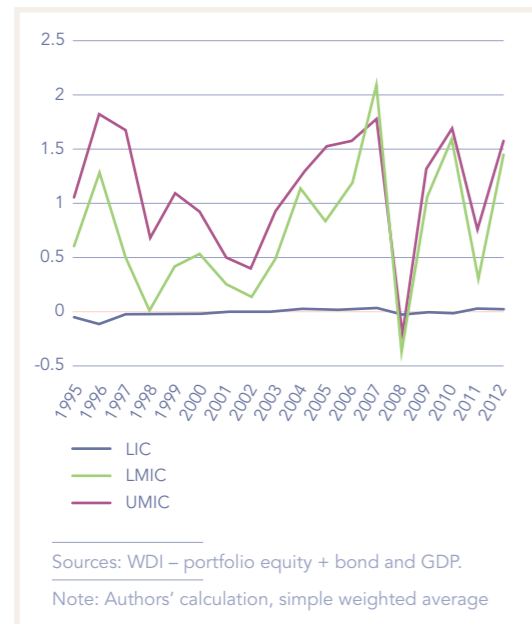


Figure 3.25 | Net portfolio equity and bond flows (as percentage of GDP) across country income groupings, 1995–2012

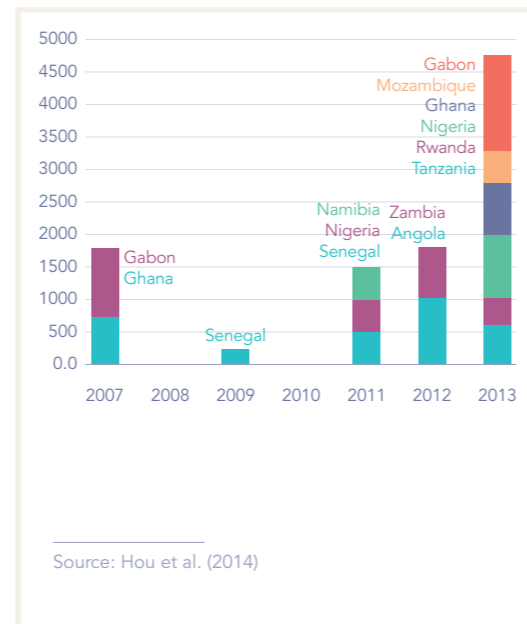


Net portfolio flows

Figure 3.25 presents the trends in net portfolio inflows (equity and bond) (PORT/GDP) to developing countries and across country groups for the period 1995–2012. It illustrates that such flows have been of significance only to MICs, with their levels fluctuating between 0.5% and 2% of GDP. During the East Asian crisis in the late 1990s these flows fell sharply, and they turned negative during the global financial crisis, illustrating their strong pro-cyclical nature.

A relatively new way for LICs and SSA countries to raise public funds is by issuing sovereign bonds. Countries in SSA issued a record \$4.6 bn in sovereign bonds (5% of issues by developing countries), up from zero in 2010 and around \$1 bn in 2001. Figure 3.26 charts progress from 2007 to 2013, excluding South Africa Sovereign-bond inflows in SSA were equivalent to 12% of FDI inflows and 20% of ODA in 2013.

Figure 3.26 | Bond issuances in SSA (excluding South Africa) 2007–2013, \$ mn



International commercial loans

Figure 3.27 below illustrates such trends in commercial banking loans as a share of GDP (CL/GDP) across country groupings. It shows that CL/GDP has experienced very significant volatility across all of them, with net outflows also a feature of the late 1990s and early 2000s. CL/GDP for UMICs has been generally positive since 2003, although below 1% of GDP. CL/GDP has also been positive for LMICs since 2004 – during which it fluctuated at 0.5% (1.5% of GDP) – and higher than levels for UMICs in recent years. CL/GDP has also been positive for LICs, since 2007 and reached 0.5% of GDP in 2012.

Figure 3.27 | Commercial banking loans (as percentage of GDP) across country income groupings, 1995–2012



3.3 Future trends and proposals for mobilising finance

Establishing a post-2015 Global Partnership requires an understanding of the evolving nature of finance needs and sources, as well as likely scenarios for and challenges related to mobilising such financing. This section synthesises existing and new analysis of possible trends in finance. It begins by addressing the likely scenarios across finance flows, and then explores a range of innovative proposals to mobilise more finance. It argues that private finance sources are likely to increase faster than public sources (especially for international flows). The innovative finance mechanisms remain small in scale but could increase significantly in the future.

3.3.1 Future trends in financing

Domestic public finance

The IMF's latest projections for government revenues across developing countries cover the period up to 2019 and suggest that government revenue for LICs²⁰ will remain stable at roughly 21% of GDP. They also suggest that 'emerging economies'²¹ will see their revenue-to-GDP ratios fall from 27.3% of GDP in 2013 to 25.8% of GDP in 2019 (IMF, 2014). These projections point towards a tough period for revenue-generation and expenditure across all developing countries, although the value of revenues will still increase.

Such an outlook is based on assumptions about the policy environment surrounding revenue-generation by developing countries where, given that current tax capacity is often below its potential, it is possible to improve performance by introducing revenue-enhancing policies and practices (IMF, 2013). The experience of LICs in SSA suggests that it is possible even for such countries to increase tax revenues by 0.5–2% in one to three years and by 2–3.5% over periods of five to ten years (IMF, 2011). Hence it is possible for tax revenues to increase in the coming years in value terms and as a share of GDP, although this requires significant reform to domestic public finance and international taxation.

International public finance

Following a slowdown in the growth of ODA in the late 2000s (OECD, 2013), total ODA fell by 6% in real terms during the period 2010–2012, before recovering to 2010 levels in 2013 (OECD, 2014a). There are, however, significant concerns about the prospects for ODA levels. The OECD projects that global ODA levels will stagnate over the period 2014–2016, suggesting both that substantive increases are unlikely and that as percentage of GDP ODA will decline significantly for all country groupings. The OECD's analysis also suggests that an increasing proportion of

²⁰ The IMF's LIC category does not correspond exactly to that of the World Bank, although most of them overlap.

²¹ Which correspond roughly to the World Bank's MICs group.



ODA will be directed towards MICs (largely due to increased ODA loans to these countries), with SSA likely to receive only small increases (OECD, 2013). It is therefore clear that changing these projections will require an increase in political commitment from donor governments, which the post-2015 process and the 2015 Addis Ababa conference on FFD provide an opportunity to mobilise. Aid from non-traditional and non-DAC donors is, however, likely to increase given the significant growth of emerging economies and rising levels of aid from these countries. Uneze (commissioned background paper, 2015) notes a 1.5–4.5-fold increase from certain BRICS in the 2003–2012 period. Further the establishment of SSC initiatives will enhance coordination among SSC partners. For example, the India-Brazil-South Africa (IBSA) Fund, where each country contributes \$1 mn a year to help LDCs to achieve the MDGs, mobilised \$20 mn and allocated \$8.6 mn from 2004 to 2011. Others include the New Development Bank and the Asian Infrastructure Investment Bank, which started in 2014.

With regard to OOF, there have been significant challenges in maintaining the significant increases that were mobilised to support developing countries (largely MICs) to respond to challenges posed by the global financial crisis. The World Bank led such efforts by mobilising large increases in outflows from its International Bank for Reconstruction and Development (IBRD) and IFC (IEG, 2010). Since 2010, however, the levels of OOFs have fallen significantly and there are concerns about the future of this source, which can be so important for MICs, especially those whose access to the most concessional forms of financing are low or falling (Kharas, 2014). An important development in this regard is the recent announcement by the World Bank of an extra \$100 bn in lending to MICs over the next decade, to be achieved largely by changing borrowing and internal lending rules (NYT, 2014).

Domestic private finance

In terms of the outlook for domestic private finance, one of the best indicators is projected gross investment, which is driven largely by domestic savings rates in developing countries. High domestic savings rates in developing countries (due to demographic and structural trends) are expected to help drive significant increases in investment in these countries, outpacing investment in HICs – see Figure 3.28. As a result, sources of private capital will increasingly come from developing countries, especially China, and by 2030 half of the global stock of capital is expected to be in developing countries (up from around 30% in 2010) (World Bank, 2013).

Finance provided by banks and pension funds located in developing countries is expected to increase further. Private resources from domestic pension funds and insurance companies in developing countries grew tenfold from 2002 to 2012 to reach US\$5.5 tr in 2012 (World Bank, 2013). They are expected to increase to US\$50 tr by 2050. Reaping the benefits from increased banking credit, more corporate bonds and stock markets will depend upon making fundamental changes to domestic financial markets in the poorest economies.

International private capital

The outlook for remittances to developing countries is largely positive, with recent projections suggesting that these will reach \$540 bn in 2016, an increase of more than 50% over 2012 levels. Remittance flows are also expected to continue to rise in all regions (World Bank, 2013).

UNCTAD's most recent projections for FDI to developing countries suggest that there will be no growth in 2014 and only modest growth in 2015 and 2016. These projections are based on concerns about growth levels in developing countries, as well as on the effects of the ending of quantitative easing in the USA (UNCTAD, 2014).

The long-term prospects for international capital flows to developing countries are, however, much more positive, as is illustrated by projected flows to SSA shown in Figure 3.29. It suggests that capital flows to SSA are expected to increase from

\$62 bn in 2012 to \$254 bn in 2030, owing to better growth prospects, demography, and improved investment climate. SSA's share in total capital flows to developing countries is also expected to increase over this period.

Figure 3.28 | Gross investment (share of global GDP) 1965–2010

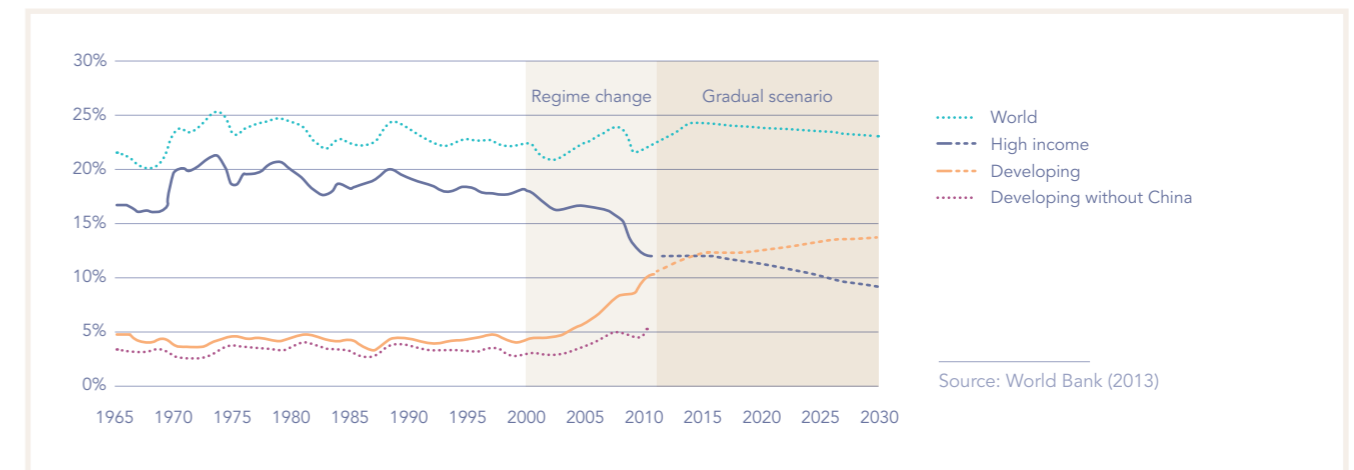
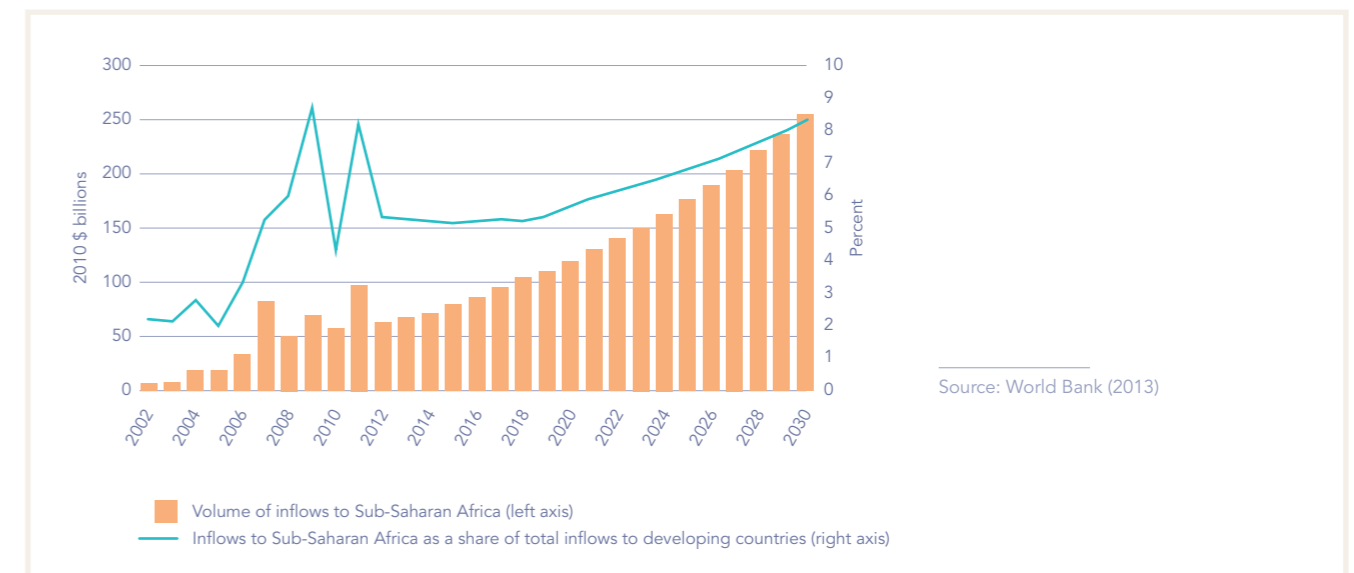
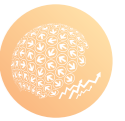


Figure 3.29 | Gross capital inflows to SSA as a share of developing country inflows





Another trend relating to international private finance is that new and more diverse sources are expected to play an increasingly important role in the coming decades. For instance, institutional investors, such as pension funds, sovereign wealth funds (SWFs) or insurance companies, manage more than \$70 tr (Kaminker and Steward, 2012). Philanthropic groups and foundations (including family offices and wealthy individuals) are also becoming more interested in social impact investing, which includes investments for social or environmental purposes (Lindenberg and Pöll, unpublished). Recently, the Norwegian pension fund announced it would invest more in developing countries. Chinese SWFs are also interested in investing in developing countries. A significant share of SWFs or institutional investment never reaches developing countries, however, and a significant effort, such as in the post-2015 (or G20) context, would be needed to mobilise and channel institutional investment towards poorer countries and infrastructure sectors.

3.3.2 Proposals and instruments for scaling up development finance

The above analysis shows that challenges could remain in maintaining or mobilising finance. International public sources are likely to be affected for some time by weak growth in HICs; international private flows to developing countries look positive in the medium term but may remain volatile as long as global economic conditions remain uncertain; and domestic public revenues are likely to increase steadily but not significantly by 2019. Private sources are likely to increase faster than public sources.

In response to concerns about this, and evolving ideas for making better use of existing financial resources to support developing countries, there has been increasing attention paid to identifying innovative sources of financing for development (IFD).²² A number of proposals have been taken forward to pursue this goal, although the results so far are relatively modest; recent UN analysis

suggests that only \$8.4 bn has been raised by IFD initiatives since 2002 (UNDESA, 2012). There is, therefore, significant potential to further pursue these and other IFD proposals, the most significant of which are presented in Table 3.5.

It should be noted, however, that there are very challenging political (and other) obstacles to be addressed in taking forward the most significant IFD proposals (especially global taxes), which face strong resistance from financial centres and energy industries, for instance. It is also not clear to what degree some of the measures proposed will provide resources for developing countries, given that developed countries will want to retain some of the revenues they generate to meet their own needs.

This results in a great deal of uncertainty about the degree to which IFD measures can be relied upon to address the financing gap for sustainable development in developing countries.

Table 3.5 | Existing and emerging innovative financing for development (IFD) proposals and mechanisms

INITIATIVE	DESCRIPTION	RESOURCES RAISED TO DATE (\$)	APPROXIMATE POTENTIAL REVENUE (\$)	OPPORTUNITIES, CHALLENGES, IMPACTS
a. DOMESTIC PUBLIC MECHANISMS				
(i) Diaspora Bonds	A debt instrument issued by a country or a sovereign entity aiming to raise funds through its overseas diaspora, who usually accept a 'patriotic discount'	India and Israel have raised over \$11 bn and \$25 bn respectively since issuance; Nigeria has raised \$100 m	Ethiopia can potentially raise \$310 m; Kenya and Uganda considering	Investments from the diaspora may have longer time horizon and are investments direct to government; debt implications
(ii) GDP-linked Bonds	Bonds on which the interest rate in any given year is adjusted according to the issuing country's rate of economic growth in that year			Additional funding direct to government; quite new, so their impact is difficult to assess; debt implications helped by index linking to GDP
b. INTERNATIONAL PUBLIC MECHANISMS				
b1. PUBLIC REVENUE				
(iii) EU Emission Trading Scheme (proceeds from initial allocations)	Portion of revenues from EU Gov sales of CO2 emission permits	Germany agrees to allocate 15% of proceeds to international climate finance and raised \$0.8 bn	\$20-35 bn Carbon mission trading under Kyoto protocol is estimated \$ 28 bn Finland's contribution for 2013 is estimated \$0.08 bn	Although financing is additional to existing ODA it is still counted as ODA by DAC members, so additionality may be limited
(iv) Share of Certified Emissions Reductions (CERs) from the Clean Development Mechanism (CDM)	Under the Kyoto Protocol a 2% levy on CERs (earned through low carbon project) is directed to Adaptation Fund	Funded 12 projects worth \$0.07 bn since 2010	\$0.06-0.75 bn	
(v) Solidarity levy on airline taxes	Typically levied as a small, fixed contribution charged to airline passengers; initiated in 2006 by UK, France, Norway, Brazil, Chile: 14 countries now members; funding to HIV/AIDS, TB and malaria	\$1 bn since 2006	\$1-10 bn \$1.35 bn since 2006; \$0.20 bn in 2014 (est)	
(vi) Global Solidarity Tobacco Levy	Participating countries commit to initiate small increases to national tobacco tax to support global priorities in developing countries		May raise \$9 bn/year for health; An increase of 0.05/pack sold in G20 would raise \$3 bn for health.	

²² There are competing definitions of IFD. An OECD review identifies three categories: (a) new approaches for pooling private and public revenue streams to scale up or develop activities for the benefit of partner countries; (b) new revenue streams (e.g. a new tax, charge, fee, bond raising, sale proceed or voluntary contribution scheme) earmarked to development activities on a multi-year basis; and (c) new incentives (financial guarantees, corporate social responsibility or other rewards or recognition) to address market failures or scale up existing development activities (OECD, 2009)



(vii) Financial and Currency Transactions Tax	Small tax on financial and currency transactions	(proposed)	\$15-75 bn Coordinated 0.005% tax on all major currencies could raise \$33 bn/year. A low-rate tax with large tax-base could raise: - Euro 200 bn/year at EU level and - \$650 bn/year at global level	Would raise additional revenue; how contributes to ODA / efforts to raise additional finance will depend on policy of implementers Very significant political challenges to introduce, although some limited progress of EU FTT 11
(viii) Carbon Tax	A tax on CO2 emissions by developed countries.	(proposed) Norway already taxing emissions from aviation	\$50-250 bn A \$2 a ton tax on CO2 would raise \$41-\$52 bn/year (Hof et al., 2011) A \$2/ton tax on all CO2 emissions would raise \$48 bn/year; Carbon taxes on aviation and ships in developed economies would raise \$250 bn in 2020; In France Euros 0.6 bn are estimated for 2013	

b2. LOANS and INSURANCE MECHANISMS

(ix) Catastrophe Risk Draw Down Option	Currently provided by the IBRD, Contingent loans provided by the IBRD that offer immediate liquidity to IBRD-eligible countries after a natural disaster.	At least 12 Catastrophe DDOs have been approved since 2008, mainly in Latin America and the Caribbean; amount drawn during 2009-10 \$259 mn.		Additional, beyond ODA eligible portion; finance when countries need it the most; debt implications
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b3. OTHER RESOURCES INVOLVING INTERNATIONAL FINANCIAL INSTITUTIONS

(x) New Special Drawing Rights Issuance (SDRs)	Regular annual allocations in favour of developing countries		\$160-270 bn	Although not a form of development financing, would free up domestic resources for development
(xi) Leveraging idle SDRs	Idle SDR holdings of reserve-rich countries are leveraged for investment in development		\$100 bn	

b4. BONDS & DEBT-BASED INSTRUMENTS

(xii) Sustainable Impact Investing Bonds (e.g. Green Bonds, WB Eco Bonds, WB Cool Bonds, etc.)	Issued by international and regional development banks to raise additional finance for climate change adaptation and mitigation projects, to which developing countries may apply.	To date been issued by the World Bank more than \$3 bn since 2008; EIB (\$1.8 bn since 2007), the ADB (\$0.9 bn), and AfDB (\$0.4 bn)	\$1 bn is estimated for 2014	Additional finance direct to countries; current projects are underway in 13 countries; possible debt implications
(xiii) Social Impact investing (e.g. SIBs, DIBs, Global Health Investment Fund, etc.)	Private investments for social (Social Impact Bonds), or development impact (Development Impacts Bonds) alongside financial returns	Current estimated market of \$9 bn in 2013 (GIIN, 2013)		Additional finance; not always clear how investments differ from traditional investments

(xiv) Debt-Conversions (Debt SWAPs) (e.g. D2E, D2H, D2N, C2D, etc.)	A % of the creditor's country foreign debt is exchanged for the debtor country's investments on social (Debt to Education), health (Debt to Health) or environmental projects (Debt to Nature), involving a two-country partnership.	Debt-2-education: since 1998, 18 swaps in 14 countries, mostly Latin America, Indonesia Debt-2-health: Australia/Indonesia, Germany/Indonesia, Pakistan, Ivory Coast and Global Fund (for AIDS, TB and malaria) Debt-2-nature: USA/Peru, France/Madagascar, Cameroon and WWF IDA buy-downs: Pakistan & Nigeria		Swaps are 'one-off' mechanisms that provide for short-term debt solutions but not for long term ones As countries become over-indebted, new opportunities for swaps arise. Those not eligible for HIPC/MDRI (multilateral debt relief facility) could consider swaps under certain eligibility criteria (during on-going wider debt-restructuring). If credit swaps managed inappropriately, countries' credit rating may be affected, increasing cost of sovereign bonds dramatically.
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c. INTERNATIONAL PRIVATE MECHANISMS

(xv) Crowd funding	Funding local projects by appealing to citizens' contributions through dedicated websites; provide either grants, loans or equity funding)	Few robust estimates for development focused funding, but certainly hundreds of millions \$2.7 bn funded more than a million projects in 2012;	\$5.1 bn in 2013 (est)	Additional finance; faces potential challenge of fragmentation
(xvi) Solidarity contributions	Contributions through transactions (e.g. credit card payments, water bills, branded purchases)	Product RED raised \$180 m since 2006		Additional finance; often requires official sector facilitation; have been slow to develop

d. PUBLIC-PRIVATE MECHANISMS

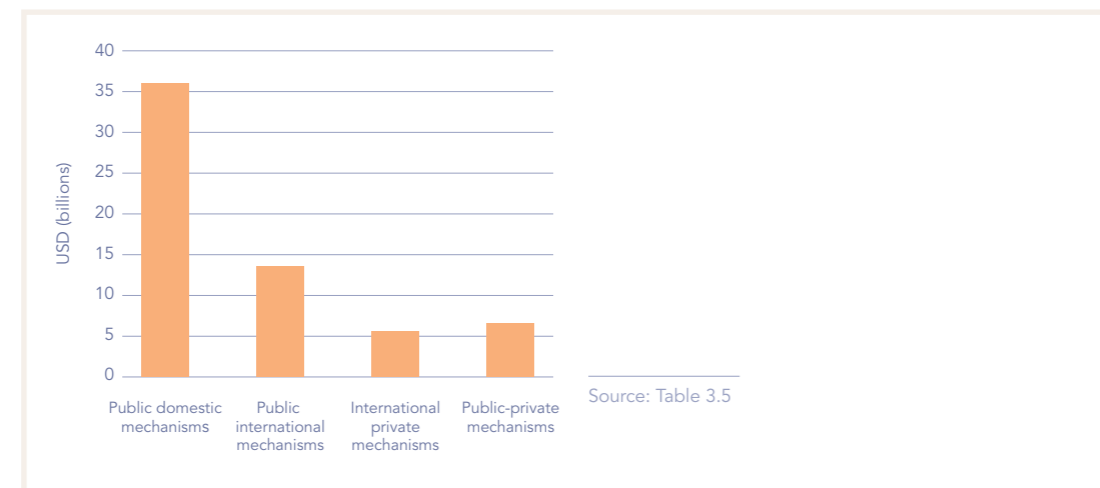
(xvii) Advance market commitments	Donors commit funds to guarantee the price of a product (e.g. a vaccine) hence motivating manufacturers to invest and develop products	Used to fund vaccines emerging from Global Alliance on Vaccines and Immunisation (GAVI) Funded \$1.5 bn		GAVI helped avert 1.3-2 million deaths by the end 2011
(xviii) Front loaded securitised finance aid	Bond issued in international market and repaid using ODA - 'buy now and pay later'	International Facility for Immunisation (IFFIM) funds GAVI, raised \$6.2 bn to date		Allows prioritising current spending, albeit with no long-term additionality; GAVI helped avert 1.3-2 million deaths by the end 2011
(xix) Loan guarantees and other risk mitigation tools	A public body guarantees private sector loans and other activities, creating incentives for private sector to invest in more risky development-oriented sectors and countries	Already widely in use by MDBs and DFIs; being explored for the Climate PPP		Potential to tap into very significant resources of the private sector; challenge for selecting suitable investments and possible issues of moral hazard

Sources: UNDP (2012); Massolution (2013) unless otherwise stated



Figure 3.30 summarises the scale of financing that could be raised from different IFD instruments from Table 3.5, split across the four categories of finance addressed in this Report.

Figure 3.30 | Finance raised by different IFD instruments



As can be seen in Table 3.5, international taxes relating to carbon emissions and financial/currency transactions are being explored and represent the most significant potential sources of financing among these mechanisms. A carbon tax is foreseen as a way to mobilise financing to address climate change, and financial/currency taxes as a means to mobilise more general development financing.

Mechanisms facilitating the contribution of private individuals towards projects and initiatives in developing countries have been growing rapidly and are receiving significant attention. These include mechanisms for providing donations (following the traditional approach of many NGOs), micro loans (e.g. Kiva) and equity investment (e.g. Symbid and Crowdcube). These mechanisms have the benefit of facilitating direct access to development-related support and by-passing bureaucracy that can undermine traditional forms of aid. However, they generally involve relatively small amounts of funding across fragmented activities, and so are inappropriate for

addressing challenges requiring large-scale and sustained funding (Gadia and Walton, 2013).

Developing countries have been exploring diaspora and GDP-indexed bonds – including in partnership with international development agencies – for mobilising financing for public investment. Diaspora bonds – funded by members of a country's diaspora – have been used successfully by India and Israel, and are being actively pursued by Kenya, Nigeria and Uganda. GDP-indexed bonds are a relatively new proposal, but would have the benefit of addressing some of the debt and sustainability questions the use of bonds raise by adjusting returns to investors on the basis of growth levels.

As identified previously, there are also important FFD opportunities from leveraging and attracting the significant volumes of resources managed by institutional investors. To attract such investors, governments and DFIs need to provide an enabling framework through the use of finance instruments or relevant policy interventions. A range of

mechanisms has been proposed to promote such investments, including risk-mitigation mechanisms such as guarantees, first-loss agreements and advance market commitments (as used by IFFIM for funding vaccinations). Donors can also use concessional financing to cover set-up costs and make investments viable (Mustapha et al., 2014). An increasing number of development agencies (especially the MDBs) are scaling up their use of such tools and exploring opportunities for widening their use further.

In conclusion, while some IFDs have already been applied, the scale is still low, but there is significant scope for expansion in the near to medium future. (Annex 3 provides more details on the effectiveness of IFDs.)

This chapter has illustrated the rapidly expanding volume and range of financing – domestic and international public, as well as domestic and international private sources – available to developing countries in order to pursue their development goals. The sources of financing for developing countries have been transformed over the last 10–15 years.

3.4 Conclusion

Since the 2002 Monterrey Consensus, in real terms (2011 dollars) developing countries have had access to an added \$0.9 tr in international private finance, \$3 tr in domestic private finance and \$4 tr in domestic public revenues. International public finance increased by just under \$0.1 tr. Such figures clearly demonstrate the need to focus greater attention in the FFD discussions on the role of other flows of finance in addition to ODA, as was argued in Chapter 2. These sources of finance have unique characteristics in terms of their welfare and public good orientation and motivation, and can therefore play a unique role in enabling countries to pursue economic, social

and environmental goals, both on their own and in combination with other types of development finance.

Domestic public resources have become the largest source of finance for all country groups. With economic growth continuing across developing countries this trend will be reinforced even if the tax take as % of GDP remains constant. However, there are significant challenges to be addressed. The tax-to-GDP ratios are either stagnant or increasing only very slightly in LICs and LMICs, so the poorest countries face major tax and public finance difficulties. For example, tax evasion and avoidance affects the tax base. International public finance has risen but is declining rapidly in relative importance and is sometimes allocated to richer developing countries. Although SSC is increasing, without a concerted effort the post-2015 period will start with subdued international public flows.

For a number of developing countries, despite its reduced importance in relative terms, ODA and other **international public sources** remain critical. For LICs, international public finance was equivalent to some 80% of the domestic public finance mobilised between 2002 and 2011. ODA is also important in supporting those MICs whose levels of domestic public finance remain modest. LMICs have often experienced more rapid declines in access to ODA and other forms of international public finance than the pace of increases in domestic public revenue (Kharas et al., 2014). This indicates the potential benefits of reallocating ODA and OOF from UMICs (whose finance from these sources has been increasing) towards LICs and LMICs.

Private sources of finance become more important as incomes rise. Domestic private finance increases consistently as a country's income grows, and this category of finance has been the second most significant in volume terms for developing countries over the last decade. This does not mean, however, that more private



finance is necessarily available. Much needs to be done on developing the financial sector, such as the banking sector, equity markets and corporate bond markets. Private capital also brings a new source of volatility, which requires proper management.

Other international private sources such as remittances and FDI become more important than ODA in volume terms at modest levels of income, but international private finance is concentrated in certain countries and sectors and is the most volatile category of finance. A considerable effort is needed to ensure these flows are mobilised, channelled and used well.

The chapter has also discussed a number of issues cutting across flows. South–South flows have increased rapidly over the past decade relative to ODA, and become a very significant resource for investments in infrastructure in sub-Saharan Africa and elsewhere. Climate finance has grown fast, with private (predominantly domestic) finance playing the most significant role and an increasing share of international public finance being focused on such issues. Financial outflows are also an important factor, with illicit financial flows from developing countries undermining domestic public revenue generation and FDI outflows providing opportunities for productivity gains and technology transfer while also presenting challenges.

Looking towards future trends, projected improvements in growth and tax efforts mean that domestic public finances are likely to increase relative to international public finance in developing countries, although much depends on domestic public finance reform. Private finance sources are likely to increase faster than public sources (especially international flows). New sources of private finance (e.g. international portfolio bond and equity flows, FDI) are also expected to play an increasingly important role in LICs in the coming decades, providing investment opportunities, but also posing challenges in relation to their volatility

and managing debt sustainably (Tyson, 2015). Scaling up ambitions in this area will require reforms to the international financial system. Innovative finance mechanisms are still small in scale but could increase in the future, especially if the significant political obstacles to taking them forward can be addressed.

Our analysis suggests that it is not an overall shortage of funds that will be the constraining factor in achieving a transformative post-2015 development agenda. Rather, it is the way in which finance is mobilised and used that will determine success in achieving the goals enshrined in this agenda. This in turn will require efforts both to improve the effectiveness of each category of financing in drawing on its unique characteristics in support of the enablers of sustainable development, and also to explore how they can more effectively work together. This will call for reform of national finance, international public finance (especially concessional aid) and the international system.

Finally, the evidence presented in this chapter suggests considerable variation across and within country income groups in terms of the importance of different finance options (see also Annex 2). It is therefore important to understand how specific countries can mobilise different finance flows. Chapter 4 addresses policies that can help to mobilise and use finance for development.

CHAPTER 4.

The role of policies in mobilising and using finance effectively

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4.

Main Messages

This chapter shows that **finance seldom reaches the intended objectives unless it is accompanied by complementary policies**. Its two messages are:

- ▶ Although there is **considerable finance available at the global level, it does not follow that it is used appropriately**. FDI does not reach the most vulnerable and poorer segments of society; tax-to-GDP ratios have changed very little in many LICs; SMEs and infrastructure are starved of capital; and much international public finance does not go to the poorest countries. Indeed, there is a **need to overcome a number of market, governance and coordination problems** in order to mobilise and channel financial resources to their most effective use.
- ▶ Policy is crucial alongside finance to implement a transformative post-2015 development agenda. **Poor or adverse policy can stop the potential of finance, but appropriate policy can:** generate, attract and steer finance; unleash more public and private finance; increase the stability of international private finance; pull finance from less productive to more productive uses; lead to more results with the same amount of finance; and reduce the need for finance.



This chapter examines the role of policies in mobilising and making finance more effective. It presents empirical evidence comprising ERD-commissioned econometric and modelling studies. It is structured as follows: Section 4.1 discusses the role of policies affecting the mobilisation of finance, and Section 4.2 examines the role of policies that shape its effective use. In both cases, policies are classified as national or international. Section 4.3 discusses the linkages among finance flows. Section 4.4 summarises the issues and presents a Table that can be used to examine in more detail the linkages between specific finance flows and policies. (Chapter 6 builds on this in relation to the examples of enablers.) The chapter focuses in particular on international policies and the global system to show the importance of policy for each flow while the focus of Chapter 6 is largely on national policies.

4.1 Mobilising finance

This section examines the importance of policies in mobilising the financial flows identified in Chapter 3, based on a review of the literature on the determinants of different types of capital flows. We focus on commonalities and differences among policies that interact with finance flows. The review shows that finance often fails to achieve its intended objectives unless it is accompanied by complementary policy. This is an important observation as it means that governments have the means to address the perceived lack of finance and the policy challenges identified in Chapter 1. While the chapter covers both domestic and international policies, it focuses in particular on international policies.

4.1.1 Mobilising domestic public finance

The IMF (2007) finds that there is a range of structural factors behind an economy's **revenue performance** (or tax-to-GDP ratio). These include per capita GDP, the share of agriculture in GDP, trade openness, foreign aid and political stability. The tax base, which underpins any sustained increase in the tax-to-GDP ratio, is driven by employment and earnings in the formal economy (income-tax base) and private spending (indirect tax base) (Morrissey, 2013).

With some exceptions, long-term changes in LICs' revenue performance have been modest.

Fragile states are less able to expand tax revenue as a percentage of GDP and any gains are more difficult to sustain (IMF, 2012). Some post-conflict economies have, however, made good progress in developing effective tax systems, e.g. Liberia (taxes grew from 10.6% of GDP in 2003 to 21.3% in 2011) and Mozambique (taxes grew from 10.5% of GDP in 1994 to 17.7% in 2011) (IMF, 2011). Some developing countries have achieved marked improvements: Peru, for example, increased its tax ratio from 6% to 13% during the 1990s and to around 17% currently.

A range of specific policies can help to mobilise tax revenues. It is not easy – but nor is it impossible – to achieve short-term changes in the tax-to-GDP ratio. About 16 of 28 LICs in SSA raised revenue ratios by five percentage points of GDP or more in at least one three-year period in the last 20 years. Many developing countries could raise a significant level of additional revenue (IMF, 2012; CIs) by adopting some or all of the following policies:

- ▶ Building administrations that limit rent-seeking, make strategic use of tax exemptions (these can be considerable, representing 3.9% of GDP between 2005 and 2007 in Tanzania; Mauritius is one of only a few countries that have used tax exemptions strategically), and eliminate those that forgo revenue to little

effect, and improve compliance to extend the tax base

- ▶ Automating the customs-clearing process, which was credited with achieving a major increase in tax-to-GDP ratios in Bangladesh
- ▶ Making effective laws and regulations to protect taxpayers
- ▶ Adopting a broad-based value-added tax (VAT) with a fairly high threshold
- ▶ Establishing a broad-based corporate income tax at internationally competitive rates
- ▶ Extending the base for personal income tax
- ▶ Establishing simple and coherent tax regimes for smaller businesses
- ▶ Strengthening real-estate tax (with potential to transform local government finance)
- ▶ Levying excises on a few key items that are appropriate to revenue needs and wider social concerns
- ▶ Developing capacity for tax expenditure and wider policy analysis

Administrations in LICs are often under-resourced, resources are not focused on areas of greatest impact, and middle-level management is weak. Domestic and customs coordination is also poor, which is especially important for VAT. Weak administration, poor governance and corruption tend to be associated with low revenue collection (IMF, 2011).

The CIs show that some countries have successfully mobilised more tax revenue (as a percentage of GDP) by undertaking a range of capacity reforms in tax authorities and adopting better tax policies. For example, Tanzania's tax-to-GDP ratio increased from 9.8% in FY 2002/03 to 17.1% in FY 2011/12,

while in Bangladesh the increase was from 7.9% in FY 1995 to 11.3% in FY 2013. The post-2015 PPF framework therefore needs to signal strong support for actions that can raise revenues in ways that are conducive to sustainable development transformation. The commissioned CI on Tanzania describes how a Tax Modernisation Programme and a Tax Revenue Authority (TRA) Corporate Plan is focusing on (a) broadening the tax base; (b) strengthening TRA to increase the efficiency and effectiveness of Tax Administration; (c) improving tax administrative infrastructure; and (d) curbing tax evasion and minimising revenue loss through tackling tax exemptions (CI, Lunogelo et al., 2015). As a result, the tax-to-GDP ratio rose from less than 10% in 2001 to more than 14% in 2010. We discuss this topic further in Chapter 6.

A specific issue applies to **mobilising revenues from the extractive industries** (EIs), such as mining and petroleum. When mineral prices are high and with the discovery of several new mineral resources in recent years, there are significant potential benefits to be obtained from EIs. The share of government revenues varies markedly across countries. The taxation of EIs is affected by a number of specific factors. Rents may be large, but the circumstances are highly volatile (e.g. due to fluctuating prices) and are difficult to predict. The extraction and operation of mineral resources require large initial investments, or sunk costs, while revenues accrue over time. This means there are higher risks for a private investor whose returns will depend on government policies over a long period. This problem can lead to 'hold-up' or low levels of investment. Furthermore, EIs often depend on a few institutions and are characterised by asymmetric information issues, in addition to operating in the context of weak state capacities and dispersed market power, all of which can make for challenging state-business relationships. This situation tends to involve TNCs that can use international operations to shift their tax base. Finally, such natural resources are scarce and non-renewable.

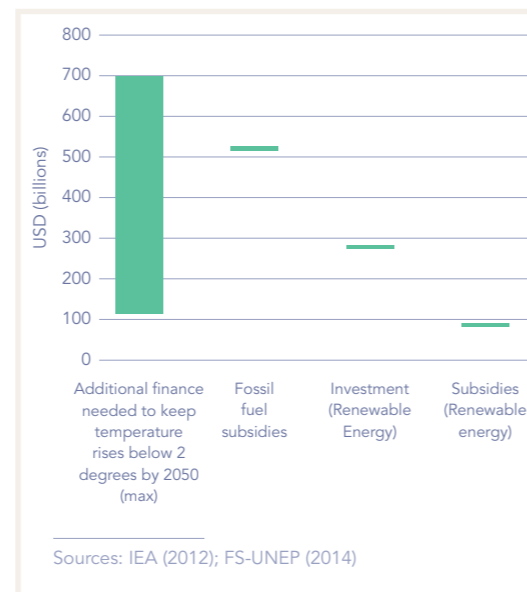


The European Report on Development 2011/2012 discussed the fact that subsidies for natural resources such as fossil fuels are often poorly applied and affect those living in poverty most severely, are economically inefficient and are bad for the environment. Through **public subsidy reform**, public resources can be mobilised and spent more effectively (see also World Bank, 2013). Global subsidies on fossil fuels are twice the level of investment in renewable energy and six times the level of subsidies on renewable energy. If governments removed fossil-fuel subsidies and spent the same money on renewable energy, they could broadly meet the finance required to keep the increase in global temperature below 2°C (see Figure 4.1). Chapter 6 discusses these issues in more detail.

Tax administrators face a range of further challenges such as **transfer-pricing abuse, reported value of production, debt payments and hedging**. For example, when TNCs calculate taxable income for their operations in each country, they need to put a price on goods and services traded among units of the same company. But what is the right price? Many TNCs use a transfer-pricing mechanism to transfer value to low-tax jurisdictions. Some studies suggest the price differentials are often more than 10% (Bernard et al., 2006). A model simulation of an increase of export prices rising by 10% shows that national incomes in SSA would rise by some \$3.5 bn annually (commissioned modelling paper; Fic, 2015). Thus, better global tax policies that lead to fairer pricing strategies could significantly boost the GDP of countries in SSA (by around a quarter of a percentage point of GDP).

The abuse of transfer prices can also significantly reduce tax revenues. Each country should have detailed requirements for how companies should deal with transfer pricing, but monitoring is problematic. Global discussions could help with designing and implementing transfer-pricing principles. For example, with external support, **transfer-pricing adjustments made as a result of**

Figure 4.1 | Subsidies on fossil fuels, green finance needs, and subsidies and investment in renewable energy



audits on TNCs have increased tax revenues in Colombia by 76%, from \$3.3 mn in 2011 to \$5.83 mn in 2012. Donors also provide assistance, such as through the Extractive Industries Transparency Initiative (EITI), to improve transparency regarding taxes paid by EI-registered companies.

Tax evasion and tax avoidance are global issues governed by laws that date back to the 1920s. OECD countries do not always tax TNCs where production takes place, enabling them to shift profits to low-tax jurisdictions and legally avoid taxes. Some companies also evade taxes by hiding large sums in offshore locations (which is illegal). The OECD is currently discussing reforms in the global tax systems (namely Base Erosion and Profit Sharing); although it is unclear how quickly new systems would be adopted. Developing countries need to be involved in such discussions as reforms could affect them in a major way. The modelling and case-study evidence on transfer pricing suggests that it is not difficult to change such regimes. At the same time, there is a risk

that addressing international tax issues such as transfer pricing might divert scarce capacities from dealing with domestic tax issues. Hence this Report emphasises the need for increased domestic tax efforts as well as global action, both of which can be supported by international public finance as argued in Chapter 6.

4.1.2 Mobilising international public finance

The determinants of **ODA** and **OOB** include poverty and per capita income, vulnerability, policy factors (targets), cultural factors (e.g. the relationship between countries and the former colonial powers) and other characteristics of specific donors and recipients. A range of studies (e.g. Nunnenkamp and Thiele, 2006; Dollar and Levin, 2005; Cohen and Katseli, 2006) has examined whether aid is allocated on the basis of needs in the recipient country, as measured by GDP per capita. Most find that ODA, especially bilateral aid, is only weakly based on such needs, but that there is great variety among donors.

Cadot et al. (ERD commissioned paper, 2015) suggest that what determines the allocation of ODA is poorly understood. They highlight that previous studies often relied on cross-sectional analysis of the determinants of ODA receipts at the country level (e.g. Maizels and Nissanke, 1984; Dowling and Heimenz, 1985; Mosley, 1985; Gillis et al., 1992; Wall, 1992). Trumbull and Wall (1994) pointed out that heterogeneity across countries was likely to confound their results and revisited the issue using a panel with recipient fixed effects. They found that ODA allocation seemed to react to variations in infant mortality and civil rights in recipient countries. This means that domestic conditions, including policies in developing countries, also make a difference in attracting ODA.

There seems to be a difference between allocations made by multilateral and bilateral agencies. The former appear to provide more

general programme assistance (including budget support) and commodity aid, and thus actively support efforts to align ODA to the priorities of the recipient country and to smooth income variability arising from commodity price fluctuations. According to Cohen and Katseli (2006), they also seem to specialise in basic infrastructure, in particular transport, water supply and sanitation, and productive sectors, most notably agriculture and financial services.

By contrast, bilateral donors are more 'politicised' than multilateral agencies in their sectoral allocations, and seem to cater to the preferences of their domestic constituency, including NGO support, emergency assistance and debt cancellation (Cohen and Katseli, 2006). Ultimately, the allocation of ODA is a policy choice, and is also highly political. Some donors have long-standing commitments to concentrate on the poorest countries (e.g. DFID's target of 90% to LICs). The OECD Development Co-operation Report (2014) suggests that 50% of ODA should be allocated to LDCs. While the allocation of ODA across country groups is ultimately a political decision it could be argued that poorer and more fragile countries need aid more as they lack sufficient income to use and distribute it.

A further finding is that aid allocations based on the adoption of specific policies have not become stronger, although Alesina and Weder (2002) suggest that Nordic donors tend to give less support to countries in which corruption runs high. Some donors do not seem to base their ODA primarily on the poverty of the recipient country. Berthélemy and Tichit (2004) examine 18 donors and find that infant mortality is a better explanatory predictor than income. Berthélemy (2006) examines trade as an explanatory variable for ODA, and Alesina and Dollar (2000) suggest the importance of single factors in influencing ODA allocations, e.g. Israel/Egypt for the USA, former colonies for France and the UK, and UN voting records in the case of Japan.



Gamberoni and Newfarmer (2011) assess whether aid for trade (AFT) goes to the countries most in need of it, using gravity-based indicators of needs and comparing the observed allocation with a simple allocation rule. They find substantial dispersion of flows around estimated needs, although the correlation between the two is positive across the countries examined.

In addition, as discussed in Chapter 2, international targets such as the MDGs have contributed to raising ODA levels especially for the social sectors (such as education and certain aspects of health). It can be anticipated that future specific global actions could contribute to increasing the amount of ODA still further.

Uneze (ERD commissioned paper, 2015) provides insights into how **SSC** is allocated. The past decade has witnessed the emergence of Southern donors, which do not refer financial assistance to other developing countries as aid, but rather an expression of solidarity (UNCTAD, 2010). All countries in the Global South are considered equals and partners, and therefore national sovereignty and mutual respect are key to their relationships. This partly explains the absence of policy conditionality on Southern aid, although there is some non-policy conditionality.

There is also a difference in the sectoral allocation between Northern and Southern donors. Development cooperation from Southern donors shows that while allocations from Brazil, Saudi Arabia and South Africa are concentrated in social infrastructure, similar to traditional donors, China, India and UAE prioritise economic infrastructure. China and India also assist the productive sector, suggesting that they deploy aid to facilitate trade and investment in other developing countries. The aid from Arab countries and Brazil tends to go to countries facing humanitarian crises.

4.1.3 Mobilising domestic private finance

Private finance is available in different quantities at

different terms in different countries and sectors. It is available in abundance in some countries whilst bypassing others. There are many reasons for this but the most important for this review is the **crucial role of policies in mobilising and steering private finance**.

There are many factors behind the **level and depth of financial-sector development** (see Beck (2013) for a recent review of the literature). Low-income countries tend to have little financial sector depth, which may be hampered by low population density (in SSA), weak savings institutions, the absence of pension systems, inefficient (development) banks, small stock markets with low liquidity, and financial illiteracy. All such (non-financial) issues, many of which are associated with market failures, affect financing for development.

Loayza et al. (2000) review a number of **determinants of private savings** (and hence domestic private finance), which include: persistence, income, growth, demographics and uncertainty. There are two major views on savings: the permanent-income hypothesis that private savings react only to permanent changes in income; and the life-cycle hypothesis that consumption and savings are spread over an individual's lifetime. Whichever is the correct hypothesis, private savings tend to react to changes in determinants only after a time lag (persistence). Moreover, evidence across a range of countries suggests that higher income per capita (and higher growth) raises savings. In developing countries, other things being equal, a doubling of income per capita is estimated to raise the long-run private saving rate by 10 percentage points of disposable income. Further, Loayza et al. (2000) argue that microeconomic and macroeconomic evidence, both at the international and country level, confirms that a rise in dependency ratios (i.e. young or old dependants) tends to lower private saving rates.

Policy can influence these aspects and hence could affect the mobilisation of domestic private

finance. The broad development of a financial infrastructure is important, such as developing a good regulatory framework for pension funds, insurance funds, and stock markets, all of which have the potential to grow fast in LICs. Better policies for developing collateral, such as land-titling and credit bureaux, will also develop domestic finance. Loayza et al. (2000) find that fiscal policy and public savings affect private savings. The effects of tax incentives on savings are found to be more ambiguous. Pension reform, on the other hand, can have major effects on private savings especially through mandatory saving requirements. Liberalisation of interest rates, elimination of credit ceilings, easing of entry for foreign financial institutions, development of capital markets, and enhanced prudential regulation and supervision are also important.

Barajas et al. (2012) discuss a number of **policies that would increase the availability and stability of domestic private finance: (a) market-developing policies; (b) market-enabling policies; and (c) market-harnessing policies**.

Market-developing policies include legal changes and substantial upgrading of macroeconomic performance and stability. These policies help to overcome constraints posed by a small financial sector and can help to expand the frontier of the financial sector (on the demand side). For example, small and undiversified economies can benefit from access to international capital markets and attract private finance by using them as risk-pooling and diversification mechanisms. Such integration requires appropriate macro-prudential policies to dampen the potentially negative effect of volatile capital flows. Informational and contractual frameworks can also help to attract finance, especially in the long term.

Market-enabling policies address weaknesses in regulatory barriers or lack of competition. They help a financial system move towards the frontier. They include more short- to medium-term policy and regulatory reforms, e.g. policies aimed at

fostering greater competition in micro- and consumer lending. Such policies can also include removing regulatory impediments and reforming tax policies, which can raise market contestability, as well opening up new payment systems and credit registries. Such policies could help to expand financial markets.

Market-harnessing or market-stabilising policies help to prevent a financial system from moving beyond the frontier. Such policies include the regulatory framework, macroeconomic and macro-prudential management, including the mitigation of risks associated with non-bank providers of financial services and consumer-protection schemes.

In conclusion, a range of policies influences the financial market and hence the availability and stability of private finance. Barajas et al. (2012) measure the development of the financial market by the ratio of private-sector credit to GDP according to the policy factor and suggest there is a level of financial deepening that is neither too low nor too high but just right. Too much credit can lead to 'boom-bust' cycles in the financial sector, and too little leads to drying up of private finance and lack of investment opportunities. There is a crucial role for policy to obtain an appropriate level of financial deepening.

4.1.4 Mobilising international private finance

FDI

As discussed in Chapter 3, the distribution of private capital flows is uneven across countries. There are often straightforward reasons for this. Several factors can help to **attract FDI**: (a) general policy factors (e.g. political stability, governance, investment climate); (b) specific FDI policies (incentives packaged in a strategy, investment promotion to address imperfect information, international trade and investment treaties, or home-country measures); (c) macroeconomic factors (human resources, infrastructure, market



size and growth); and (d) firm-specific factors (e.g. technology) and one-off factors such as the availability of natural resources or large-scale privatisation (Dunning, 1993; UNCTAD, 1999; te Velde, 2006).

There are also various specific national and international policies to mobilise international private finance. There are too many to discuss in detail, but we identify four as relevant to the post-2015 debate: (a) FDI incentives; (b) trade and investment global and regional policies; (c) global financial rules that can help to reduce the incidence of crises; and (d) global environmental rules.

The literature suggests that **specific FDI incentives** are less effective in attracting FDI than so-called general economic fundamentals, such as good quality and appropriate education and infrastructure. Incentives do tend to have an effect on the choice of location at the margin (examples include Ireland and Singapore over the 1970–1990 period) (te Velde, 2002), and tax lawyers take tax treaties into consideration when advising their clients. Incentives are most effective in determining in which of a number of similar locations footloose export-oriented investment will focus. Morrisset (2003) also argues that time-series analysis and surveys indicate that tax incentives are a poor means to compensate for negative factors in a country's investment climate, but that incentives do affect the decisions of some investors some of the time. Since incentives are costly in terms of forgone revenues, the question is how to minimise wasteful tax incentives and avoid a 'race to the bottom' for tax incentives (and tax levels generally, as expressed in the OECD's work on base erosion and profit-sharing).

Global and regional trade and bilateral investment agreements may help to mobilise FDI. Although causalities are difficult to disentangle, multilateral trade liberalisation in the framework of the General Agreement on Tariffs and Trade (GATT)/World Trade Organization (WTO) has probably contributed to the massive increase

in vertical FDI over the last 20 years. While the impact of bilateral investment agreements on FDI flows remains controversial (Sauvant and Sachs, 2009; UNCTAD, 2009; Berger et al., 2011), empirical studies on the impact of regional trade agreements (RTAs) on FDI tend to suggest that they encourage extra-regional FDI flows and for some regions intra-regional FDI (te Velde and Bezemer, 2004; Büthe and Milner, 2008; Büge, 2012). Other studies also show that different countries within a region experience different effects with respect to attracting FDI. This difference reflects variations in the relative size of the industrial sector, but also the degree to which economic integration, directly or indirectly, increases the geographical advantage of a country relative to others in the region.

In addition to trade-related provisions of RTAs the strength of investment provisions also matters for promoting FDI. The examination by Dee and Gali (2003) of older RTAs suggests that FDI responds significantly to their non-trade provisions. Te Velde and Bezemer (2006) find that membership of a region (including ACP and non-ACP regions) as such is not significantly related to inward FDI, but that if a country belongs to a region with a sufficient number and level of provisions on trade and investment (e.g. describing treatment of foreign firms, large trade preferences), this helps to attract more inward FDI to the region. More recently concluded RTAs usually include comprehensive investment chapters, although their contents vary considerably (Kotschwar, 2009). Opening up the 'black box' of RTAs' investment chapters – accounting for variations with regard to their commitments – recent studies find that the significant positive effects of RTAs on FDI flows can be attributed to the extensiveness of the provisions (Leshner and Miroudot, 2007; Miroudot, 2009) and in particular on the inclusion of clauses on market access in the form of pre-establishment national treatment (Berger et al., 2013).

Box 4.1 gives an example of the role of global policies (international mitigation agreements)

that could help to mobilise climate finance. The presence of a strict global emission-reduction target would mobilise around \$100 bn from a bunkers' fuel tax, reducing the need to mobilise climate-related finance from other sources.

Portfolio flows

A range of national and international factors drives **short-term capital inflows**, including economic growth potential, commodity exports and prices, inflation and exchange rates, deficits on current account and government balances, capital account convertibility, financial-market development, marketing drive, appropriate pricing and size of (sovereign) bond transaction, and global monetary conditions (see Hou et al., 2014).

Global economic policies are crucial for the prospects of portfolio flows to developing countries. The global financial crisis of 2007–2008 and its severe economic consequences – a significant slowdown in global economic activity, a collapse in global trade, debt- and unemployment-related problems in a number of advanced economies – have not only encouraged a re-evaluation of the prospects of global economic growth but have also prompted a re-design of global regulatory and economic policy frameworks. The effects on developing countries have been severe (e.g. te Velde et al., 2010). Increased volatility in capital flows has made macroeconomic management difficult worldwide. Moreover, global economic policies (monetary, financial, and fiscal) that address the volatility of finance flows can have major impacts on developing countries.

Take, for example, the effects of **monetary policy in developed countries**. Faced with a major crisis and lack of effective conventional monetary measures, with interest rates reaching the zero bound, central banks turned to unconventional monetary policies by making large-scale purchases of assets, including government

bonds and asset securities. This significantly affected bond and equity markets, and the wider economy, across developed and developing countries. Ending these unconventional policies will also affect developing countries. A modelling study undertaken for this Report (commissioned modelling paper; Fic, 2015) suggests that the (announcement of a) withdrawal of the US monetary stimulus in 2013 led to an increase by 80 basis points in the USA and some 100–300 basis points in emerging economies' bond yields. Using a global econometric model, the tapering of US monetary stimulus is expected to take 0.8% off the GDP of countries in SSA. In Latin America and the Commonwealth of Independent States (CIS), the more restrictive monetary policy taken by the US Federal Reserve ('the Fed') may have spillovers amounting up to 0.25% of their GDP. The Middle East and the Far East are likely to be least affected. Overall, higher bond yields result in a decrease in the US GDP of about 1%, and of about 0.5% in developing countries. This suggests that global coordination of monetary policies, a global public good, can have major impacts on the stability of financial flows.

A further example (commissioned modelling paper; Fic, 2015) is the attempt to create stable **global banking rules** aimed at preventing costly financial crises. Basel III rules require banks to implement stricter capital requirements. This leads to an increase in borrowing costs. Modelled through an increase in the investment premium reflecting tighter regulation in the area of bank capital and liquidity, GDP in all of the major developed and emerging economies would be reduced by up to 0.25 basis points. In SSA, higher capital and liquidity effects would also lead to a decrease in GDP of up to 0.1%. These costs are, however, much smaller than the benefits associated with averting financial crises by adopting more stable banking rules. In SSA, the impacts of a crisis are more than ten times greater than the introduction of tighter capital requirements, which means that the region as a whole would ultimately benefit from more stable global financial rules.



Griffith-Jones et al. (commissioned background paper, 2015) argue that a major global challenge is to focus on ensuring that the **financial sector serves the real economy**, by enhancing its role in intermediating savings for funding enterprises and households in a sustainable way. This can be helped by strong and effective regulation, which both increases the solvency and liquidity of banks, reduces and/or separates financial activity of a more 'speculative' kind, such as many of the activities of unregulated 'shadow banking', and encourages sustainable financing for the real economy.

Such regulation should, for example, ensure that banks are safer, by being sufficiently capitalised and not having excessive leverage. In this sense, although Basel III represents progress, its aims may be too modest at least for developed countries.

For example, there is much consensus that capital adequacy and agreed leverage requirements are too low for developed countries, and that they need to be gradually increased. The scale and pace of such increase must be done in ways that facilitate increased lending, for example to SMEs, at reasonable cost. The challenge is to design rules to ensure that banks and other financial institutions assume less financial risk but more economic risk.

A greater involvement of the users of finance (e.g. non-financial corporations, consumers, trade unions) in designing such rules may be a useful way forward. This can be achieved by open and transparent dialogue among financial institutions, regulators, policy-makers and other stakeholders on financing sustainable development. In a second stage, the users of finance could be

Box 4.1 | The impact of different CO2 policy scenarios on mobilising climate finance

The adoption of an international climate agreement (a non-financial MOI) will influence international carbon prices, and hence how much climate finance can be mobilised. Data from Hof et al. (2011) offers insights into the scale of the impact of climate-related agreements on the mobilisation of climate finance according to three different emissions scenarios – one that is compatible with a 2°C climate scenario, and unconditional and conditional Copenhagen pledges scenarios. The study uses the FAIR model (analysing environmental and cost implications of climate regimes) to analyse four climate finance proposals in relation to these scenarios (see also the discussion in Chapter 3):

- Norwegian proposal – withholding and auctioning 2% of Annex I countries' emissions allocations
- Swiss proposal - a global carbon tax on energy-related CO2 emissions of \$2 per tCO2 (with a basic exemption of \$1.5 per tCO2 per capita)
- IET levy – levy of international emissions trading, including the Clean Development Mechanisms (CDM) and Joint Implementation
- Bunker fuel emissions tax - on international travel and shipping

The carbon price is determined endogenously by the FAIR model, and provides an approximate carbon price of \$15 per tCO2 for the unconditional pledges scenario and \$50 per tCO2 for the 2°C scenario. The study finds the scale of climate finance mobilised under the different proposals to be dependent on the mitigation scenario, and the scenarios have different effects on revenue according to the proposal. These findings are summarised below.

In all of the scenarios the predictability of climate finance would be greatly increased by the presence of an international binding mitigation agreement, however stringent. The scale of revenue generated in each scenario is determined by both the chosen proposal and the stringency of the international agreement adopted. The impact of scenarios is especially marked on the proposal to tax bunker fuel emissions, which has the potential to raise the largest revenue of all proposals under a conditional pledges or 2°C scenario.

Table 4.1B | Climate finance mobilised under different proposals

PROPOSAL	REVENUE MOBILISED (\$ BN)			IMPACT OF SCENARIOS AND CARBON PRICE
	Unconditional pledges	Conditional pledges	2°C	
Norwegian proposal	3	15	26	The high volume of emission allowances auctioned under the unconditional pledges does not compensate for the low prices, which means that the conditional pledge scenario mobilises more funds (the price effect is greater than the volume effect). The most stringent CO2 scenario (2°C) mobilises the greatest revenue.
Swiss proposal	52	46	41	The higher revenue under the pledges scenarios is caused by the higher emissions in these scenarios. The carbon price has less effect on revenue than the scale of emissions.
IET levy	2	<1	1	The revenue is low, and influenced by level of emissions more than by carbon price.
Bunker fuel emissions tax	17	65	111	In all three scenarios significant revenue is mobilised. The tax level was set at the global carbon price - this could be more predictable by making taxation levels independent of the carbon price. The carbon price (or scenario), however, has a strong impact on revenue.

directly involved in the broad design of rules and regulations to govern the financial sector, to help make it both more stable and better serve the needs of the real economy.

As global conditions change, it will be important to monitor the ways in which financial institutions contribute to meeting the interests of society, particularly its poorest members. We discuss elements of an effective international financial architecture for the poorest countries in Box 4.2. As policies both at the global level and in HICs have an impact on poorer countries, it is important to ensure that the views of the latter are heard, including in support for their coalitions. Te Velde (2011) has argued that vulnerability to a shock equals the exposure minus resilience, which means that the way to reduce exposure is to avoid financial crises or the adoption of distortionary policies in developed countries. While poor countries cannot directly affect such policies, they can still mitigate the negative consequences of shocks by increasing domestic

resilience. For example, they can insure against shocks (e.g. build up reserves, private insurance, capital markets) or simply cope with a shock when it occurs. As a last resort, countries can use donor-funded shock facilities.

Remittances

There are many macro **determinants** of remittances, such as the number of migrants working abroad, and their relative length of stay, relative wage rates and economic conditions between sending and destination countries, relative exchange rates and interest rates, political risk, and financial market development/facilities to transfer funds (i.e. institutions) (Katseli et al., 2006). Micro-level determinants, including altruism, insurance, loan repayments and bequests also appear to be important determinants (see, for example, El-Sakka and McNabb (1999); Gupta et al. (2009); Singh et al. (2009)). Many of these determinants can be influenced by policy, e.g. the availability of financial facilities.



Singh et al. (2009) find remittance inflows to be counter-cyclical, acting as a shock absorber. The CIs provide conflicting evidence. Remittances are a major contributor to the Moldovan economy (CI, Ghedrovici, 2015), but declined significantly from 2007 to 2009 as the global and EU financial crisis forced many Moldovan migrant workers to return home. In contrast, Bangladesh did not

experience the mass return of migrant workers, and remittances remained high, rising annually and steadily between 2006 and 2009, comprising 9.6% of GDP in 2007, 11.2% in 2008, and 11.8% in 2009. Unlike Moldova, the EU is not a significant source of remittances for Bangladesh, so it was spared the effects of the EU financial crisis.

Box 4.2 | A coherent international financial architecture for more and better capital flows to low-income countries

Private capital flows have the potential to provide essential financing for sustainable development, but are subject to risks (as well as opportunities) that have been highlighted by the global financial crisis. Post-crisis trends in flows to LICs are positive but relatively small in absolute terms and relative to GDP. In particular, FDI has expanded steadily and portfolio flows, which fell to negligible levels during the crisis, recovered in 2013 with strong sovereign bond issuances for certain LICs. There remain risks to these positive trends. Tyson et al. (2014) suggest four elements of a coherent policy on the international financial architecture as it affects LICs.

- **Promoting positive impacts of policies in developed countries**, including greater international coordination on monetary policy, such as monetary easing and its tapering. A G20 agenda regarding finance for the SDGs could be more effective if there were a new partnership between the G20 and developing countries. It could, for example, set explicit objectives to leverage G20 investment for the benefit of the G20 and LICs, coordinate capital management between recipient and donor countries to their mutual benefit, and coordinate spillover issues, such as monetary policy, tax-base erosion, illicit capital flows and profit-shifting.
- **Promoting a more effective voice for LICs** in reforming the global economic and financial architecture (e.g. in the Financial Stability Board (FSB)). For example, of the 27 nations whose central banks are represented on the Basel Committee, and of the 24 nations represented on FSB, there are only seven MICs and no LICs.
- **Using aid and shock facilities to leverage capital** for addressing long-term gaps and supporting flows in times of crises, especially in the poorest and most vulnerable economies.
- **Supporting capacity-building in LICs for regulatory and institutional development.** It is important for financial systems in a country receiving private capital flows to be sufficiently robust and stable. Many LICs are experiencing rapid growth in the financial sector, including private-sector credit relative to GDP and expansion of financial access (Beck et al., 2011) and increasing early-stage integration into global financial markets. Stable development and integration of the financial sector have good potential, but the quality and pace need to be appropriate, especially as the deepening of domestic financial systems amplifies exposure to the transmission of global financial shocks. Where financial systems are weak, large and rapid outflows can cause liquidity and asset-market problems. Conversely, large capital inflows may foster asset-price bubbles and an excessively rapid expansion of credit. Some LICs have had less benign experiences. For example, banking institutions have increased leverage and liquidity risks, and asset quality remains vulnerable to deterioration in domestic economies (IMF, 2013b). There is also evidence of excessive domestic credit growth in some sectors and asset bubbles driven by speculative flows. For instance, in 2012 and early 2013 stock-price rallies occurred in a number of African LICs such as Kenya, Tanzania and Uganda, linked to international capital inflows (IMF, 2013a). Such issues can lead to boom–bust cycles in consumption and asset markets, deteriorating banking asset quality, and diverting scarce capital from pro-development investment in agriculture, industry and infrastructure.

Source: Tyson et al. (2014)

4.2 Making finance more effective

This section examines the importance of policies and other factors behind the effective use of each of the finance flows identified in Chapter 3.

4.2.1 Effective use of domestic public finance

There is a large econometric literature on the **effective use of public expenditure** in developing countries, only a selected sample of which this Report can summarise. The general debate now centres on the level and composition of spending, while the earlier literature focused mainly on composition. Barro (1991) used cross-country analysis of 98 developing countries for the period 1960–1985 and found that public consumption was negatively correlated with growth, while public investment had no significant impact on economic development. In contrast, Levine and Renelt (1992) found that for 119 countries during the 1974–1989 period there was a negative relationship between government consumption and growth, but a positive link between public investment and growth.

More recent studies emphasise the importance of **complementary policy**. Gupta et al. (2005) show that the capital part of government expenditure in LICs has a positive impact on growth when it is combined with a lower budget deficit, and Baldacci et al. (2008) suggest that better governance can help to make spending on education and health useful for growth in developing countries. This role of governance could help explain why some earlier studies found a generally weak relationship between social spending and social indicators.

Collier (2011) discusses the importance of the concept of **investing in investing**. It is not just that investment itself is low, but the productivity of that investment is also often low in SSA. Countries in SSA therefore need to improve the process of

both public and private investments. This requires capacity in the country's main institutional arrangements, including the necessary capacity to be (or become) capable of designing, selecting and implementing projects.

The process of investing in investing can be enhanced by adopting **Medium Term Expenditure Frameworks (MTEFs)**. Grigoli et al. (2012) examine the impact of MTEFs which have been adopted by more than 120 countries. Such budgetary institutions can help central governments to make credible multi-year fiscal commitments. Grigoli et al. (2012) find that MTEFs improve fiscal discipline (measured as the central government's budget balance as a percentage of GDP), with a larger impact for more advanced MTEFs. Advanced MTEFs also improve allocative (measured as the volatility in per capita health spending in dollar PPP) and technical efficiency measured as efficiency scores from a stochastic frontier model of the provision of health services. More generally, their review of the econometric literature finds that numerical constraints have limited effectiveness because they can be circumvented, that the effect of reduced social discretion on macroeconomic volatility remains an open question, and that the political environment makes a difference to the effectiveness of budgetary institutions.

4.2.2 Effective use of international public finance

We surveyed the substantial literature on aid and growth in Chapter 2. A major finding is that aid works better in environments that are better governed or where governments have adopted better policies (e.g. countries with a higher absorptive capacity). In this section we explore some further examples and discuss two studies commissioned by the ERD focusing on the effectiveness of aid in particular.

One commissioned paper argues that aid targeting is important in promoting transformative effects. **Thus, the targeting of sectors makes a**



difference to aid effectiveness. If ODA is to be effective and have a transformative role, it makes sense to focus on those productivity bottleneck activities ('weak links'²³) to remove impediments to productivity growth. Cadot et al. (commissioned background paper, 2015) argue that in the presence of industrial complementarities, 'weak links' can hold back an entire industrial structure. Such weak links can be sectors that produce goods but more often they are services sectors such as energy, finance, and transport. In other words, low efficiency of those services sectors might reduce the productivity of other sectors to which they supply and thereby reduce productivity throughout the value chain.

One constraint is that there is no direct measurement of the productivity of those services that would allow identifying them as weak links in a given country. However, input-output matrices make it possible to indirectly identify weak-link clusters on the basis of observed productivity in the sectors to which they supply, correcting for their importance as the share of inputs in this sector. The paper examines empirically whether aid is directed towards weak-link clusters, with the idea that such targeting would have greater transformational effects. Indeed, if aid were focused on removing bottlenecks or binding constraints in the weak link sectors, this could have positive implications for industrial output by improving the productivity of the sectors supported by the 'weak link' service sectors. Such implications could be transformational. The paper finds that sector-allocable aid is targeted at low-productivity clusters, although this effect depends on donor type and the form that ODA takes (loan or grant). Controlling for various factors, they thus find evidence of weak targeting, with effects depending on the type of donor, mode of delivery and the income level of the recipient country.

It is not only the targeting of aid that matters for effectiveness. The policy context is crucial. The Report commissioned a **modelling study examining the link between governance and**

finance. Box 4.3 highlights the importance of effective government in accompanying and making specific finance flows (i.e. FDI and ODA) more effective, using the International Futures (IF) model. Government effectiveness in the IF model is measured using World Governance Indicators (or Kaufmann indicators) and depends on income levels and average years of education (commissioned modelling paper; Lenhardt, 2015). Government effectiveness is an important factor in the IF model, affecting a range of equations, so a change in that indicator will have a number of knock-on effects. The regression results linking flows with governance use measures of institutional quality based on the Kaufmann indicators. The modelling study shows that for LICs an improvement in governance alone leads to a decline in poverty of 2.71% and the FDI shock alone to a 3.07% decline, but a combined governance and FDI simulation leads to a 5.92% shock. Hence it is important to think about the policy context within which finance is mobilised. In this case improved governance greatly enhances the effects of FDI and ODA.

Box 4.3 | Modelling the interaction between finance and policies

Lenhardt (2015) uses the International Futures (IF) model, which covers 186 countries, to gauge the importance of non-financial MOI in combination with ODA and FDI. The model is unique in integrating a comprehensive set of global systems across a broad range of countries. It also facilitates the development of scenarios based on user-generated assumptions about the drivers of a future condition, producing structure-based, agent-class-driven dynamic projections (Hughes, 2004). The 'shocks' to the model explore different scenarios of how changes in future financial and non-financial flows could affect poverty, inequality, GDP per capita and CO2 emissions in LICs, LMICs and UMICs.

These scenarios are:

1. *Increasing ODA from OECD countries to 0.7% of GDP (over ten years)*

ODA from donor countries as a percentage of GDP has fluctuated significantly. Although a commitment to contribute 0.7% of GDP was made in the 1970s, hardly any countries have met this target. We therefore apply a positive shock, which sees ODA as a proportion of GDP of OECD countries reach 0.7%. This also assumes that the distribution of aid across countries remains the same.

2. *A 40% increase of inward FDI in the relevant countries or country income group (over ten years)*

Until 2007, all country income groupings were steadily increasing their proportion of FDI to GDP. From 1997 to 2007 LICs made some of the largest gains on average, starting from low levels of FDI relative to GDP in 1997, to meeting the range of other country categories at 3.2% FDI to GDP by 2007. Lower-middle-income countries also increased on average from 1.6% FDI to GDP in 1997 to 3.4% in 2007. Upper-middle-income countries maintained some of the highest proportions of FDI to GDP over this period, and increased from 3.3% in 1997 to 4.7% by 2007. We use the rate of change of FDI to GDP for UMICs of 1.4% over this period as a realistic positive shock.

3. *A 60% increase in government effectiveness (over ten years)*

Looking at past trends, there have been no significant changes in government effectiveness across country categories, though individual countries have undergone various changes. Each country category has remained relatively stable since 1996 when these statistics were first collected, although there is a distinct relationship between country categories and levels of government effectiveness. High-income countries have maintained a level of government effectiveness of around 4/5, UMICs around 2.4/5, LMICs around 2/5 and LICs around 1.6/5. The positive shock for government effectiveness introduced for each country and country category reflect what UMICs would need to achieve in order to reach the HICs' level of government effectiveness, i.e. an increase of 60% on current trends.

Table 4.3B1 provides the summary results for the alternative scenarios (absolute difference from base) of two financial flows for development:

- The increased ODA scenario has the highest positive impact on poverty reduction across LICs, with a further decline of 8.3 percentage points on the \$1.25/day definition of poverty from the baseline scenario.
- Increased FDI is projected to have a significant impact on per capita incomes in LMICs, but also sees the Gini coefficient (inequality) rise slightly.
- Some of the largest absolute GDP gains to be made from increased FDI are in UMICs (although in relative GDP terms the gains are smallest).

²³ A weak link is a sector whose activities have low productivity, which affects the productivity of sectors to which it is providing inputs and which cannot be easily substituted by imports, implying that a weak link is a real bottleneck.



Table 4.3B1 | Simulating increases in FDI and ODA to 2030 (absolute difference from base)

BASELINE PROJECTIONS TO 2030			
	LICs	LMICs	UMICs
Poverty (% pop)	34.55	10.41	0.832
GDP per capita	982	2779	11890
Inequality (Gini)	0.408	0.377	0.45
CO2 (million tons)	191.6	1874	5140
FDI INCREASE (40%)			
Poverty	31.48	9.42	0.813
Δ from base	-3.07	-0.99	-0.019
GDP pc	1,096	2,981	12,150
Δ from base	114	202	260
Inequality	0.482	0.391	0.454
Δ from base	0.074	0.014	0.004
CO2	202.2	1,934	5,190
Δ from base	10.6	60	50
AID INCREASE (OECD TO 0.7% GDP)			
Poverty	26.23	9.951	0.82
Δ from base	-8.32	-0.459	-0.012
GDP pc	1,124	2,813	11,900
Δ from base	142	34	10
Inequality	0.419	0.378	0.45
Δ from base	0.011	0.001	0
CO2	205.6	1,887	5,151
Δ from base	14	13	11

Table 4.3B2 presents the summary results of the alternative scenarios of improved government effectiveness alone as well as improved government effectiveness in combination with increased financial means for development. From these results we can make the following observations:

- Improved government effectiveness has projected positive gains across country income categories, particularly in terms of GDP per capita. The greatest (absolute) gains are in UMICs, with nearly \$2,000 additional per capita income than in the baseline scenario.
- By combining improved government effectiveness with increased financial means, the effect of each financing flow is enhanced. The largest GDP per capita gains are to be made in LICs and HICs from combining improved governance, with increased financial resources and firm tax rates. In LMICs the largest gains are by combining improved governance with increased ODA.
- Improved governance in combination with increased ODA is forecast to lead to a further 11 percentage point reduction in poverty rates in LICs – the largest decline across scenarios.
- Improved governance and increased financial means is forecast to have a very significant impact on CO2 emissions, especially when improved governance is combined with increased FDI.

Table 4.3B2 | Improved governance scenarios in combination with increased financial means

GOVERNMENT EFFECTIVENESS INCREASE (60%)			
	LICs	LMICs	UMICs
Poverty	31.84	8.154	0.583
Δ from base	-2.71	-2.256	-0.249
GDP pc	1,096	3,214	13,830
Δ from base	114	435	1940
Inequality	0.41	0.379	0.449
Δ from base	0.002	0.002	-0.001
CO2	203.5	1,987	5,415
Δ from base	11.9	113	275
FDI + GOV INCREASE			
Poverty	28.63	7.216	0.562
Δ from base	-5.92	-3.194	-0.27
GDP pc	1,222	3,441	14,100
Δ from base	240	662	2,210
Inequality	0.43	0.393	0.453
Δ from base	0.022	0.016	0.003
CO2	215	2,050	5,456
Δ from base	23.4	176	316
AID + GOV INCREASE			
Poverty	23.72	7.706	0.575
Δ from base	-10.83	-0.448	-0.008
GDP pc	1258	3255	13,830
Δ from base	276	476	1,940
Inequality	0.421	0.38	0.449
Δ from base	0.013	0.003	-0.001
CO2	219	2,002	5,416
Δ from base	27.4	128	276

A comparison of Tables 4.3B1 and 4.3B2 shows that a combined governance plus financial flow shock yields much greater income and poverty-reduction effects than either governance or financial flow shock individually or the sum of them. The governance simulation leads to a decline in poverty of 2.71%, the FDI shock to a 3.07% decline, but a combined governance and FDI simulation leads to a 5.92% shock. Hence it is important to think about the context within which finance is mobilised. In this case improved governance greatly enhances the effects of FDI and ODA.



As discussed in Chapter 2, a large empirical literature has examined the impact of aid in the context of different governance regimes. There has also been a general literature on **aid effectiveness**, which includes the Paris Declaration, and principles such as harmonisation, alignment, and ownership (including capacity-building).

Different **aid instruments** (e.g. grants or loans) are attracted to different contexts. There are advantages and disadvantages to grants and loans from a macroeconomic, strategic, institutional/political, financial and operational perspective. Loans carry a debt-sustainability risk, but can encourage fiscal discipline in recipient countries (Odedokun, 2003), contribute to improving LICs' debt-management capabilities (Bulow and Rogoff, 2005), and allow for the provision of larger volumes of finance over longer periods of time. Grants may help to finance heavily indebted countries without the risk of exacerbating debt overhang, and may provide incentives to recipient countries to undertake projects that are not

financially viable but potentially have significant positive externalities. Grants may, however, introduce issues of moral hazard in recipient countries (Radelet, 2005; Cohen et al., 2007), and are less responsive to specific project needs.

There has been increased emphasis on **blended finance** (combining loans and grants), which depends on the availability of specific facilities and institutional development in donor and recipient countries. Blending mechanisms are a response to the need to increase the volume of finance in a context of constrained resources and rising needs, to speed up ODA disbursement, and to make it sufficiently flexible to adapt to the changing environment. Table 4.1 summarises the benefits of blended finance compared to grants or loans alone and although the ratios for grants and loans to leverage other resources look impressive for several blending schemes (including EU schemes), no studies to date have put this to a robust statistical test.

Table 4.1 | Potential benefits of blended finance, compared to loans or grants

	BENEFITS OF BLENDED FINANCE	POTENTIAL CHALLENGES
Compared to grants	Financing more and bigger projects Achieving macroeconomic sustainability Reducing moral hazard issues Exerting influence on recipient countries' policies	Donors lose visibility and control Potential delay in decision-making
Compared to loans	Making transfers to heavily indebted countries without exacerbating debt-overhang problems Correcting externalities, thus making it possible to fund operations with a high socioeconomic and/or environmental impact Improving the quality of funded projects Exerting influence on recipient countries' policies	Donors lose visibility Potential delay in decision-making Crowding-out effects Market distortions

An ETTG report (2011) suggests that in order to guarantee an efficient allocation and implementation of blended finance it is important to:

- ▶ reduce the complexity of blending mechanisms, for instance by clearly assigning responsibilities (accountability) in order to avoid transparency issues
- ▶ carefully assess the impact that mixing a loan with a grant element could have on a recipient country in order to avoid crowding-out other potential sources of funding
- ▶ define the percentage of the grant element in such a way as to deter recipient countries from imprudent borrowing
- ▶ reach agreement among donors on requirements to provide funds in a timely fashion and avoid delaying decision-making processes

There is comparatively little systematic evidence on the **effects of DFIs**: although there are several micro-level evaluations (albeit imperfect), few studies assess the DFIs' macro-level impact on productivity (see, for example, Jouanjean and te Velde, 2013). The role of DFIs is examined in Chapter 6.

4.2.3 Effective use of domestic private finance

An efficient financial system helps (a) an efficient exchange of goods and services; (b) the pooling of savings from many individual savers and overcoming investment indivisibilities; and (c) a reduction in screening and monitoring costs, agency problems, and liquidity risk. There is a large literature on the link between **domestic private finance and growth**. The early evidence suggested that an expansion of the (domestic) financial sector is correlated to growth (King and Levine, 1993); and that the effect is through productivity rather than capital accumulation (see Beck et al., 2000). Recent research shows,

however, that this may not hold for high levels of financial-sector development because if it is too large or expands too quickly it may lead to crises, which undermine growth (Arcand et al., 2012). Aghion et al. (2005) argue that the impact of finance on growth is strongest among LICs and MICs but fades as countries approach the global productivity frontier. These are important empirical observations as they illuminate the relationship between finance and development, which is not simply that more finance will lead to more growth.

Much research has focused on the relative importance for growth of financial institutions (banks, insurance companies, non-bank financial institutions) and financial markets (bonds, stocks, and financial derivatives), concluding that both are significant and have independent effects (see Levine and Zervos, 1998; Beck and Levine, 2004). When a LIC graduates to MIC status, there tends to be an expansion in the depth and complexity of the financial sector. Financial sectors lead to growth by providing various functions, and different structures may provide a different mix of functions, appropriate for various stages of economic development and types of firm. Evidence indicates that, as economies develop, the financial structure changes and financial markets play a larger role (see Demirguc-Kunt et al., 2012). But there are contested issues about the appropriate number, size and ownership of banks (see, for example, Claessens and Van Horen, 2013). In conclusion, a range of general factors determines whether and how finance systems affect development.

There are several ways to ensure better use of domestic private finance. The broad development of the financial infrastructure is important, e.g. developing a good regulatory framework for pension funds, insurance funds and stock markets. A further major challenge can be the cost of financial intermediation, which depends on factors such as (a) individual bank-specific factors such as operating or administrative costs, non-performing

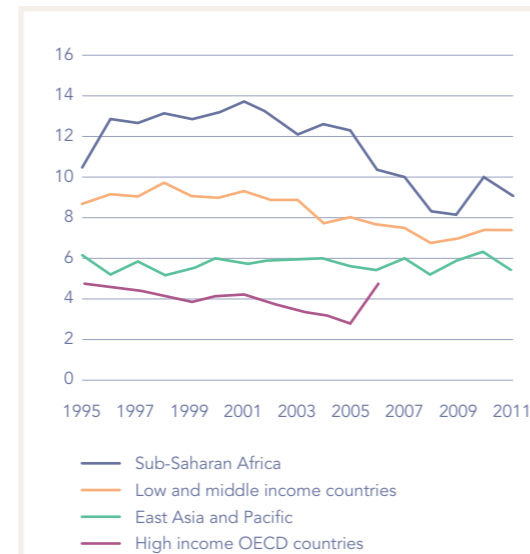


loans (NPLs), bank size, liquidity ratio; (b) banking sector-specific factors such as the degree of competition or regulatory requirements; and (c) macroeconomic factors such as GDP or fiscal policy. Bank profits are also included in the costs of intermediation. Unfortunately, the lack of an effective competition regime and of incentives to innovate prevents banks in LICs from engaging in innovation and becoming more efficient. Inefficiency is often expressed as a high interest rate spread, which drives up intermediation costs – a short-term gap between the central bank rates and the lending rate. A high spread means higher costs of credit, which stifle investment and according to Beck et al. (2011) has direct negative repercussions for the depth and breadth of financial systems. Higher market power results in higher interest rate spreads and, ultimately, in lower levels of bank lending.

A high interest rate is evident, for example, in Ghana's banking sector; where lack of competition, inefficiency and a high interest rate spread are clear (Ackah, 2013). Despite the recent reforms of the financial sector and the global financial crisis, rather than narrowing, the spread has been either stagnant or has grown. There has been some progress in Kenya, where the financial sector has become more efficient (and bankers' salary increases have been moderated), although additional solutions such as improving the collateral process, credit information and other targeted interventions could help further (Mwega, 2013).

Figure 4.2 suggests that interest rate spreads in SSA have consistently been two percentage points higher than the average in LICs and MICs. Given that access to credit for the private sector stood at 61% of GDP across the region in 2012 (representing around \$759 bn), this means that private investors in Africa face an additional costs of around \$15 bn (2% of credit extended) compared to the average interest rate spread in developing countries, simply in order to access finance. Non-financial policies, such as competition and innovation policies (or those that

Figure 4.2 | Interest rate spread by region, 1995–2011



Source: WDI data: the interest rate spread is the interest rate charged by banks on loans to private-sector customers minus the interest rate paid by commercial or similar banks for demand, time, or savings deposits. The terms and conditions attached to these rates differ by country, which limits their comparability.

reduce NPLs), that would lower the SSA interest rate spread to the LIC and MIC average could, therefore, increase the availability of finance by more than 1.2% of GDP and increase investment by 6%.

The effects of **bank lending** depend on financial regulations and the areas in which loans are made. The size of the financial sector also matters since if it is too large it is a drag on growth. The incentives and regulations for the formal sector to lend to productive sectors (e.g. development banks for agriculture) or to the small-scale sector affect social and economic outcomes (te Velde and Griffith-Jones, 2013).

4.2.4 Effective use of international private finance

The policy context is also crucial for the effective use of international private finance. Here we discuss three types of international private finance: remittances, FDI and portfolio flows.

Remittances

There is a large literature on the **impact of remittances**. Gupta et al. (2009) find that they lead to an increased income in the host country and help to reduce poverty. Remittances can smooth access to credit in countries with poorly developed financial services. Woodruff and Zenteno (2007) further suggest that, in the case of Mexico, remittances alleviate a credit constraint for investors. Dustmann and Kirkchamp (2002) find that savings made by migrants returning from Germany to Turkey are an important source of start-up capital for microenterprises. The Nepal case study commissioned for the 2012/2013 European Development Report found that remittances had contributed to improving household expenditure in social areas (education, health, nutrition), and the World Bank attributed 20% of the Nepal's progress towards reaching the MDGs to remittances.

Importantly for this Report, several researchers (e.g. Fajnzylber and López, 2007), find that the **impact of remittances on economic growth depends on the context**, including governance and the depth of the financial sector. They explain real per capita growth in Latin America by remittances and other variables and include an interaction term between remittances and either human capital, institutions or financial depth. The findings suggest that the accumulation of human capital or an improvement in institutional quality complements the positive role of remittances in relation to economic growth, but that financial depth substitutes for remittances in promoting economic growth.

The effects of **remittances** depend on whether they are used for consumption or investment

and whether they stimulate entrepreneurship. Ratha (2013) finds that remittances have an insurance and consumption-smoothing effect. He also argues that policy-makers can do more to optimise the impact of remittances by making less costly and more productive investment in human and physical capital, e.g. by using diaspora bonds, remittance-linked loans and securitisation of remittance flows.

The **costs of sending remittances** can be significant: the more it costs to send it, the less money will be transferred. Watkins and Quattri (2014) suggest that SSA countries in particular face high costs in sending remittances. With respect to institutional quality and economic policies in the migrant-sending country, Freund and Spatafora (2005) find that high transaction costs have a significantly negative effect on remittances, as they lead to increased use of informal channels and reduced flows.

FDI

The general means through which **FDI** can affect development are listed in Table 4.2. The literature on **FDI and spillovers** emphasises a specific role for local institutions, absorptive capacity (Blomström et al., 1999), human resources (Borensztein et al., 1998; Xu, 2000), trade regimes (Balasubramanyam et al., 1996), financial-sector development, and industrial policy (clustering). Environmental and social policies also contribute to determining the effects. Hence, a range of policies can help to make FDI work for development.

Portfolio flows

The literature on the impact of FDI (long-term capital flows) on development paints a generally positive picture. The reverse seems true for the **impact of short-term capital flows**, at least in LICs. Hou et al. (2014) review the academic literature on the effects of short-term capital inflows, finding that portfolio bond flows in LICs overall and SSA countries in particular have had



a neutral or even negative effect on growth. For example, in a review of 44 countries between 1986 and 1997, Reisen and Soto (2001) find that FDI and portfolio equity flows affect growth significantly, while bonds and official flows have little or no effect. Some studies stress that policies

and country characteristics can make the impact positive. The effects might be negative in LICs because bond flows have been small or because complementary policies have been weak – both factors that are subject to change.

Table 4.2 | Inward FDI and development

IMPACT AREA	STATIC EFFECTS		DYNAMIC EFFECTS	
	Indicators	Differences between foreign and local firms	Potential dynamic benefits of FDI	Potential dynamic costs of FDI
Employment and income	Employment-generation in foreign firms. Wage levels for staff with given characteristics.	Foreign firms are larger and pay higher wages (especially for skilled employees) than local firms.	Provides employment and incomes directly.	May indirectly crowd-out other employment by replacing existing employment or pushing up factor prices; may lead to increased wage inequality.
Physical capital	Fixed capital formation. Financial transfers.	Foreign firms tend to be more capital-intensive.	Stable source of external finance, improving the balance of payments, and potentially raising fixed capital formation.	May pre-empt investment and opportunities of domestic firms.
Market access	Share of inputs imported. Share of output exported.	Foreign firms tend to be more trade-intensive.	Firms can gain access to export markets by using global networks of TNCs.	TNCs can maintain tight controls of export channels.
Structure of factor and product markets	Concentration in product and factor markets. Profit margins.	Foreign firms can often be found in sectors with 'barriers to entry'.	Entry by foreign firms may lead to more competition, which could reduce product prices.	The entry of foreign firms can lead to further concentration and market power. This may raise prices of own and other products.
Technology, skills and management techniques	Skill level of employees. Training budgets. Output per employee. R&D budgets. Types of technology used.	Foreign firms are more skill intensive, tend to use more up-to-date technologies offer more training.	Provides up-to-date techniques, skilled personnel and advanced management systems, raising the return to skills offering additional incentives for education. Positive spillover effects on domestic firms through backward and forward linkages, demonstration effects and human resource development.	Spillovers are not automatic or free. Reliance on foreign technology and skills may inhibit development of local capabilities. Increased linkages raise dependency of domestic firms on TNCs.
Fiscal revenues	Fiscal payments Grants to foreign firms	Tax holidays or grants are sometimes offered to foreign firms.	TNCs can raise fiscal revenues for the domestic government through the payment of taxes in case of new economic activities with more value-added.	If TNCs crowd-out domestic firms, fiscal revenues may actually be lower through the use of special tax concessions, eventually leading to an erosion of the tax base Special tax concessions are an implicit subsidy and without full transparency can lead to rent-seeking.

Source: Developed from UNCTAD (1999) and te Velde (2006)



Encouraging stability in international private finance

Capitals flows can be highly volatile. The effects of **short-term equity and bond inflows** depend on the use of a number of specific policies including (a) macroeconomic policies (fiscal, monetary and exchange rate policies) to smooth the potential impact of increased inflows on inflation, exchange-rate appreciation, fiscal expansion and heightened volatility; (b) financial-sector policies to manage, regulate and maximise the potential of short-term equity and private-bond flows; (c) effectiveness of programmes to spend sovereign bonds receipts; and (d) capital-account management measures (see IMF Regional Economic Outlook for Africa, 2013c; Hou et al., 2014). Box 4.2 discusses a range of national and international policies comprising an international financial architecture for more and better capital flows to developing countries.

While better banking rules and global monetary coordination can help to avoid financial crises, other **global mechanisms such as shock facilities** and domestic complementary policies (macro-stabilisation policies) can help to stabilise economies once they are hit, affecting all types of capital flows. Sudden external shocks can involve sudden net capital outflows, a fall in export revenues, and increased costs of essential imports such as food and oil products, or a drop in remittances. The CIs suggest that countries have been affected differently by a range of effects, e.g. food price inflation in Bangladesh in 2007–2008, the global financial and European economic crisis resulted in lower remittances in Moldova during 2007–2009 because many migrant workers returned home, while Ecuador and Indonesia experienced a sharp drop in exports during the global financial crisis with slow or incomplete recovery since then (CIs: Khatun, 2015; Ghedrovici, 2015; Borja and Ordóñez, 2015; Damuri et al., 2015).

Such shocks affect growth and government revenue. This can lead to increased poverty in the short term, as well as a reduction in critical expenditures, which can have long-lasting negative development effects. Evidence shows that the problem in poor countries is not just a failure to record periods of positive economic growth but also the frequency of downturns (Winters et al., 2010). Countries classified as low-income in 2008 increased their per capita GDP by only 11% between 1960 and 2007 (or 0.23% annually). This is not only because growth rates have been low each year, but also because there have been many years of negative as well as positive growth. Indeed, if periods of negative growth rates had been eliminated altogether, GDP per capita would have more than doubled and average annual growth would have increased to over 2% (rather than 0.23%). Donors and international financial institutions (IFIs) have designed **shock facilities²⁴ to cushion the impact of shocks on the poor and protect critical spending categories** in order to sustain growth. Te Velde et al. (2011) review the experience of shock facilities and argue that scale, speed and coordination are important and that the EU and IMF facilities helped, but there are questions about whether the current facilities (including international organisations) will be sufficient to deal with future shocks.

4.3 Linkages among flows: a catalytic role for ODA and DFIs

There are several relationships among financial flows, e.g. between tax revenues and FDI (OECD, 2008), or between ODA and FDI (te Velde, 2007), or exposure by DFIs and investment. Here we focus on the catalytic role of ODA and DFIs:

- ▶ *Links between ODA and tax revenues.* Morrissey (2013) argues that it may appear that ODA reduces efforts to raise taxes since

countries with higher ODA-to-GDP ratios tend to have lower tax-to-GDP ratios, but this is because poorer countries have lower tax revenues and receive more ODA. Indeed, he argues that ODA has no systematic effect on tax efforts. Some countries may be discouraged from raising taxes because they expect to receive ODA, but in general, ODA can support better public financial management and tax-collection systems that may eventually increase tax revenues. There are impressive examples of where ODA has helped tax administrations to become more effective (e.g. Rwanda and Burundi, see Granger, 2013). The African Development Bank (African Economic Outlook, 2010) finds that the benefit–cost ratio of a dollar spent on tax administration is close to 6:1 in Sierra Leone and Ethiopia and 3:1 in Rwanda and Tanzania.

- ▶ *Catalysing effect of DFIs on private-sector finance.* Additionality and catalytic effects can be described as a situation in which there is more public and private investment in a country than there would have been without DFI investment. In general, DFIs provide different types of evidence. First, DFIs suggest that their presence catalyses other investments, citing descriptions and historical accounts. Second, they provide so-called leverage ratios, indicating how much the private sector or other DFIs have also invested.²⁵ Third, DFIs point to the distribution of their portfolio. By allocating funds to countries that have little access to private capital markets, DFI investment is by definition additional. Similarly, when DFIs allocate more resources to frontier sectors or financial products (e.g. first-loss guarantees) than would otherwise have been the case, they are additional. This Report examines in more detail how DFIs can leverage more flows.

Although the data provide useful insights, they are also unsatisfactory for a number of reasons. First, for every good example of

catalytic effects there could be a negative one. Leverage ratios could be a sign of catalytic effects and additionality, or they could suggest the opposite, such as when DFIs invest in locations that already attract other funds. No DFI provides macroeconomic evidence of additionality or catalytic effects in a dynamic sense (e.g. spillovers and indirect effects), so it is hard to say conclusively how effective DFIs are, although individual accounts suggest that they give an important stamp of approval and have a special role in projects' financial closure. The effects of DFIs could be measured at an aggregated level (sector or national measures), e.g. te Velde (2011) estimates a simple equation that explains domestic gross fixed capital formation as a percentage of GDP. A specific way in which DFIs can catalyse other investment is by financing project-preparation costs, which are generally estimated to be 10% of total investment. Without business plans, impact assessments, or regulatory/sector reform, a project is unlikely to go ahead. Such costs can be paid back once the project is profitable.

- ▶ *ODA and remittances are linked in various ways.* Some aid-supported schemes can boost remittances, while Kpodar and Le Goff (2011) find that remittances lead to lower aid dependency when they are invested in human and physical capital rather than in consumption.
- ▶ *ODA and investment.* The link between ODA and investment is complex. It can be used to push investment into developing countries (e.g. investment missions, or reducing the costs of investment by offering insurance not provided by the market) or it can be used to pull investment into developing countries (e.g. when it finances education, skills and the business environment generally). Te Velde (2007) argues on the basis of econometric tests for FDI from the UK that it is more effective to pull than to push FDI.

²⁴ Shock facilities are donor funded financial mechanisms that provide funds for developing countries when they are faced with certain macro-economic shocks. For example, countries could face sudden balance of payments (BoP) shocks and then the IMF can provide BoP support in the form of interest-free / low-interest loans. Other donors such as the EU provide grant based shock financing through FLEX and V-FLEX mechanisms, which pay out based on some trigger a large decline in export revenues; or an expected financing gap.

²⁵ Kingombe et al. (2011) estimate that every dollar of CDC investment coincides with \$5 of other investment. Since 2004, CDC has committed more than \$5 bn to 65 fund managers, and other investors have committed a total of \$24.3 bn. The IFC (2011) argues that every \$1 of its investment leverages about \$3 from others. For EBRD, it is around \$1: it suggests that, alongside €7.9 bn investment in 2009, it attracted additional co-financing worth €5.1 bn. Of this, €2.3 bn came from private and €2.8 bn from public co-financiers, of which €2.7 bn was from the IFIs (2008: €0.4 bn).



In the above examples, ODA plays a specific role in addressing market, coordination or governance failures: it can be catalytic in the case of tax administrations, or if channelled through DFIs it can reduce the uncertainty and challenges associated with large upfront costs for infrastructure projects, or address missing markets and develop financial instruments for mobilising remittances or insurance projects for development investment. Some argue that ODA should finance the social sector because this is what it has done since the adoption of the MDGs. Others maintain that ODA can play a catalytic role in mobilising and channelling other flows that will be essential for financing the post-2015 development agenda. As we argue throughout this Report, it is not the general availability of finance that is the problem, but rather its mobilisation and allocation towards the most important goals.

4.4 Conclusions and implications for the global system

The reviews presented in Sections 4.1 and 4.2 suggest the policy context is crucial for mobilising and making more effective use of finance flows. The policy context includes economic fundamentals (e.g. skills development, private-sector development) and good governance (e.g. effective public-private dialogue for FDI) as well as national (e.g. capacity of tax authorities) and international (e.g. international treaties on FDI or tax regimes) policies for mobilising flows and national policies for managing flows more effectively, such as domestic cyclical policies (macroeconomic management to manage short-term capital flows) or specific institutional set-ups (public financial management (PFM) systems for aid).

Policies help to manage the characteristics of different finance flows (see Chapter 3). Table 4.3 summarises selected links between financial and policies. It distinguishes between national and international dimensions and serves as a guide for Chapter 6.

There is a range of general findings on the links between policies and finance:

- ▶ Good governance is a key factor in mobilising and using all forms of finance effectively; in some cases, national governance is of major importance, in others regional and international governance also matter (e.g. in the case of GPGs).
- ▶ A range of international policies affects international private finance (e.g. RTAs, global financial rules, global environmental policies) and to a degree domestic public finance. International policies do not seem to affect ODA, which is, however, affected by specific development targets and other issues, such as domestic policies in developing countries.
- ▶ Some policies, such as domestic financial regulation and development of dedicated local institutions and instruments, will have a predominant effect on local private finance but less so on other flows. Although they might reduce the demand for remittances and increase the development effect of FDI.
- ▶ Some policies are designed to avert crises and volatility and promote stable finance (e.g. macro-prudential policies; Basel III), others at filling gaps (e.g. shock facilities; AfT).
- ▶ One-off factors such as the availability of natural resources affect mobilisation of public (e.g. national SWFs) and international finance (e.g. FDI), but also highlight the need for appropriate policies to use these flows effectively.

This chapter has emphasised that a Global Partnership needs to take into account national and international policies that could reduce the need for further finance and/or make better use of existing finance.

Table 4.3 suggests three important reform areas:

- ▶ Reforming domestic policy and finance frameworks: a range of factors can increase tax revenues and make domestic private finance work more effectively. Both domestic public and private finance needs much improvement in the poorest countries.
- ▶ Reforming international public finance: aid effectiveness principles and smarter, more catalytic use of ODA can help to improve impact (see also Section 4.3).
- ▶ Reforming the international system.

Chapter 6 focuses on the first two areas. Table 4.3 below summarises the key elements of a reformed international policy environment. We have reviewed existing policies and provided new evidence. Developing countries have been hit by the global financial crisis through real and financial channels. Global financial rules could help to prevent such banking crises. The CIs show the importance of trade access in promoting economic development (see also Chapter 6) and hence more and better trade access through global trade rules (e.g. on trade facilitation or reduction in trade-distorting subsidies) will help. Global tax rules will assist DRM by reducing illicit capital flight, which is currently reducing tax revenue in developing countries. Finally, climate change will affect the poorest countries most severely although they contributed least to causing it.

While finance is often used as a second-best solution to address the negative consequences of international shocks on developing countries (e.g. through shock facilities, AfT and climate finance), reforms to the global rules are often more effective approaches and may also reduce the need for additional finance. For example, reforming trade policies has a greater effect than AfT resources. Duty-Free Quota-Free (DFQF) access for LDCs to the markets of the G20 countries (beyond the EU, which already provides such access) could

increase national incomes in LDCs on average by 0.5% of GDP, which is a similar amount to the \$30–40 bn of AfT provided annually. The benefits to accrue from full implementation of the WTO agreement on trade facilitation are even greater. Curbing illicit capital outflows would support financial capacity, economic development and revenue collection in poor countries. Reforming banking rules would reduce the likelihood of financial crises, which in turn reduces the need for shock facilities. The cost of avoiding a crisis is ten times less than what a financial crisis costs SSA countries. Hence reforming the international system through the provision of governance GPGs (see Table 4.4) is a crucial element in the post-2015 development agenda, by making more effective use of existing finance and mobilising additional finance as well as ultimately reducing the need for other finance. We consider reform of the global system is an essential part of the FFD discussions.



Table 4.3 | The role of policies in the mobilisation and effective use of finance: illustrative examples

	POLICIES FOR MOBILISATION		POLICIES FOR EFFECTIVE USE	
	Domestic	International (regional/global)	Domestic	International (regional/global)
Domestic public finance (tax revenues, and SWFs, sovereign bonds)	Tax authority capacity Introduction of VAT, property taxes Natural resource subsidy reform Governance Policies for formal-sector employment and earnings (the income tax base) and private spending (the indirect tax base)	International agreements on tax cooperation/capacity and transfer pricing International cooperation to promote liquidity on bond markets	MTEF, PFM systems, managing tax revenues Well governed SWFs and development banks to channel natural resource revenues Public-sector governance (accountability, consistency)	International cooperation (e.g. IMF article IV; tax assessments) EITI
International public finance (ODA, OOF, blended finance)	Fragility, poverty, crises, political ties Graduation Global development targets ODA definition	Blending schemes for ODA grants to leverage OOF Shock facilities to address shocks and crises	MTEF PFM systems National level governance and absorptive capacity	Realising synergies ODA, OOF and technical cooperation ('smart aid') Reducing transaction costs and improving coordination
Domestic private finance (banking, pension funds, corporate bonds etc.)	Develop pension fund, and stock markets Land-titling, collateral and credit bureaux Business climate policies Attitude toward private sector Financial literacy	Regional stock markets Regional DFIs	Competition and innovation to reduce intermediation costs Well-governed development institutions Financial regulatory governance Financial literacy	Appropriate financial rules to avoid systemic risks
International private finance (FDI, bank lending, portfolio)	FDI strategies (capped incentives, EPZs) Business climate policies Market size, national and international governance, economic fundamentals	Regional/global agreements for trade and investment Basel III, trade finance, monetary conditions and other finance rules for stable finance CO2 emissions reduction for green investment Natural resource subsidies Project preparation funds and guarantees (equity, loans, guarantees etc.) DFIs for mobilising institutional investors Absorptive capacity (education, infrastructure and financial-sector development) Responsible investment strategies	Debt management strategies Macro-prudential policies to manage volatility Capital controls 'after-care' investment services	Global compact/CSR strategies (social and environmental standards) for TNCs, e.g. EITI Technology transfer (IPR regimes) Global financial rules to avoid systemic risks
International private finance (remittances and philanthropy)	Innovative instruments (e.g. diaspora bonds) Level of development (differentials between home and host)	Migration policies Remittance costs Anti-money laundering regulation	Financial systems to make sound use of remittances Governance (esp. household level)	Foundations' strategies

Table 4.4 | Reforming the international system

	GLOBAL TAX RULES	TRADE RULES	FINANCIAL RULES	CLIMATE RULES	SHOCK FACILITIES
Importance for mobilisation and effective use of finance	Better tax rules reduce illicit capital outflows and increase domestic resources. Better transfer pricing rules will lead to more tax resources in LICs. Annual losses in outflows are greater than ODA to SSA	Stable environment increases trade access which attracts finance and makes it more effective Annual gains for developing countries are greater than the value of AfT	Less volatility increases the quantity and quality of finance Reduces the need for shock finance, although some will still be required	Stricter commitments on CO2 emissions incentivise green investment Reduces the need for additional green finance	A more stable economy is better for long-term growth, which can attract more finance.
Illustrative evidence provided in Report	NIESR/NIGEM model estimates in Chapter 4 (commissioned modelling paper; Fic, 2015)	Country Illustrations (Bangladesh Mauritius) and Chapter 6	NIESR/NIGEM model estimates (commissioned modelling paper; Fic, 2015) on costs of crises versus costs of avoiding them (see Chapter 4)	Box 4.1 based on climate modelling literature and Chapter 6	Evidence on importance of shocks and lessons on effective shock facilities
What should be done?	Change OECD tax rules (follow OECD BEPS and other plans), implement better transfer-pricing rules and consider impact of tax rules on developing countries	Change WTO rules and implement a trade facilitation agreement	Improve voice of poorest countries in international financial architecture; include banking sector (see Box 4.2 on coherent financial architecture)	Increasing commitments to the reduction of CO2 emissions, where developed countries and BRICS need to take responsibility	Maintain shock architecture that is fit for purpose (e.g. scale, speed, coordination). Build on good examples of EU V-FLEX and IMF.

CHAPTER 5.

A framework for assessing the role of finance and policies in enabling a transformative post-2015 agenda

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Main Messages

The framework presented in this chapter is intended to encourage a **joint discussion of finance and policies together rather than in a disconnected fashion**. This finance and policy framework represents a **leap that is critical to the success of a future Global Partnership**. The main messages arising from this chapter are:

- ▶ The role of finance in promoting poverty eradication and sustainable development needs to be seen in the policy context. Finance does not operate in a vacuum and **it is the combination of finance and policies that permits the development of enablers**.
- ▶ **Action should focus on these drivers or enablers of change**. Poverty eradication and sustainable development cannot be achieved without improving and financing longer term enablers such as: **local governance; infrastructure; human capital; biodiversity; green energy technology; and trade**. This focus on the enablers contrasts starkly with **outdated views that ODA or finance alone can suffice**.



Chapter 1 looked at the discussions on the proposed SDGs that are pointing towards the need for a transformative development agenda. This chapter presents the Report’s conceptual framework for examining the role of finance and policies in enabling this agenda. Without radical transformation, there are unlikely to be rapid increases in productivity, more jobs, low-carbon energy, protected biodiversity, zero poverty and egalitarian societies, or that it will be possible to promote a universal, sustainable and inclusive development agenda. Experience suggests that earlier transformations have had unique characteristics. Different paths have been followed and different choices have been made in the process. These have varied across countries and time periods and have been shaped by history, resource endowments, political, social and cultural institutions, and policy choices. A transformative post-2015 agenda will need to be very different from what has been seen in the past in order to secure a sustainable future – specifically, it will need to encourage developed and developing countries to adopt a radical strategy to achieve transformative green growth and inclusive development.

This chapter introduces the Report’s framework for examining the role of finance and policies in supporting such a transformative agenda. Achieving it will require adequate consideration of the social, economic and environmental dimensions. A key issue is that promoting sustainable development requires long-term perspectives, which depends on having the means to make these possible – what this Report refers to as enablers. Section 5.1 presents an integrated conceptual framework that links financial flows, complementary policies and enablers of sustainable development and Section 5.2 presents the Report’s selection of enablers for sustainable development to which the framework will be applied in Chapter 6, placing this in the context of existing literature and empirical approaches.

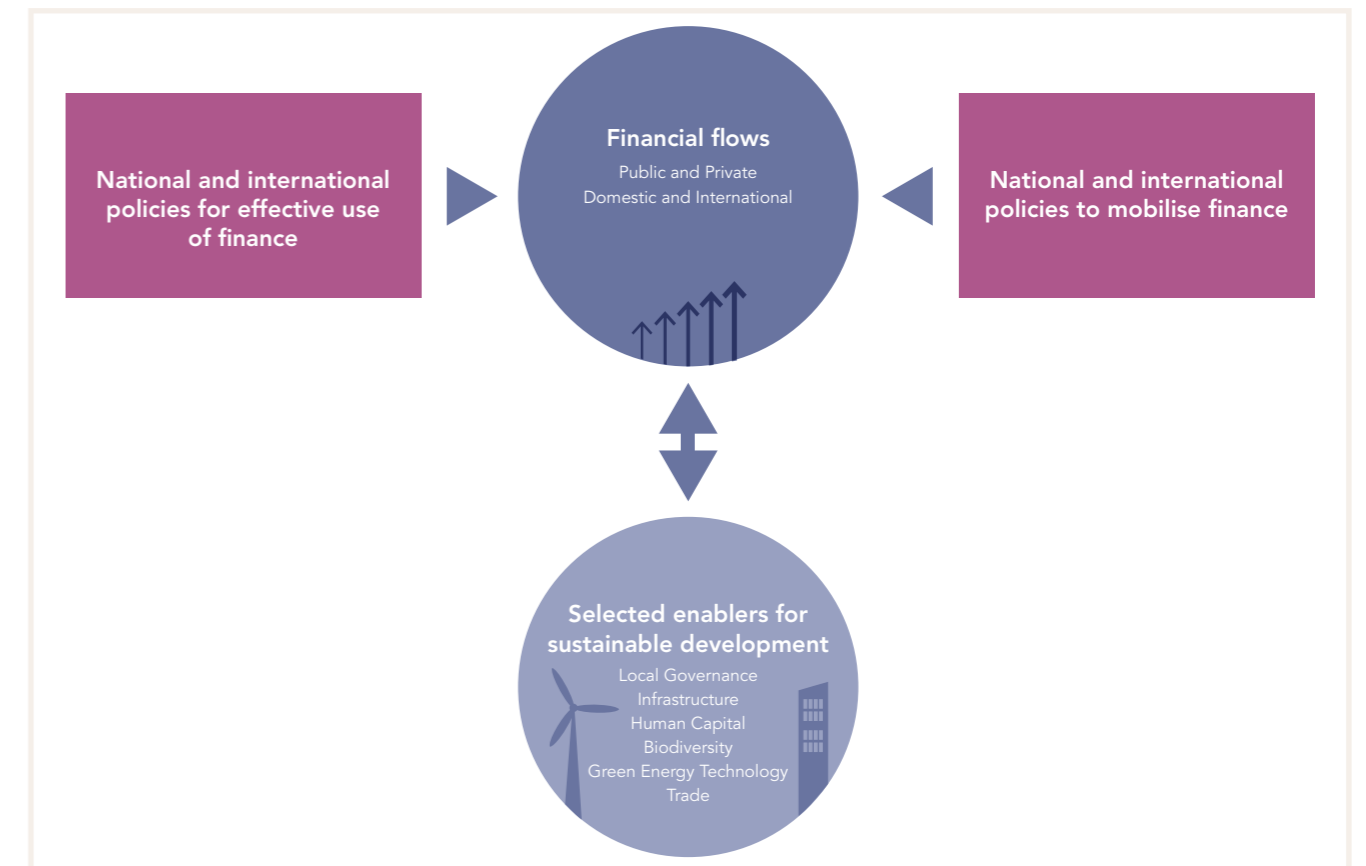
5.1 An integrated conceptual framework for the role of finance and policies in enabling a transformative post-2015 development agenda

Finance is a crucial Means of Implementation (MOI) for a transformative post-2015 development agenda and it has been flowing in different quantities and on different terms to different types of country (discussed further in Chapter 3). It is important, however, to consider the national and international policy context of finance (Chapter 4).

It is a major challenge to establish a framework within which to consider the links between finance and policies. By drawing on the literature we suggests ways (financial, regulatory and other) in which various actors can promote and guide finance so that it flows to the right areas. Chapter 6 examines the link between finance and policies in developing selected enablers for sustainable development.

Figure 5.1 sets out the integrated conceptual framework central to this Report. It describes the role of financial flows (domestic and international, public and private, see Chapter 3) in promoting sustainable development. It illustrates how finance flows that are mobilised with the help of policies, can promote the enablers of sustainable development, again in the context of policies. One of the key messages is that the role of finance in promoting sustainable development needs to be seen in the policy context. This framework is intended to promote the joint discussion of policies and finance (through the illustrative examples of sustainable development enablers whose selection is explained in Section 5.2).

Figure 5.1 | Integrated conceptual framework for finance and policies in enabling a transformative post-2015 development agenda



Traditional thinking on finance needs often made a direct link between finance (in particular ODA) and the achievement of the MDGs, although in practice finance was used in conjunction with policies. Finance was used to fund the achievement of (largely) social goals without considering fully the economic and environmental dimensions of sustainable development, and in particular without taking into account the need for an integrated approach that considered the importance of enablers (see Chapter 2).

Our framework builds on the lessons to be drawn from the implementation of MDGs and envisages a more restricted but also more realistic role for finance in a transformative post-2015

context than the predominant interpretation and implementation of the 2002 Monterrey Conference. Rather, we see the role of policies, alongside finance, as crucial. On the mobilisation side, an appropriate policy framework can generate and attract more finance and a small policy change can sometimes tap into more finance. On the effectiveness side, better policies can pull finance from unproductive to productive uses, better policies can achieve more results with the same amount of finance, they can improve the stability of finance and better policies reduce the need for additional finance.

The enablers are particularly relevant areas of action through which the Report aims to illustrate



the interplay between finance and policies. Thus policies can help finance to develop the enablers of sustainable development. There is no automatically positive link between the two, however. What often appears to be a financial constraint might be the outcome of a general or specific policy or of market failures and conditions. For example, excessive budget deficits or a debt overhang will limit the availability of finance at reasonable costs to viable exporting firms and hamper new investment activity in productive sectors. Similarly, the absence of land titles or clear property rights will prevent the unlocking of private investment for the enablers of agriculture. It would be ineffective to increase financial flows to agriculture without first resolving the regulatory and legal framework. Correspondingly, there are several ways in which policies can influence finance and have an impact on the enablers of sustainable development. How policies and finance are linked to the enablers is illustrated by six examples that are presented in Chapter 6.

There are several reasons why policies play a role, e.g. why leaving finance flows entirely to market forces will not lead to their socially optimal allocation and use. Market coordination and/or governance failures²⁶ that negatively affect the mobilisation of finance and typically include:

- ▶ **Incorrect pricing that fails to reflect the true cost of a resource**, e.g. when the externalities of energy use are not included in the price of energy, affecting both the profitability of finance and investment in renewables and the willingness of private firms to invest (see ERD, 2011/12).
- ▶ **Limited (i.e. imperfect) information**, e.g. in the process of channelling finance to opportunities. Investors may be unaware of potentially profitable projects, which may especially be true for foreign investors looking for local opportunities.

- ▶ **Insufficient coordination**, e.g. when the effectiveness of finance in one sector raises the profitability of finance in another sector or activity, for instance when investment in agriculture is profitable only when there is also investment in infrastructure or when donors fail to coordinate their actions on the ground.
- ▶ **Hold-up**, e.g. when investment and finance become too risky due to large upfront capital investments and long payback periods influenced by government policy and practice. This often leads the private sector to refrain from investing until more information and assurances are available.
- ▶ **Imperfect capital markets**, e.g. when the market is associated with credit constraints, caused by uncertainty surrounding the (future) profitability of projects on which basis lenders determine the probability of loan repayments. High transaction costs arising from screening, monitoring, and enforcement in the credit market create obstacles to lending. The use of collateral might reduce such needs and reduce transaction costs. Poor people, informal firms, small firms and start-ups may not, however, be able to pledge capital or formal rights to land and houses as collateral. This prevents them from financing what could be profitable projects.
- ▶ **Insufficient provision of national and global public goods**, e.g. when investment is hindered because of shortages in relevant skills, inadequate education or infrastructure or unclear property titles, poor governance or uncertain rules and regulations.

There are also market coordination or governance failures in the incentive structure that are associated more closely with project implementation and the effective use of finance. These include:

- ▶ **Regulatory and governance inadequacies** in project implementation, e.g. long delays or high transaction costs in licensing procedures for doing business, delays in legal, dispute or arbitration settlements, unclear property rights, barriers to entry in product markets.
- ▶ **Other policy problems**, e.g. overvaluation of exchange rates, price distortions, tax rate uncertainty.
- ▶ **Inadequate skills and capacities**, e.g. infrastructure, education or skill shortages, low administrative capacity.
- ▶ **Poor coordination and/or high transaction costs** in the provision and allocation of financing, e.g. failure of donors to coordinate in aid allocation and avoid project duplication.
- ▶ **Principal-agent problems** in the implementation of projects, e.g. when the public (or aid) sector lacks perfect information about how the private sector implements projects (which may lead to moral hazard or conflict of interest).
- ▶ **Negative externalities from excessive volatility** (inflows and outflows) of short-term private capital flows, with destabilising effects on investment and the economy.
- ▶ **Imperfect competition**, e.g. when firms collude and set prices in a monopolistic way thereby appropriating monopoly rents (this may affect the banking sector, for instance, when banks collectively decide not to innovate and provide the same level of service at a high cost, using high barriers to block new entrants).

A range of supportive policies can address these market and coordination inadequacies and enhance the effective use and mobilisation of finance (see Chapter 4). Evaluating the importance of certain supporting policies is a key research question for this Report and is explored in relation to selected critical enablers in Chapter 6. Such policies can in principle include a wide variety of different types (a policy is excluded only by choice and relevance) including:

- ▶ Capacity-building (e.g. regulatory, legal and administrative capacity)
- ▶ Tax policies (e.g. tax rates, transfer pricing regimes)
- ▶ Trade policies (e.g. protectionism, export restrictions, agricultural subsidies, trade-facilitation measures)
- ▶ Financial policies (e.g. international banking rules, financial market policies)
- ▶ Science, technology, innovation policies (e.g. technology institutions)
- ▶ Industrial policies (e.g. SME development policies; competition policies and market surveillance; investment incentives, procurement policies and standards)
- ▶ Macroeconomic policies and financial regulation (e.g. fiscal, monetary and exchange policies; banking supervision)
- ▶ Private-sector development and corporate governance (e.g. regulation)
- ▶ Education and health policies (e.g. education, training, migration policies, primary health care)
- ▶ Social-protection policies (e.g. social security, unemployment and other benefits, active employment schemes)

²⁶ In economics, 'market failure' means that the market alone cannot allocate resources efficiently and in a way that maximises sustainable development. Governance and policy failures mean that policies that do not aim or fail to overcome market failures also hinder the achievement of sustainable development.



- ▶ Environmental and energy policies (e.g. appropriate pricing of carbon; fossil-fuel subsidies)
- ▶ Legal policies on rights, the rule of law, transparency, accountability and redress

These policies may be local, national, regional or global (e.g. they can refer to global climate policies on CO2 emissions, which can lead to appropriate pricing of natural capital, or they can be local capacity-building initiatives). We classify some of the above policies in two broad groups in terms of their relation to finance: policies for the effective use of finance, and policies for its mobilisation.

Sometimes these two categories overlap, since some policies such as reduced protectionism, can make FDI more effective and also attract more FDI, as discussed in Chapter 4.

While the framework introduced in this section may be regarded as lacking in detail, it introduces one further level of reality – the interaction between policies and finance for enablers – that is essential in considering the role of finance for sustainable development.

5.2 A focus on selected enablers of sustainable development

Figure 5.2 presents the six selected enablers – local governance, human capital, infrastructure, biodiversity, green energy technology and trade – that are crucial to overcoming the constraints to sustainable development. This section provides the analytical underpinning of these enablers and explains why sustainable development depends on them. The enablers have in common that they describe the state of the economy (e.g. level of human resources, technology, quality of governance, degree of integration and linkages). They are not flow variables (how many changes are recorded in a given year). They are also different from supporting policies or an enabling policy environment, which together with finance can help to change the availability and quality of the enablers.

Figure 5.2 | Selected enablers for sustainable development



We discuss the following enablers in turn below:

5.2.1 Local Governance

▶ **Local Governance.** Governance generally is the most fundamental enabler of development, and we focus on local governance because of its importance in the provision of many critical functions and because few other reports focus on the financing aspects at this level. We draw on the CIs and a commissioned modelling study on the impacts of government effectiveness on ODA and shocks affecting FDI (see Box 4.3) to provide further insights.

▶ **Infrastructure,** which econometric studies show is important for all dimensions of sustainable development, a conclusion supported by a commissioned study modelling infrastructure scenarios in Moldova (see Box 6.7), and by the CIs.

▶ **Human capital,** whose importance in development is also supported by a range of empirical studies, also has a direct link with the eradication of poverty.

▶ **Biodiversity,** which is important for all dimensions and for environmental progress most directly. Here, the Report yields new insights with respect to financing because biodiversity is often referred to as a public good.

▶ **Green Energy** technology and its dissemination lie at the heart of a move from a high-carbon to a low-carbon economy.

▶ **Trade,** whose importance as an enabler comes out very strongly from the CIs and yields differential insights, especially with respect to the role of private-sector finance.

Governance refers to the complex of institutions in the broadest sense. North (1991: 97) defines institutions as 'humanly devised constraints that structure political, economic and social interaction. They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct) and formal rules (constitutions, laws, property rights)'. They include economic institutions (e.g. property rights) and political institutions (the way power is distributed and managed) or political settlements (the social contract established between elites and other groups in society). Institutions affect all dimensions of development, whether incremental or radical. It has been argued that what matters most in why some countries have failed to achieve advances in development and others have succeeded is not geography, culture, or value systems but rather the country's political and economic institutions (Acemoglu and Robinson, 2012; Levy, 2014). It is often the interplay between formal institutions (anchored in the constitution, codified in laws etc.) and informal rules (based on social, cultural, ethnic, religious norms and beliefs) that shape both the distribution of power, the nature of competition and the functioning of markets and also countries' potential to promote successful transformative agendas (ERD, 2013: 35).

In many countries, the lack of political leadership to reform institutions, coupled with unevenly distributed power and poor governance, have been critical binding constraints to sustainable development. The CIs show that leadership and a shared vision, especially between the government and the business sector, are crucial to long-term and sustainable policy changes. Poor countries often lack sufficient government capacity to design, plan and implement a transformative agenda. Countries that have been relatively successful in promoting economic development, such as Mauritius and most of the East Asian countries, adopted a long-term and market-based vision and used far-reaching and coherent



industrial policies, most notably export-oriented industrialisation, to reward success, e.g. in exports, trade-investment interlinkages and integration in value chains. In many other instances, most notably in Latin America and the Caribbean (LAC) and sub-Saharan Africa (SSA), incentives and policies often ended up supporting unproductive firms and/or rent-extracting practices.

Extractive or inappropriate institutions and governance tend to produce systemic policy inertia or even detrimental structural or industrial policies. Some analysts have suggested 'that policy passivity and "markets only" strategies of the 1980s and 1990s, as promoted by the Washington Consensus, successfully enhanced macroeconomic stability, but failed by and large to promote structural transformation and

sustained growth' (Breisinger and Diao, 2008:1). On the contrary, it is now widely accepted that 'the countries that managed to catch up with the old industrialised and high-income countries are the ones whose governments proactively promoted structural change, encouraging the search for new business models and markets, and channelling resources into promising and socially desirable new activities' (Altenburg, 2011:1). The recent literature on economic development and diversification also suggests that an appropriate institutional setting and vision for industrial policy is crucial (see, for example, IMF, 2014; Page, 2012b; Hausmann et al., 2014; Lin et al., 2011). Te Velde (2013) argues that such proactive policies can be pursued successfully only in the presence of effective state-business relations.

Box 5.1 | The importance of governance and effective state-business relations

The quality of governance and effective and transparent state-business relations have been shown to be important across economic, social and environmental development. Mauritius is a good illustration of how good-quality institutions drove transformative changes. The CI suggests that effective state-business relations facilitated the building of a consensus around the country's economic direction, which helped to direct finance (the public sector in the lead and the private sector following) by investing sugar rents in the garment-manufacture and tourist sectors (CI, Treebhoohun and Jutliah, 2015). The approach identified those who benefited and those who stood to lose out from such changes, and involved retraining the latter. This consensus-seeking model has supported the country's social development to date and is guiding current and future policy on environmental development via the implementation of the Mauritius *Ile Durable* Strategy.

Source: CI, Treebhoohun and Jutliah (2015)

The OWG report (2014: paragraph 10) states that good governance and the rule of law are essential for sustained, inclusive and equitable economic growth, sustainable development and the eradication of poverty and hunger. For example, governance is important for social development and a **post-2015 development agenda which 'leaves no one behind'**, as certain segments of the population are frequently excluded by politics and social norms; inadequate intermediate

political and institutional arrangements at the local level; lack of voice, poor accountability systems and space for organised demand; or simply by the lack of good public and social services with the necessary human resources, capabilities and infrastructure. The process of social development is inherently long term and expensive, requiring sustained government investment. This is clearly a major constraint for poor countries, but beyond the budgetary question the binding constraints

are often political. They relate to institutions such as the nature of political settlements and social contracts between elites and other social sectors, and how these affect the prioritisation of social policies in government spending. A 'political settlement' refers to the way social actors operate in pursuit of their interests, and organise and exercise power (DFID, 2010). Power and politics influence the nature of the state bureaucracy, its relationship to elected politicians, the composition of elite groups, the incentives and motives of politicians and political leaders to undertake certain actions or favour particular policies, and the ways in which citizens engage with the state and exercise oversight over power holders. The political settlement shapes the governance and domestic accountability landscape, the way in which rights and resources are distributed in a given country (ODI, 2010) and the prospects for development and the adoption of pro-poor policies. Brautigam et al. (2008) further argue that governments' authority, effectiveness, accountability and responsiveness are closely related to how they are financed. It matters, for example, that governments tax their citizens rather than relying on resource revenues and ODA, and it also matters how they tax them.

Achieving environmental progress (or low-carbon development) also depends on good governance and strong leadership in order to develop coherent policies across sectors and to create space for behavioural shifts in multi-level and multi-phase processes. In this perspective, radically improved environmental outcomes depend upon traditional forms of leadership as well as the promotion of institutional change from below, facilitating knowledge and vision-building and developing social networks (Westley, 2013). Stable governance and the rule of law are critical foundations of sustainable development (TST, 2014). For example, UNEP (2014) claims that at least 40% of all violent conflicts in the last 60 years have been broadly linked to natural resources.

Chapter 6 examines local governance in more

detail. Most countries are involved in some form of decentralisation as certain services such as health and education are provided either by local governments or by a 'deconcentrated' central government unit and/or para-statal bodies. Many similar issues arise at the national and local levels but there are also differences between them. Local institutions are often weaker, their capacities are more limited, and financing is more precarious since they have less access to external funding. At the same time local government should be closer to citizens and the accountability links are potentially more immediate, and social organisation and voice are often stronger. This can be an asset, for instance with regard to local taxation (commissioned background paper; Brun and Chambas, 2015). Decentralisation is likely to increase in the coming years. Over half of the global population lives in urban areas and this proportion is rising, and poor populations are also increasingly urban. As these trends continue and perhaps even accelerate, local authorities in large towns and cities will be at the forefront in providing services and infrastructure. Financing local government for social transformation is therefore an issue of growing international importance.

Decentralisation²⁷ has been high on the development agenda since the 1990s and can be conducive to local development contributing to the reduction of poverty. It is expected to enhance the quality, efficiency and effectiveness of local infrastructure and services, improve local environmental management (e.g. implementation of Agenda 21), promote local employment, collect and increase local revenue, and hence improve livelihoods. Decentralisation reforms are also expected to improve governance by allowing the emergence of effective local political representation, an accountable and responsive local administration, an active local citizenship able to participate in local political decision-making, and strategic alliances between the public and private sectors and local communities (EC, 2007; Steffensen, 2010; Romeo, 2012; CI by

²⁷ Decentralisation is a complex political process that involves many levels and actors and three interdependent dimensions: political, administrative and fiscal. Arrangements to provide services vary widely depending on how power and resources are transferred, i.e. devolution, delegation or deconcentration.



Damuri et al., 2015). In reality, the relationship between poverty reduction and decentralisation is far more complex. The impact of decentralisation on public services, corruption, fiscal management and growth in developing countries and emerging economies is poorly documented and evidence is in many cases inconclusive (Martinez-Vazquez, 2011). The effectiveness of decentralisation seems to be dependent on whether local authorities, over and above a legal mandate, have sufficient autonomy, financial resources and independence of higher tiers of government (Romeo, 2012; LDI-LLC, 2013; UCLG, 2010).

There is some consensus that certain poverty-reduction efforts are better carried out at the local level: this is true of targeting, since in principle local authorities have better knowledge of legitimate beneficiaries, whether these are communities or individuals. There is still a need for centrally designed systems to encourage correct targeting, in the absence of which local politicians may opt to divert resources to other priorities. Ideally, the design of anti-poverty programmes should be integrated into the decentralisation process, while retaining strong coordination between central and local government (see Section 6.6). The CIs on Bangladesh and Indonesia identify one of the main difficulties in implementing local public-private partnerships (PPPs) as lack of capacity at the local government level.²⁸ In conclusion, local governance is important for all the dimensions of development, but has not received the same level of attention as national governance.

5.2.2 Infrastructure

Infrastructure refers to transport, water, energy and information and communication technology (ICT). Poor infrastructure is a major impediment to sustainable development. It needs to keep pace with population growth as well as economic development as it becomes more intensively used, grids are expanded and more maintenance is required. It has been estimated that SSA as a whole loses one percentage point a year in

economic growth per capita owing to poor infrastructure (UNCTAD, 2011). Self-reported losses associated with power outages can amount to more than 10% of sales in some countries (Gelb et al., 2014). Thus, average economic rates of return for World Bank projects evaluated over the 1983–1992 period were estimated at 11% for electricity projects and 29% for road building (Lin and Wang, 2013). Recent developments in ICT and broadband networks show a significant impact on expanded productive activity. It is estimated that a 10% increase in broadband penetration led to an average increase of 1.4% GDP growth in developing countries overall (UN TST Issues Brief, 2013).

Improved roads or telecommunications infrastructure can lower transport and logistics costs as well as the costs of communication and information exchange. Investments in water or energy grids can reduce the cost of inputs to all productive activities, enhance factor productivity and release labour to engage in productive activities. Provided the costs are sufficiently low, the poor can also obtain access to these assets. At the same time, improved infrastructure can promote market integration for trade, employment and production processes. Better connectivity through investments in infrastructure enhances labour mobility and promotes employment. It fosters urbanisation, diversification and industrialisation, all of which go hand in hand with structural transformation (McMillan et al., 2014). Finally, investment in infrastructure enables better access to health and educational services, provided that care is taken to ensure that poorer groups are included, thus improving standards of living and environmental conditions. Investment in infrastructure has to be appropriate, however, in order to enable sustainable development. For example, in order for a railway project to realise its optimal benefits there needs to be complementary investment in feeder roads and storage facilities at the linking nodes (see, for example, CI by Lunogelo et al., 2015).

Improved infrastructure also leads to job creation. '[An] increase in infrastructure investment of one per cent of GDP would translate into an additional 3.4 million direct and indirect jobs in India, 1.5 million in the US, 1.3 million in Brazil and 700,000 in Indonesia', and so could potentially increase productivity levels, if jobs are created in the right sectors (Page, 2012a). It is also important to boost productivity by scaling up good practice and making better use of existing infrastructure. Doing this could enable countries to reach a 60% improvement in infrastructure productivity, which amounts to a total annual saving of \$1 tr (McKinsey, 2013).

Infrastructure deficits are large in all country income groupings, yet the transformative potential of more and better (physical) infrastructure (e.g. transport, energy, water or communications) is immense. Studies suggest that improved infrastructure allows countries to move up the value-added ladder, increase productivity and transform the economy, and also contribute to job creation at all skill levels. When green technologies are adopted and social standards are included in project design and/or contract provisions, infrastructural development can also be instrumental in promoting environmental and social development. The commissioned

MAMS model simulations for Moldova (see Table 1.1) show that financing the development of infrastructure expands growth and employment and reduces poverty (see Box 6.7). At the same time, however, it may not reduce inequality in the absence of appropriate redistributive policies and transfer schemes to specific groups that have low-factor market participation (commissioned modelling paper; Kinnunen, 2015)

5.2.3 Human capital

A lack of human capital can be a major constraint on sustainable development. Lack of skills and training appropriate to the jobs available, lack of economic opportunities and employment and of decent work in particular, lack of access to productive assets including natural assets and resources, and lack of access to public services particularly in health and education, can all hold back social development. Governments need to ensure universal access to the trio of policies (education, health and social protection) generally accepted as comprising a 'social protection floor' (Bachelet, 2011). Equally, governments need to achieve a 'political settlement' or national political consensus on the objectives of social development.

Box 5.2 | Social policies in Mauritius

Mauritius has long sought to maintain a welfare state to protect the most vulnerable. This has included free access to education, health services, subsidised housing and subsidies on food staples (rice and flour). The Education for All policy has led to a reduction in inequality overall and particularly for women. Income inequality improved in the 1990s but over the past decade it has increased (Gini coefficient rising from 0.371 to 0.413 for period 2002–2012) while the economy grew more slowly and unemployment rose.

Source: CI, Treebhoohun and Jutliah (2015)

²⁸ Other reasons identified in the CIs include problems in acquiring land, an unsupportive business environment and poor governance.



Human capital and education underpin human development and poverty reduction (Sen, 1999). Measuring human capital by the percentage of the working-age population with secondary education, Mankiw et al. (1992) find that it raised output in around 100 developing countries. In LICs, limited access to basic education was found to be the most important constraint on economic growth (Mankiw et al. 1992). As a country develops, it is important to extend and upgrade inclusive education systems and address inadequate vocational training and retraining. Skills are often eroded by long-term unemployment, the lack of jobs

and social protection, skill mismatches or extensive brain drain. This not only renders investments inefficient but may also hamper economic and social development. Access to education and skills training for the poor, and not only for elites, is crucial to ensure that investments in human capital do indeed promote social development and do not exacerbate existing inequalities. The enhancement of human capital emphasises the importance of an appropriately skilled and healthy workforce for moving economies higher up global value chains (GVCs). This is illustrated by several of the CIs, notably on Ecuador and Mauritius.

Box 5.3 | Human capital policies in Ecuador

From 2007, the Ecuadorean government has invested heavily in enhancing the country's human capital and thus achieved major social transformation. Both urban and rural poverty have decreased substantially (urban poverty gap fell from 8.5% to 6.8% over the 2006–2011 period, and agricultural poverty fell from 59.57% to 50.09%). Nationwide, inequality has also declined (the Gini coefficient went down from 0.505 to 0.441) including among the most vulnerable groups (Afro-Ecuadorean, women and unemployed).

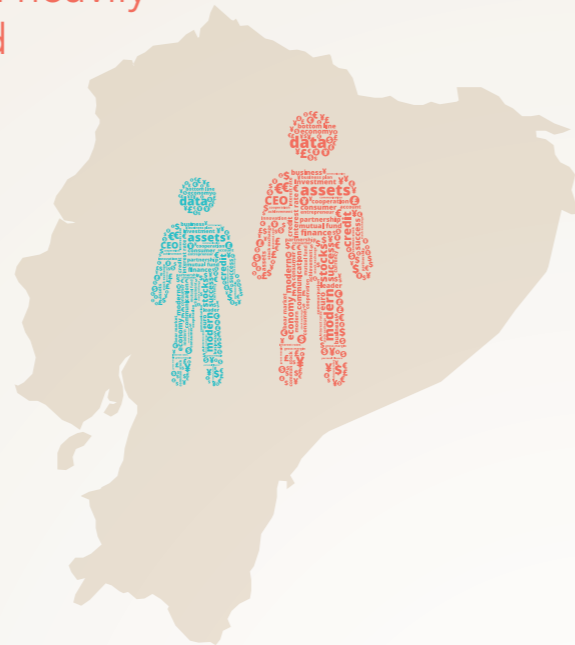
This has been achieved by a combination of universal distributive policies including direct transfers and subsidies. In particular, there is now universal education up to 10th grade, health coverage is universal, social security covers 55% of full-time employees (53% of the workforce) and the national Conditional Cash Transfer programme coverage increased from 1.1 to 1.8 million people between 2006 and 2011. The latter, the *Bono de Desarrollo Humano*, provides \$35 per month conditional on 75% school attendance and monthly health check-ups for the children of beneficiaries. The programme is available to the two poorest quintiles, which comprise 45% of households, and is intended to ensure that the poor receive at least the minimal level of consumption and to strengthen investment in human capital via education and health.

Source: CI by Borja and Ordóñez (2015)

ECUADOR COUNTRY ILLUSTRATION

Human capital policies boost Ecuador

Since 2007, the government has invested heavily in enhancing human capital and achieved a major social transformation.



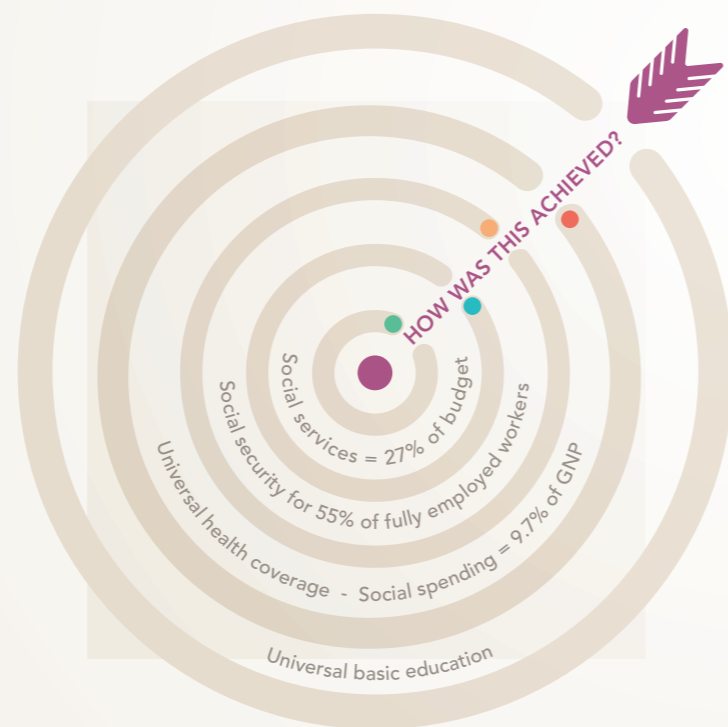
CHILD LABOUR



EXTREME POVERTY



INEQUALITY



Financing and enabling social development

FINANCING DEVELOPMENT



- INCOME TAXES RISING TO 4.5% OF GDP ◀
- SUBSTANTIAL IMPROVEMENT IN TAX COLLECTION ◀
- VAT INCREASED TO 12% AND COVERAGE EXTENDED ◀
- CAREFUL MANAGEMENT OF EXTERNAL DEBT AND RESERVES ◀
- EXTERNAL SOURCES INCL. ODA (0.5% OF GDP), REMITTANCES AND FDI ◀

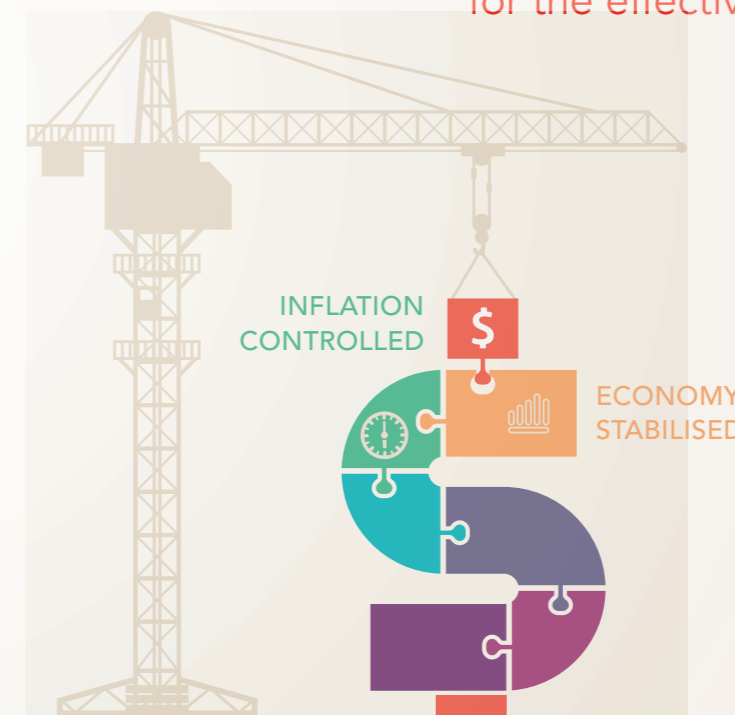
DRIVERS OF DEVELOPMENT



- ▶ IMPROVED QUALITY OF PUBLIC INSTITUTIONS
- ▶ THE OVERALL STABILITY OF THE UNITED STATES ECONOMY
- ▶ STRONG LASTING POLITICAL SETTLEMENT AROUND PRESIDENT CORREA
- ▶ A CLEAR VISION AND INCLUSIVE DEVELOPMENT PHILOSOPHY ('BUEN VIVIR')
- ▶ TRADE INCLUDING THE SUSTAINED RISE IN INTERNATIONAL OIL PRICES REVENUES
- ▶ ENHANCED HUMAN CAPITAL THROUGH BETTER EDUCATION & HEALTH POLICY COVERAGE

'Dollarisation'

Using the US dollar as national currency since 1999 was a key policy for the effective use of finance.





5.2.4 Biodiversity

Natural capital, defined as the quality of land, water, air and other environmental assets, is an important enabler of sustainable development. The World Bank (2011) report on green growth and the Organisation for Economic Co-operation and Development (OECD, 2011) argue that valuing natural capital is crucial for both environmental sustainability and economic development. The concept of 'natural capital' (also called environmental or ecological capital) emerged in the 1970s in the context of the limits-to-growth discourse, with its focus on sustainability (Hinterberger et al., 1997). Climate control, drinking-water supply, pollination, recycling of nutrients, provision of food, wood and other resources, the disposition of a genetic library, nature's bequest and existence values,²⁹ to name only a few (Folke et al., 1994; Hinterberger et al., 1997), are recognised as environmental services flowing from a stock of environmental wealth.

Ecological economists emphasise that neo-classical concepts of capital had to be extended by considering nature and the wide range of its ecosystem processes and functions (Hinterberger et al., 1997). Natural capital provides four main functions (De Groot et al., 2002; Chiesura and de Groot, 2003; Ekins et al., 2003: 169): regulation (e.g. life-support systems), production (e.g. raw materials), habitat (e.g. for wild plants and animals), and information (e.g. cultural) functions.

The poorest are most dependent on natural capital for their livelihoods and therefore bear disproportionate effects of resource degradation. This has implications for the importance of natural capital for social development, and for the need to consider the interactions between the environment and poverty. Access to safe water and sanitation is a prerequisite for a decent, dignified, secure and healthy life and to avoid water-related illnesses. In many countries, women and girls are responsible for fetching and carrying water, a chore that is time-consuming, hazardous

and can have high opportunity costs in terms of girls' education and women's participation in the economy. Between 30% and 60% of existing rural water-supply schemes are dysfunctional (Brikké and Bredero, 2003) and the poorest people end up paying the most for inferior water services. It is also the poor who settle in fragile environments (such as flood plains and deforested watersheds that are subject to landslides), and who are most vulnerable to water-related risks.

The ERD 2011/12 showed that large-scale (foreign) land acquisitions tend to disadvantage the poor because they have little or no voice in such deals, even though they may be intensive users of the land. This is often a source of tension and conflict. Poorly regulated, high-cost land-tenure systems that lack transparency and sound redress systems tend to disadvantage the poor, increase their insecurity and make it harder for them to use their land as collateral for credit. For instance, the rapid expansion of palm-oil farming, such as in Indonesia, in order to meet the demand for biomass for energy production can create economic opportunities for smallholders, but the benefits are skewed in such a way that the poor local farmers are being pushed onto more marginal land and at the same time valuable mangrove ecosystems are lost. Hence, avoiding resource degradation and restoring biodiversity are important for sustainable development.

There can be complex links between physical and natural capital. To be sustainable, the current use of natural resources and services should not deplete the stock that is endowed to future generations. 'Green accounting' methods make it possible to quantify this. There are two ways to approach intergenerational transfer. The first is referred to as 'weak sustainability', which means that the legacy for future generations must be at least equal to the amount of total existing capital, regardless of the type, assuming that the different types of capital are mutually substitutable. The depletion of natural capital is sustainable only if the rents from exploiting natural resources are reinvested in

other types of capital (national or international), for example in education or infrastructure (Hartwick, 1977). More recently, however, it has been argued that 'strong' sustainability means that there is only limited potential to substitute different types of capital, and that it is not enough to maintain the total stock of capital for future generations because some forms of natural capital are irreplaceable. This is also emphasised by Rockström et al. (2009) in their nine planetary boundaries: climate change, ocean acidification, stratospheric ozone, global phosphate and nitrate cycles, atmospheric aerosol loading, freshwater use, land use change, biodiversity loss and chemical pollution. They state that beyond a critical threshold these systems cannot recover to the previous (or current) state.

Most of the ecosystem services provided by biodiversity have public or common-good characteristics in the sense that they can be consumed and depleted without adequate payment for their use and regeneration. In addition, many of the benefits of biodiversity do not lend themselves to quantification. While the valuation and pricing of benefits in the form of consumables such as timber, bush meat, tourism, or genetic information is technically feasible (though not always practical), this holds to a lesser extent or not at all for other benefits of, say, forest biodiversity. These involve non-consumables such as water purification, erosion regulation, flood protection or spiritual and cultural values; option values such as the future benefits of genetic information; bequest values; and existence values (OECD, 2013: 26). Thus, many of the benefits of biodiversity are invisible to market transactions and, given the complex and sometimes fragile interplay of ecosystem factors, an unsustainable use of forest resources can result in high environmental, economic and social costs that the market does not capture. This makes biodiversity a very illuminating example of a public good that needs to be incorporated into FFD discussions.

5.2.5 Green Energy Technology

Technology and green energy technology (GET) specifically, is a crucial enabler of sustainable development. Technology generally is a key component of structural transformation to support upgrading within or between sectors. In LICs, ensuring high and sustained economic growth combined with high levels of social development is unlikely to be achieved without productivity changes based on widespread economic diversification and structural transformation – led by technological change and innovation (Hall and Jones, 1999; Lin et al., 2011; UNECA, 2011).

Innovation and the spread of technology are at the heart of radical transformations (e.g. the role of breakthrough technologies such as computerisation). Their absence makes it increasingly difficult for firms to compete in the global economy and for countries to retain and enhance their comparative advantages. Technological backwardness is one of the critical bottlenecks that prevents transformation in many developing countries as firms and companies, too small in size and informal in their modes of operation, do not adopt new production processes, lack access to or do not use more advanced products and blueprints, including ICTs, or do not have the ability to absorb and use them. Dutz et al. (2011), Ugur et al. (2012) and Katz and Margo (2013) discuss the positive links between innovation, productivity and employment growth. Technological change and innovation are thus major drivers of total factor productivity increases that the early social scientists identified as major drivers of sustainable growth (e.g. Solow, 1956; WEF, 2013).

Complementary skills and capital goods are needed in order to adopt technology, especially in the case of systemic or general-purpose technologies such as electricity and ICT (Hall and Khan, 2002). The same applies to political, cultural, institutional and regulatory constraints that often hamper necessary changes in productive or

²⁹ A bequest value is the non-use value of preserving the environment for future generations. Existence value refers to the non-use value that is derived from the fact the asset exists (e.g. the value that people attach simply to knowing that tropical rain forests exist).



organisational processes. Differences in these barriers account for important disparities in income across countries, while the sustained reduction of these barriers can ‘induce development miracles’ (Parente and Prescott, 1994: 299). For example, in many LICs, agricultural transformations have been stalled for a variety of reasons: farmers lacked the necessary information and knowledge or the wish to adopt new production techniques; organisations in charge of transferring technology to farmers or providing support services to them did not do their job effectively; farmers adopted the technology only partially or managed it incorrectly, so that potential productivity gains were not realised or when they gains did occur there was no market for the increased output (Crawford, 1993). As countries have proceeded to industrialise, technological constraints appear to be aggravated by inadequate market integration and lack of participation in supply chains as well as limited skills and affordability (World Bank, 2008).

Research and development (R&D) is important in improving technological readiness. Other factors such as the depth of domestic credit markets, educational variables, the extent of protection offered to intellectual property rights (IPRs), the ability to mobilise government resources, and the quality of complementary academic institutions also appear to be important in explaining a country’s technological readiness (Lederman and Maloney, 2003).

Chapter 6 focuses on green energy technology, whose dissemination lies at the heart of a move from a high-carbon to a low-carbon economy, making possible (green) growth by de-coupling economic growth and resource use. Green growth cannot be achieved without radical technological change for producers and consumers – while the past 30 years have seen an improvement in energy efficiency of around 2% annually, this needs to be tripled in order to keep temperature rises to a maximum of 2°C by 2050. Achieving this will be dependent on the diffusion of green energy technology. While Kenya has invested

in renewable energy (hydro, geothermal, wind) Tanzania has taken longer than expected to exploit its identified renewable energy potential, other than traditional hydro sources (CI, Lunogelo et al., 2015). The difference in the use of green energy technology is responsible for the disparity of the renewable energy share between the two countries. This Report will examine in greater detail how finance and policies work together to explain these differences. The consequences of better technologies to address climate change will also help the poorest who are the most vulnerable to it (Stern Report, 2006; WGBU, 2011).

5.2.6 Trade

Trade constitutes the last of the enablers discussed in this Report. Trade helps to connect people and firms across borders. Societies and economies that are not well connected tend to stagnate, hence the importance of networks generally as an enabler of sustainable development.

Rauch (2001) reviews the literature on trade networks. He finds that numerous statistical and case studies show that transnational corporations (TNCs) and social networks promote international trade by alleviating problems of contract enforcement and providing information about trading opportunities. Openness to trade is conducive to growth, provided there are appropriate domestic policies and institutions (Rodrik, 1999) and ‘an export orientation imposes a discipline and set of constraints on all economic policies that prevent the adoption of very many measures severely antithetical to growth’ (Krueger, 1990: 110).

A range of recent econometric studies have found positive links between trade and growth.

Wacziarg and Welch (2008) examined 141 liberalisation episodes, comparing growth before and after liberalisation and found that the impact of trade liberalisation on growth was substantial, even after controlling for several other determinants of growth. Per capita growth of liberalising countries

was around 1.5 percentage points higher than before liberalisation. Brückner and Lederman (2012) suggested that trade openness causes economic growth in Sub Saharan Africa: a 1 percentage point increase in the ratio of trade to GDP is associated with an annual increase of 0.5% in growth in the short-run and an annual 0.8% growth increase in the long-run. Le Goff and Singh (2013) use a panel of 30 African countries over the period 1981-2010 and find that trade openness tends to reduce poverty especially in countries where financial sectors are deep, education levels high and governance strong.

Limited trade openness and integration of domestic productive activities into regional and global supply chains are important factors in low productivity growth. Developing countries in Asia have consistently benefited from market linkages and openness as a means to enhance productivity growth as compared to African and especially LAC countries, which also lag behind in their integration into GVCs. East Asia in particular has been characterised by such value chains, driven by FDI and trade activity; these have allowed firms in the area to upgrade their technological base and to restructure, first by attracting labour-seeking or resource-based investment and subsequently by component-outsourcing or service-related investment in the context of regional integration.

Insufficient market size and integration, however, negatively affect the net return expected on any productive investment. Fragmented markets are a powerful entry barrier for new businesses and a binding constraint on new investment activity and competition. Thus, weak linkages of agriculture to the rest of the economy, including lack of participation in agricultural value chains, have hampered agricultural transformation.

Similarly, due to the absence of linkages with the rest of the economy, a very strong and negative association has been recorded between a country’s reliance on primary products or raw materials, even if these are exported, and the rate at which

structural change contributes to growth. It is no coincidence that in SSA, where productivity levels are low, fuels comprise 40% of total merchandise exports and ores and metals another 26%.

There is a positive correlation between productivity growth and backwards GVC participation across countries in Africa (African Economic Outlook; AfDB et al., 2014). Improvements in trade openness and supply-chain participation in Africa reflect the dominance of the mineral-exporting sector as well as the large contribution of primary-goods exports in much of the continent. In many cases, these result in limited contributions of value-added and employment generation in other sectors, especially compared to the Asian countries. Exports of primary commodities or mineral products may contribute to within-sector productivity growth, but unless they contribute to productivity growth in other sectors, the resulting growth is not transformative (African Economic Outlook; AfDB et al., 2014). Resource-driven economies that have failed to diversify their productive base have remained at a distinct disadvantage, as diversification and structural change have been slowed down and the export sectors have been unable to absorb much labour even when productivity was enhanced (McMillan et al., 2014). In addition, not all firms and workers benefit to the same extent from GVCs, suggesting that not all trade reaches the range of firms and workers in ways that contribute to social development.

Trade also enables the diffusion of green technologies – e.g. for renewable energy – that can render domestic production cheaper and more efficient. Linkages to regional and global carbon markets or emissions-trading platforms can facilitate the adjustment of incentives for low-carbon investments.

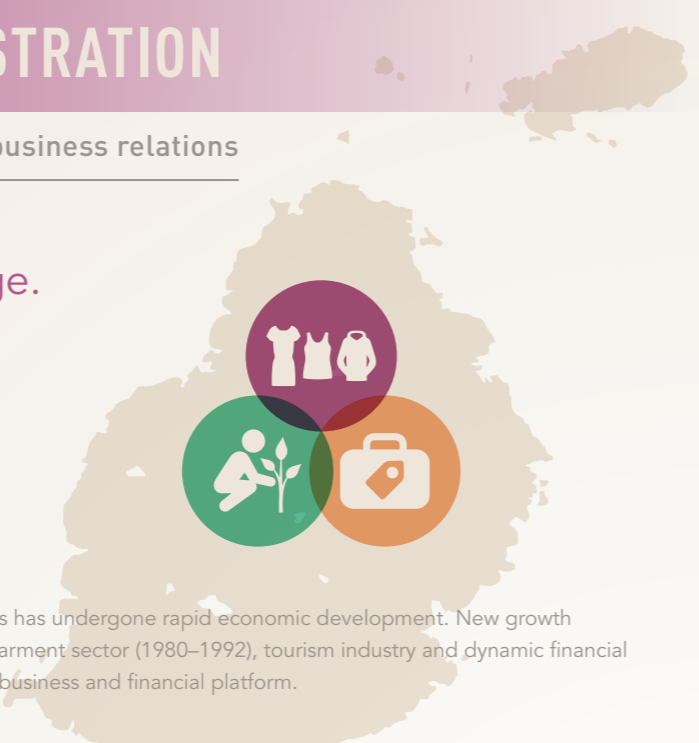
The importance of trade is clear from the CIs. The Bangladesh and Mauritius CIs show that the use of preferential access to markets in the EU and USA for garments and sugar exports helped diversification

MAURITIUS COUNTRY ILLUSTRATION

High quality governance enables effective state-business relations

Mauritius shows how high-quality institutions can drive positive change.

Effective state-business relations helped building consensus around the country's economic direction and directed finance (public sector first, then private sector) to diversify the island's economy from agriculture to garment-manufacture and tourism.



Trade is a key enabler

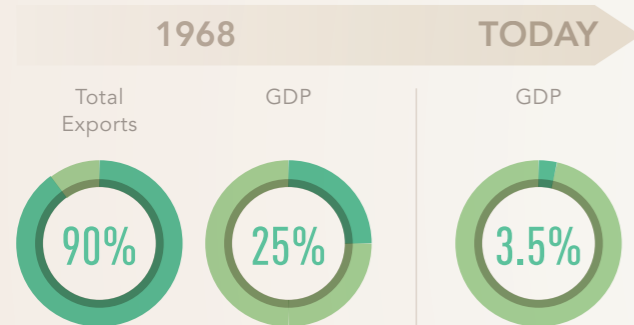


1968

Since independence in 1968 Mauritius has undergone rapid economic development. New growth sectors: export-oriented textile and garment sector (1980-1992), tourism industry and dynamic financial and business services. It is a regional business and financial platform.

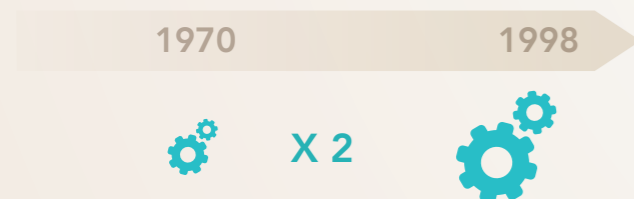
AGRICULTURE

Agriculture (sugar) represented 90% of total exports and 25% of GDP. Today, the economy is diversified and service-oriented with agriculture accounting for only 3.5% of GDP.



MANUFACTURING

The share of manufacturing of GDP doubled between 1970 and 1998.



PER CAPITA GDP

Per capita GDP (2005 prices) rose from \$200 in 1968 to over \$7,700 today.



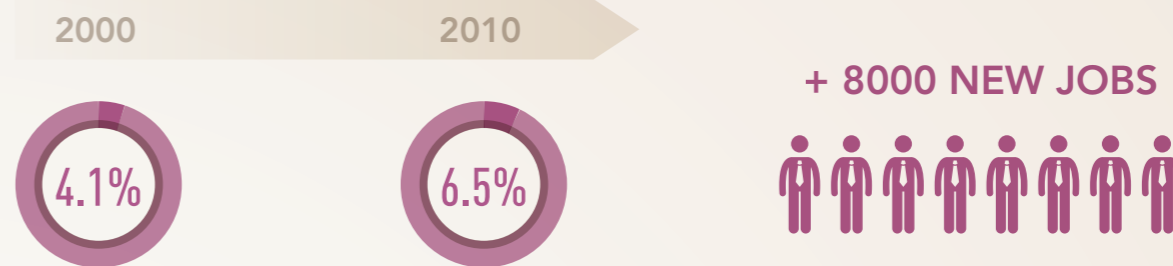
EXPORT PROCESSING ZONE

The establishment of an Export Processing Zone (EPZ) created a 50-fold increase in merchandise exports between 1971 and 1990.

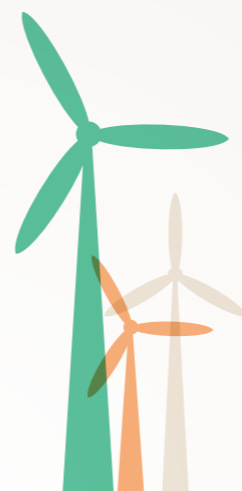


ICT AUTHORITY

The ICT Authority was set up in 2001. The contribution of ICT to GDP grew from 4.1% in 2000 to 6.5% in 2010 creating 8,000 new jobs.



Key to Mauritius' change is its export-oriented industrialisation strategy.



Facilitated by

- ▶ The strategic outward-oriented vision pursued by its political leaders
- ▶ Inclusive institutions
- ▶ Ethnic diversity and extensive diaspora networks
- ▶ Dynamic indigenous entrepreneurs
- ▶ A well-structured private sector engaged in regular dialogue with the government.

2008 saw the launch of the 'Maurice Ile Durable' strategy investing in technology, including renewable energy. The Blue and Green growth strategy: a cyber island in a 2 million km² maritime zone!



Mauritius' policies mobilise trade finance

As the economy of Mauritius diversified, the sources of financing shifted from an exclusive reliance on import and export duties on sugar (1972-1980) to domestic taxation and private flows.

- ▶ FDI as a proportion of GDP remained below 2% over the period 1990-2005.
- ▶ Net FDI inflows have increased by 96% to \$361 mn in 2012 compared to 2004 levels.



Social policies: Mauritius protects the vulnerable

For its most vulnerable citizens Mauritius provides free access to education, health services, subsidised housing schemes and subsidies on staples foods. The Education for All policy led to a reduction in inequality overall and particularly for women.





both directly and indirectly (see Chapter 6; CIs: Khatun, 2015; Treebhohun and Jutliah, 2015). Although a Least Developed Country (LDC), Bangladesh is now the second-largest exporter of garments after China (CI, Khatun, 2015). Mauritius provided powerful incentives to its private sector, e.g. tax and financial incentives, creation of an Export Processing Zone, to continue diversifying the productive base towards services, including tourism, financial services and ICT and more recently to promote green and blue growth (see Chapter 6; CI, Treebhohun and Jutliah, 2015). Regional trade and participation in regional and global value chains are also important as countries increasingly opt to be part of organised geographical or market networks as a major strategy for private-sector development.

As the experience of Bangladesh and Moldova demonstrates, the creation of domestic productive clusters across SMEs, most notably in the agri-food, textile and clothing sectors, and the integration of such clusters in regional or global value chains, can spur transformative changes and provide incentives for supply-chain financing especially by the development finance institutions (DFIs) and multilateral development banks (MDBs) (CIs: Khatun, 2015; Ghedrovici, 2015). The integration of national extractive industries, e.g. in the petrochemical sector, is an important but not a sufficient condition for sustainable development.

Evidence at the country level further suggests that trade can be helpful for green energy technology and social development. China has used market access to become the world's leading solar-panel producer and exporter. Bangladesh promoted women's employment by gaining preferential access in the ready-made garments (RMG) sector by adopting the EU's Generalised System of Preferences (GSP) and the Everything But Arms (EBA) initiative. Ecuador's links with the global oil market allowed it to gain oil revenues that underpinned its *Buen Vivir* strategy and to sustain social development (CI, Borja and Ordóñez, 2015). Without such trade these countries would not have been able to engage in transformative changes.

To summarise, Table 5.1 provides illustrative examples behind the importance of enablers for the three dimensions of sustainable development.

Table 5.1 | Enablers for sustainable development: some illustrative examples

ENABLERS (CATEGORIES)	ECONOMIC DIMENSION OF SUSTAINABLE DEVELOPMENT	ENVIRONMENTAL DIMENSION OF SUSTAINABLE DEVELOPMENT	SOCIAL DIMENSION OF SUSTAINABLE DEVELOPMENT
Local governance	Transformative vision, good governance, transparency and accountability key to investment promotion and productivity-led growth; Effective state-business relations create consensus around which strategic actors can mobilise	High-quality and inclusive institutions can lead to green approaches (e.g. national consensus on need to preserve environment) and create conditions for cross-sectoral policy coherence as well as space for change agents to promote behavioural and institutional change	High-quality and inclusive institutions are essential to provide health, education and social protection services to tackle poverty and reduce inequality. The way they are run can be more or less inclusive (e.g. national consensus on redistributive policies)
Infrastructure	Appropriate infrastructure helps all firms to buy and sell goods and services and raise productivity	Renewable energy plants are key for level of CO2 emissions	Infrastructure needs to be accessible (location and price) to the poorest. Water, roads and energy are all essential for production purposes, to reach markets or jobs, for SME development, household activities)
Human capital	Education, health and skills are important for labour productivity	Skills important for green jobs	Skills and good health are important for obtaining and retaining employment, they drive SME development, and farm and non-farm activities
Biodiversity	Land and natural resources are important for agriculture and resource-intensive activities	Preserving natural capital (land, biodiversity)	Possession of and/or access to land good quality water and biodiversity are important assets for the poorest who are often first and most affected by environmental degradation
Green Energy Technology	Technology drives total factor productivity	Development of green energy technology and complementary infrastructure to make them cost-competitive and widely available	Mobile phone technology helps poor farmers to market their produce. Low cost innovation can also make informal production and enterprise more efficient.
Trade	Linkages across firms and participation in value chains expand effective market size and depth and increase demand	Market size for environmental goods and services (e.g. ability to access new markets for solar panels)	Networks foster labour migration; enable poorest to move to more productive employment. Linkages between informal rural activities and urban markets expand opportunities and can alleviate poverty; Knowledge-sharing affects social standards



5.3 Conclusions

This Chapter has presented a framework which considers the joint role of finance and policies in enabling a transformative post-2015 development agenda. Focusing on a transformative development agenda requires attention to developing critical enablers without which any type of transformation is hard to achieve. We discussed the importance of six selected enablers to promote sustainable development (including local governance, infrastructure, human capital, biodiversity, green energy technology and trade).

Crucially, finance does not operate in a vacuum but it is the combination of finance and policies that is important for the development of enablers. The integrated conceptual framework for finance and policies in enabling a transformative post-2015 development agenda presented in section 5.1 allows us to consider the effects of policies on the mobilisation and effective use of finance. The next Chapter will examine how this framework works in practice for the selected enablers.

CHAPTER 6.

The link between finance and policies for selected enablers

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6

Main Messages

This chapter offers concrete examples of **how finance and policies can be combined to enable sustainable transformations**, based on existing evidence and specific country experiences. The main messages are:

- ▶ **The composition of finance differs markedly by enabler.** Finance for institutions and **governance** seems to be largely public. Patterns of finance for **human capital** vary across education, health and social protection, although all depend heavily on domestic public finance. A broad range of financial instruments is used to finance **biodiversity** and the appropriate mix is highly situation-specific. Finance for **infrastructure and green technology** tends to come from a mixture of public and private sources, although national government expenditure is the principal source for infrastructure. **Trade finance** is largely provided by private banks through the extension of Commercial Letters of Credit, although this is changing rapidly in the wake of the global financial crisis.
- ▶ Changes to **domestic and international policies and systems work together** by mobilising and using tax revenues more effectively, or by creating financial rules that reduce the volatility in capital flows.
- ▶ **DFIs are playing an increasing role** in leading transformations in key areas such as infrastructure, green energy and trade, by leveraging private finance, supporting the selection of appropriate projects and policies, and providing technical assistance, credit and risk-mitigation instruments and blended finance.



This chapter examines the links between finance and policies for six selected enablers: Local Governance (Section 6.1), Infrastructure (Section 6.2), Human Capital (Section 6.3), Biodiversity (Section 6.4), Green Energy Technology (Section 6.5) and Trade (Section 6.6). Each of the sections contains an introduction, describes the financial flows for the enablers and then focuses on how policies can mobilise and make finance more effective for the development of that enabler before drawing conclusions.

The chapter examines selected policies for the effective mobilisation and use of finance. It focuses on:

- ▶ building capacity and developing strategies
- ▶ implementing standards and promoting transparency
- ▶ establishing regulatory frameworks and reforming incentives
- ▶ developing financial-sector instruments
- ▶ promoting DFIs and specialised funds relating to enablers
- ▶ supporting global rules on trade, tax, climate and finance

These policies are selected on the basis of where the empirical evidence, CIs or other commissioned background papers suggest they are crucial. The policies for the mobilisation and effective use of finance discussed in this chapter are chosen to illustrate the above categories, e.g. national policies such as building capacities to undertake infrastructure projects, or developing strategies for AfT or universal health coverage (UHC), the development of micro-insurance or financial instruments for PPPs, the reform of fossil-fuel subsidies and other regulatory issues for green energy technology, or the use of DFIs for mitigating the risk of

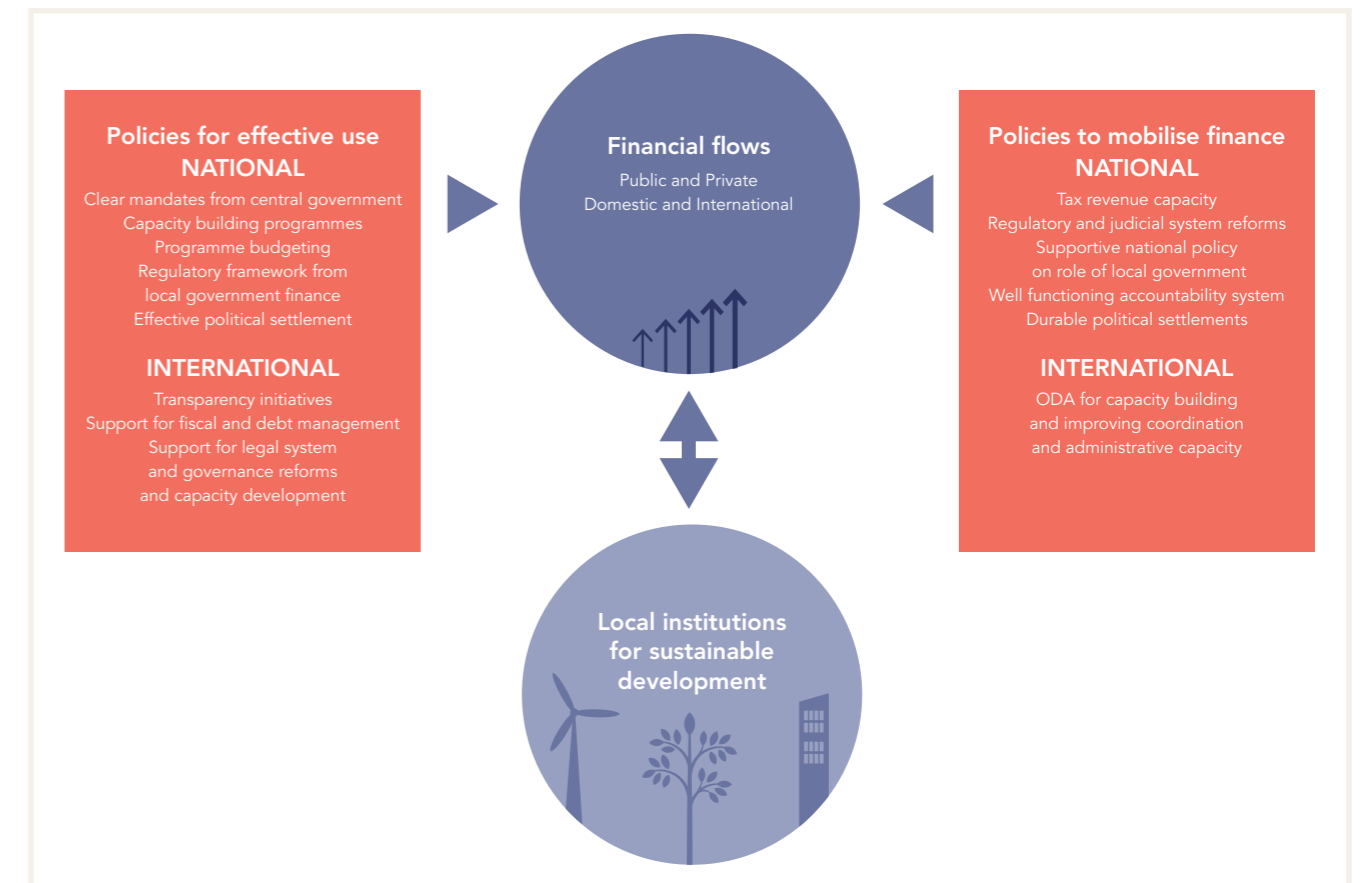
investment in green energy technology. At the international level they include using standards to upgrade GVCs, and using special funds for social protection, infrastructure or biodiversity.

6.1 The role of finance and policies for local governance

This section focuses on governance and institutional enablers at the level of local government. Most countries are involved in some form of decentralisation, albeit with different degrees of success (Europe Aid, 2007). Basic social services, such as health, education, and water and sanitation, are provided either by local governments or by a 'deconcentrated' central government unit and/or para-statal bodies. This means that most public policies with strong impact on poverty reduction and redistribution depend on local dynamics. The impact of decentralisation on poverty is not straightforward, however, and depends on the national government's capacity to fulfil its basic functions and its commitment to devolving power to local tiers (Jütting et al., 2004). Similar issues arise at the national and local levels but there are also differences between them. Local institutions are often weaker, their capacities more limited and their financing more precarious, in addition to having less access to external funding.

At the same time local governments have comparative advantages (Brugmann, 1994), such as the use of participatory planning or the potential to leverage additional resources for local development (Romeo, 2012). Local taxation arrangements can also be an asset (commissioned background paper, Brun and Chambas, 2015). Over half of the global population lives in urban areas and this proportion is rising, while at the same time poverty is increasingly an urban phenomenon. As rural-urban migration trends continue and perhaps even accelerate local authorities in large towns and cities will bear the brunt of managing

Figure 6.1 | The role of policy for mobilisation and effective use of finance for local institutions



the resulting challenges, including providing social services and infrastructure. Financing local government for social development is therefore an issue of growing international importance.

This section discusses the sources of finance for local governance; the link between finance and policies for effective local governance and future implications. Figure 6.1 summarises the main policy issues addressed in this section.

6.1.1 Local financial resources: municipal finance for infrastructure and services

According to United Cities and Local Government (2010), 'local government finance is prospering

in much of Europe, North America, and parts of East Asia and the Pacific [...]. It remains at an early stage in some regions, such as the Middle East and Western Asia, where most [local] governments are deconcentrated units of the central government with limited autonomy [...]. In Latin America and Eurasia, local finances are generally improving, but still face challenges associated with past centralised traditions [...] African local governments are rarely well empowered, but there are hopeful advances, especially in some Anglophone countries'. According to Alm (2010), however, 'it seems very unlikely that municipal governments, especially in the poorer countries, will be able soon to generate the funds needed to build facilities: they



do not have access to capital markets, and they seldom generate significant revenues on their own (e.g. the property tax is unproductive, cost recovery is poor, access to productive revenue sources is limited)³⁰. This suggests that progress in local government finance is slow and patchy, with wealthier countries understandably doing better.

On the revenue side of fiscal decentralisation, there are three main means of financing local government: (a) intergovernmental fiscal transfers (IGFTs); (b) local revenues, including taxes (e.g. property tax), fees (e.g. for licenses and fees)

and user fees (e.g. market fees); and (c) local government borrowing and access to financial markets. Some of these are better suited to the initial financing of new infrastructure and others to the operation and maintenance (O&M) of existing infrastructure (Alm, 2010) and services (see Table 6.1). The analysis of municipal finance is hampered by important data gaps on municipal borrowing for and spending on infrastructure. It is therefore important to redouble efforts to develop reliable data on the various dimensions of infrastructure finance and the administrative capacities of local governments (Alm, 2010).³⁰

Table 6.1 | Suitability of different municipal funding sources

IGFT	Capital grants are well suited to finance lumpy capital investments, offset different infrastructure endowments, address externalities across sub-national governments and pursue national sectoral objectives. IGFT should be used to finance services that generate spillovers to nearby jurisdictions, since strictly local finance will lead to inefficient provision.
Local revenues	User fees are the ideal source for O&M expenses, particularly to finance goods that provide measurable benefits to identifiable individuals within a single jurisdiction. Municipal tax revenues should be used to finance local services for which it is difficult to identify individual beneficiaries and to measure individual costs and benefits.
Local government borrowing	Particularly suited to finance long-term capital investments in infrastructure; allows local governments to shift some of the burden of finance to future generations that will benefit from durable and long-lived projects.

Source: Alm (2010)

Intergovernmental fiscal transfers (IGFTs) constitute on average more than 60% of all local government revenues in developing countries, although in countries such as Cambodia, Indonesia, Nepal, the Philippines, Tanzania and Uganda, and many others, such transfers constitute more than 80% of the total income of local governments (Steffensen, 2010). This is because the 'expenditure tasks devolved to subnational governments substantially exceed their capacity to raise revenues from sources under their own control' (Steffensen, 2010).

In most countries, **local revenue collection** is not a significant source of income for local governments, accounting for less than 4% in developing countries as a whole and less than 15% in Bangladesh, Bhutan, Cambodia, Nepal, Tanzania and Uganda. These are important elements in the overall funding arrangements, and they can promote downwards accountability (Steffensen, 2010). Other sources of subnational revenue, such as royalties from the extraction of non-renewable resources or access to financial markets, are significant in only a small number of developing countries (Faust and Haldenwang, 2010).

6.1.2 The role of policies and finance for local governance

Policies to mobilise finance for local governance

Improve the regulation and management of intergovernmental transfers

There are no ideal systems for financing local government and local infrastructure, but it is crucial to consider the political economy and context. Typically, a fiscal imbalance will result when transfers lag behind the decentralisation of expenditure to local government. Usually there is some combination of local revenue-raising and IGFTs to resolve this. The Tanzania CI shows, however, that when local governments have limited sources of local revenue they depend largely on transfers from central government in six areas (education, health, local roads, agriculture, water and administration) (Lunogelo et al., 2015). Where there are significant inter-regional disparities, there is a greater need for IGFTs to offset the horizontal fiscal unevenness that would otherwise occur. The existence of such imbalances means that it is impossible to design an appropriate system of sub-national taxation without simultaneously designing an appropriate system of intergovernmental transfers (Bird, 2011), as discussed below.

High levels of transfers as a proportion of local government revenue can undermine their autonomy, especially when these are conditional, although Bird (2011) argues that IGFTs are not inherently good or bad, 'what matters are their effects on policy outcomes such as allocative efficiency, distributional equity, and macro-economic stability'.

Improve local autonomy through local revenue mobilisation

'Fiscal decentralisation lies at the heart of any local government system as its rules define the generation and distribution of resources (both between and within different government levels)

that are utilised to fulfil citizen's demands' (Yilmaz, 2010). At the macro level, well-designed fiscal decentralisation can encourage growth, revenue generation and fiscally responsible behaviour, which are key elements in reducing poverty. Conversely, poorly designed frameworks can have wider negative impacts. They can, for instance, fail to create additional value, boost economic performance or generate revenue. In the worst case, irresponsible fiscal practices and negative incentives at various levels can jeopardise macroeconomic stability. Yet fiscal decentralisation is also vital in order to ensure 'funded mandates' for the provision of services and, therefore, local government financing.

Local governments are thought to be more accountable to citizens when they rely on their own tax bases (Steiner, 2005), but they can raise tax revenues only when the central government allows a sufficient level of fiscal decentralisation and there are significant challenges to overcome. Equally, subnational taxation works only if IGFTs provide the right incentives to local governments to raise their own taxes (Yilmaz et al., 2008).

Low collection of local revenue is explained by several factors, including the small tax base in poor districts; a critical lack of tax administration capacity at local and intermediate levels; and limited fiscal competences owing to high degrees of centralisation and economies of scale achieved by more centralised tax collection (Faust and von Haldenwang, 2010). The relationship between government and citizens is not driven by improvements in (local) public services. Since paying local taxes is not always rewarded by better local services, people may tend to avoid payment, especially if they already pay para-fiscal contributions (Diawara, 2006). Local taxation can thus be undermined by para-fiscal contributions requested by local administrations in order to provide a service or by voluntary contributions to supplement inadequate local budgets (for a local event, for example). Furthermore, formal taxation is often regressive (Alm, 2010).

³⁰ For a comprehensive analysis of municipal finances, including different instruments and experiences, see Farvacque-Vikovic and Kopanyi (2014).



In addition to transfers of revenue from central government, local authorities have recourse to three sources from which they can generate their 'own' revenue – taxes, non-tax revenue and royalties. Local revenues are the most effective way to secure local discretion in how they are used, but there is no universal definition of what constitutes a 'good' local tax. Local taxation does not happen in a vacuum but in the context of the IGFT. There are some broad theoretical principles that link the distribution of taxes to stabilisation, redistribution and allocation functions, but tax revenue is context-specific and always entails trade-offs between efficiency and equity and between political and economic criteria. Local taxation policies may also benefit from local government's proximity to the local population and the greater accountability this may permit (commissioned background paper, Brun and Chambas, 2015). Thus while 'local governments should have the discretion to raise their own revenue' (Yilmaz, 2010) there is no 'one right way' to do so.

According to Alm (2010), 'a "good" municipal tax system should not unduly distort individual and firm decisions, should generate sufficient revenues to allow the government to finance at the margin their expenditure and should burden only local residents'. In his analysis of municipal finance for urban infrastructure, Alm warns local governments against mobile tax bases, especially capital, and on imposing progressive income tax, as they 'will lead to the out-migration of more mobile, higher income individuals, thereby leaving more immobile, lower income individuals to bear the burden of the taxes [...] by the same token, attempts to induce in-migration of mobile factors can lead to [...] local governments compete [...] to attract and hold and hold those factors by extending tax breaks and other fiscal incentives' (Alm, 2010).

Local taxation systems can be regressive and impoverishing, as they were in Uganda in the early 2000s, stifling local business and agricultural production without providing a strong financial

base for local governments (Bahigwa, 2004). There can be perverse results when local governments are required by law to raise revenue, but are not required to stimulate economic growth or reduce poverty: if they were, at least start-up businesses and very small businesses might be exempted from tax. Generally, subnational taxation is likely to work better in a more equal setting since in countries with high levels of inequality local governments are likely to have very unequal tax bases. Some of these inequalities can be offset by carefully designing financial transfers, as has been the case in Brazil, Colombia and Peru (Litschig and Morrison, 2013; Canavire-Bacarrea et al., 2012). Property tax can play a critical role in financing local governments, especially when the latter are supposed to take increasing responsibility for providing major public goods and services linked to health and education. Property provides a tax base that is both locally specific as well as relatively slow to change, and properties cannot be moved in response to tax rates. Even a well-administered local property tax is not, however, likely to provide sufficient revenue to finance major social and infrastructure expenditure (Bird, 2011), so it can be only one component in the mix used to fund local expenditure. Moreover, given that it is local elites who own most property, it can be difficult to convince them to pay tax and update property values; on the other hand, property is visible wealth that can be justifiably taxed if the political leadership is minded to do so (Bird et al., 2010).

Local government borrowing and access to financial markets

In most countries, municipal governments cannot finance initial capital investments from current savings (Alm, 2010) and borrowing is therefore an important means by which 'to reduce shortfalls in the financing of local infrastructure and a vital tool with which to meet rising investment needs by attracting external finance' (DeLoG, 2013). However, according to UCLG (2010), borrowing is 'the most neglected aspect of local government finance in many regions of the world'.

In fact, many central governments impose restrictions on (or even prohibit) borrowing by local authorities to prevent 'moral hazard' problems, such as local governments borrowing more than is economically justified or lenders making excessive loans to local governments, assuming that the central government will assume responsibility for any unpaid debts (Alm, 2010). These restrictions limit local discretion in addressing investment needs (Yilmaz et al., 2008), although local government borrowing could usefully be developed further in many contexts as long as appropriate restrictions and safeguards, as well as good accountability systems, are in place (Yilmaz, 2010).

Subnational borrowing can be used mainly to attract external funds to finance or part-finance high initial costs, reducing finance gaps for infrastructure investment, and to spread investment costs over periods of time that more or less match the lifespan of the infrastructure being financed. Long-term debt repayments can then be serviced from continuing streams of local income, ensuring inter-generational equity. Such lending is not without risk: excessive debt burdens can endanger macroeconomic stability, limit the scope of political action, threaten the solvency of

local governments and produce inter-generational inequities. GIZ has made an extensive analysis of the prerequisites for sub-sovereign lending and the main factors that tend to limit or preclude access to local financial markets, which include inadequate legal and institutional frameworks, a gap between local governments' financial resources and fiscal competencies and assigned responsibilities, the lack of capacity to use resources, and the lack of effective internal and external controls and oversight. This points to the need to develop capacity on both the demand and the supply sides (GIZ, 2012).

There are two main sources for local government borrowing: private capital markets via bond issuances and specialised financial institutions/intermediaries (including municipal development funds, social investment funds and community-driven development programmes). In developing countries, the absence of capital markets to which local governments can have meaningful access limits the option of bond issuances. The use of financial intermediaries can enhance the capacity of local governments to obtain access to debt markets.³¹

³¹ For a comprehensive discussion on the advantages and disadvantages of borrowing from commercial banks, bond banks, development banks, financial institution, and municipal development funds, see Farvacque-Vitkovic and Kopanyi, 2014.



Box 6.1 | Municipal Development Funds: a mixed experience

Municipal Development Funds (MDFs) are used to build domestic municipal credit markets, strengthen local governments' technical capacity (e.g. project design, appraisal, and execution of investment programmes, financial management) and to channel external finance to subnational entities. In many countries, central governments have established MDFs to provide municipalities with longer-term credit at lower interest rates than those available in the domestic market. MDFs are pooled financial arrangements that combine resources from private lenders, central governments and donor agencies; they provide local governments with finance for investment purposes. Local governments can obtain funds on the basis of their capacity to repay the loans. One advantage of MDFs is that they reduce the cost of borrowing for smaller local governments by spreading the risks across many countries.

More than 60 countries have established MDFs, with support from international donors, particularly the World Bank and the Inter-American Development Bank (IADB). The results are mixed. MDFs have been relatively successful in helping municipalities to gain experience in debt financing and the design and implementation of large projects, but they have been less successful in helping municipalities to gain access to local financial and capital markets. Some reasons for the limited success of MDFs include over-estimating municipal revenues and underestimating the difficulties of local authorities to repay the loans; withdrawal of commercial banks because the risks are too high for them; and political biases, abuses and corruption.

Four examples of successful MDFs are:

- The Bangladesh Municipal Development Fund - local governments have improved their asset-management systems and accounting procedures, and have experienced a general increase in own-source revenues.
- The Parana State Urban Development Fund in Brazil - contributed to educating Brazilian municipalities to enter the credit market and improve project selection and supervision.
- The Tamil Nadu Urban Development Fund in India - facilitated the access of creditworthy municipalities to the private capital market.
- Senegal's Fund of Local Communities - a key piece in consolidating the decentralisation process and played a major role in strengthening the capacity of local authorities to manage investment resources, raise revenues, observe borrowing constraints and prioritise expenditures.

Source: Alm (2010); Farvacque-Vitkovic and Kopanyi (2014)

The role of international aid agencies

ODA can play a significant role in providing direct support for local authorities, especially in poorer regions with weaker capacities, in the form of financial and technical co-operation. To be effective, external support for local governance and decentralisation must respect the legal, institutional, regulatory and statutory framework, recognise local authorities' discretionary powers and autonomy, and allow financial modalities that support local governments' budgets directly³² (ECDPM, unpublished). The Tanzania CI reports that local authorities have access to Local Government Capital Development Grants

(LGCDG), which are part-funded by ODA, and are held accountable for the quality and transparency of development plans, financial management and procurement (see Box 6.2). Although donors increasingly rely on programme-based approaches to support decentralisation and local governance (DeLoG, 2011), the project approach remains dominant (DeLoG, 2006; 2011). In particular, donors should seek to use and support existing transfer mechanisms to channel ODA directly to local governments or use ad hoc performance-based grants when transfer mechanisms are very weak. They should also seek to support local revenue-generation capacities.

International donor agencies, recipient governments and implementing partners are paying growing attention to results-based management systems and the use of Performance Based Grant Systems (PBGs). These are intended to be integrated into national IGFT systems and to provide local governments with real incentives to improve their institutional, organisational and functional performance, thereby reducing the risks associated with IGFTs and making decentralisation more effective, efficient and responsive as a strategy for providing public goods and services. Based on evidence from 15 countries, the PBGS approach has been found to lead to better local government performance in the areas of administrative functioning, public financial management, local resource mobilisation, transparency and accountability, cross-cutting issues (gender, social inclusion, poverty targeting and the environment), capacity-building, coordination with development partners, infrastructure and service delivery (UNCDF, 2011).

Finally, international donors need to be alert to and help to address any service-provision bottlenecks caused by fiscal decentralisation by entering into policy dialogue and multi-actor and multi-level dialogue (e.g. involving associations of local authorities). This can also lead into supporting the capacity of local authorities to formulate local policies, engage in dialogue at the national level, take on core functional areas (PFM, revenue mobilisation etc.), and provide services.

Policies for effective use of finance for local governance

Local governments are seen by many central governments as key partners in providing more efficient and equitable social services, and infrastructure that supports economic development and enhances the quality of life (UCLG, 2010). However, their performance and capacity to carry out both their specific mandate in implementation and their general mandate as policy-makers are closely dependent on fiscal

decentralisation. Ideally, the capacity to generate revenue should match spending responsibilities, but in practice decentralisation seldom achieves such perfect equilibrium. Fiscal imbalances and unfunded mandates are frequent and undermine local government autonomy and capacity. The reason is that most national governments have moved faster in decentralising expenditures than revenues. 'If local governments are denied the fiscal instruments and funding to make real use of their political autonomy, decentralisation is doomed' (Yilmaz et al., 2008).

Intergovernmental (central-local) transfers enhance intergovernmental coordination and ensure a consistent framework of fiscal decentralisation. They are intended to achieve numerous objectives, including to: (a) reduce horizontal fiscal imbalances by ensuring that local governments with different fiscal capacities are equally equipped to provide public services at some desired level; (b) achieve individual/household redistribution (i.e. reduce income inequality); and (c) reduce regional disparities in average income level and other indicators, and promote regional development. While the first is a legitimate objective that can be achieved to some degree, IGFTs are inadequate instruments for achieving the other two (Bird, 2011, 2012; Alm, 2010).

Financing arrangements make a major difference to outcomes. For example, the failure to provide for O&M in poorer communities may result in wasted capital expenditure (Mansuri and Rao, 2013). It is also important to establish mechanisms of good governance for transfers in order to promote the transparency, predictability and stability of local revenues that will enable local planning and service delivery.

According to Alm (2010) the impact and effectiveness of different types of IGFTs is poorly understood, particularly in developing countries, given the lack of reliable data, although the Indonesia CI shows how both general and earmarked allocation grants are used successfully.

³² This work was commissioned by DG DEVCO as part of its PPCM Methodological Support and Training for Project and Programme Management to feed into the drafting of a guidance document on 'Support to decentralisation processes using the project approach'.



Table 6.2 summarises the main advantages and disadvantages of conditional grants (for specific purposes) versus unconditional grants (for general purposes).

Table 6.2 | Conditional grants versus unconditional grants

TYPE OF GRANT	ADVANTAGES	DISADVANTAGES
Unconditional	<ul style="list-style-type: none"> Support local autonomy and efficiency, local planning and budgeting Easy to administer, reduce transaction costs Strengthen downward accountability Useful for devolved services 	<ul style="list-style-type: none"> May lead to inefficient spending without local capacity to plan and prioritise May lead to crowding-out of local services
Conditional	<ul style="list-style-type: none"> Support national minimum service standards Stimulate services in core areas Useful for agency functions and functions with externalities 	<ul style="list-style-type: none"> May lead to too much control and lack of clear accountability Hard to measure and control - many transaction costs May distort local priorities May reduce overall efficiency in allocating resources according to local needs and priorities

Source: Steffensen (2010)

Fiscal decentralisation has a significant effect in determining income inequalities, but whether the effect is positive or negative depends on the overall size of the government sector in the economy. Where this is relatively low (around 20% of GDP or lower), greater decentralisation might result in a diversion of scarce funds from redistributive central government programmes, and thus lead to greater inequality (Sepúlveda and Martínez-Vazquez, 2011). At higher government share levels, fiscal decentralisation works to decrease income inequality, perhaps due to the type of expenditure that can be made at the subnational level, in combination with the fact that central government budgets are large enough to implement sizable redistributive programmes (Sepúlveda and Martínez-Vazquez, 2011). A useful comparative study of centralised Mexico and decentralised China found both systems to be reaching their limits (Ahmad, 2009), suggesting that both approaches may be valid and that there is no ideal solution. Another study

(Sepúlveda and Martínez Vazquez, 2011) using a panel of 56 countries at different stages of development in the 1971–2000 period, found that fiscal decentralisation at lower levels, as measured by the share of subnational expenditures in total public expenditure, reduces poverty, but at higher levels of decentralisation it can increase poverty. The optimal point was found at subnational expenditure representing around 30% of total government expenditure.

Even when equalising transfers exist and work well, as in Brazil and South Africa (see Box 6.3; Watkins and Alemayehu, 2012) or in Peru (Canavire-Bacarreza et al., 2012), they may have a limited impact on regional disparities where these are significant, as in Southeast Asia (Hofman and Cordeira Guerra, 2004). This is partly because the transfer of adequate resources does not guarantee that the local government will use them appropriately and provide efficient services if it lacks the capacities or the incentives to do so.

This means that complementary policies should include incorporating capacities and incentives into the transfers.

South Africa’s formula (see Box 6.3) has been criticised for not matching transfers to the varied costs of providing an agreed standard of services. Other countries – Ethiopia, Nepal and Rwanda, for example – have formulas that recognise that costs will vary (Watkins and Alemayu, 2012). In Nigeria, the overdependence on uncertain IGFTs leads to evasion of responsibility by local authorities that claim fiscal powerlessness (Yilmaz et al., 2008).

While devolving the provision of responsibility for infrastructure can work for rich regions, in the case of remote, small, and very poor communities with limited economic activities, the investments required to provide the necessary local infrastructure for basic public services must either be provided directly by a higher-tier government or at least financed (with perhaps some in-kind or other local cost-sharing) by a regional structure, whether a county, a second-tier municipality, or special district. In other words, there is a need to develop an approach to suit each circumstance (Bahl and Bird, 2014). Conditional non-matching grants have been successfully used for this (see Box 6.4).

Box 6.2 | Insights from the Tanzania CI on the use of formula-based allocations and ODA

Since 2004, the Tanzanian government has provided formula-based allocations to local government authorities (LGAs) for recurrent expenditures in six key sectors – education, health, local roads, agriculture, water and administration. At the same time, a new joint donor/government-funded block grant for development, the Local Government Capital Development Grant (LGCDG), was introduced. In this arrangement, all LGAs receive a discretionary development grant of approximately \$1.5 per person if they fulfil minimum conditions regarding the quality and transparency of their development plans, financial management and procurement systems (REPOA, 2011). One of the challenges facing LGAs is the pace of budget execution in any given fiscal year due to delays in disbursements from the central government. Further, and perhaps more critically, most of the LGAs have very narrow sources of local revenue to finance development and social services. The country has also introduced innovations in resource mobilisation, by creating a Developmental Fund from oil and natural gas proceeds, some of which to be used for stimulating development at local government levels.

Source: CI by Lunogelo et al. (2015)

Box 6.3 | South Africa’s Provincial Equitable Share budget

The Provincial Equitable Share budget is at the heart of the devolved financing system in South Africa. Allocated by the central government, this accounts for over 80% of provincial government revenue. The transfer is based on a formula that is updated annually. For the 2008 budget, the distribution was that education indicators accounted for 51% of the weighting, health indicators 26% and population 14%.

Some elements of the formula are overtly redistributive. Provinces such as Eastern Cape, Limpopo and KwaZulu-Natal receive larger shares of the anti-poverty, health and education budgets over and above their basic share, while more prosperous provinces with better indicators receive less.

Source: Alm and Martínez-Vasquez (2009)

Box 6.4 | Conditional non-matching grants

Conditional non-matching grants, with conditions imposed on attainment of standards in quality, access and lower level of services, can be used to improve equity and efficiency in the provision of essential services at the sub regional level, without creating perverse incentives for substandard provision. These are rarely used in developing or transitional economies. Brazil is a case in point. It has two national minimum standards grant programmes for primary education and health care. Under the 14th amendment to the federal constitution, state and municipal governments must contribute 15% of their two principal revenue sources (state VAT and state share of the federal revenue-sharing transfers for states, services tax, and the municipal share of the state revenue-sharing transfers for municipalities) to the special fund for primary education (FUNDEF). If the sum of the state and municipal required contributions divided by the number of primary-school pupils is less than the national standard, the federal government makes up the difference. FUNDEF funds are distributed among state and municipal providers on the basis of school enrolments. A possible reason for the success of Brazil's reforms is that a range of reforms aiming to achieve greater equality and redistribute power at local levels were implemented across the public sector at the same time, so they supported each other.

Source: Shah (2006)

Infographic 3 | Enabler: Local Governance

ENABLER: LOCAL GOVERNANCE

Finance and the role of Local Government

Conducive political settlements are essential for good governance at both local and national level. The record of local government involvement in providing services is mixed, especially in low income nations.

It is essential to ensure that domestic policies on the roles of local government are fully worked out and ensure that local governments are properly equipped to meet their roles.

Central government funding (including elements of international and domestic public finance) are the principal source of finance, but there are also positive examples of local governments raising revenue locally provided adequate regulatory frameworks and public finance management systems are in place.



The financial policy needs to be carefully adjusted to the country context

- 1 The role played by local government must be clear
- 2 Financial support be provided primarily via intergovernmental fiscal transfers (IGFTs)
- 3 Expectations that revenue can be raised locally should not be exaggerated



- 1 Local governments can be brought into broader processes of public-sector reform
- 2 This can enhance their contributions to eradicating poverty
- 3 It may be possible to increase IGFTs
- 4 More can be expected in terms of local taxation and user fees
- 5 As financial management capacities increase, options to borrow increase

Formula-based allocations in Tanzania

Since 2004, the Tanzanian government has provided formula-based allocations to local government authorities (LGAs) for recurrent expenditures in six key sectors: education, health, roads, agriculture, water, administration.

The Local Government Capital Development Grant (LGCDG), a joint donor/government-funded block discretionary grant for development, was also introduced with funding of ~ \$1.5 per person to all LGAs. The grant is made subject to conditions regarding the quality and transparency of LGA development plans, financial management and procurement systems.

In addition, Tanzania has introduced an innovative Developmental Fund utilising oil and natural gas proceeds that are partially disbursed to stimulate development at LGA level.





6.1.3 Conclusions and implications of finance for local government

Conducive political settlements are just as essential for governance at the local as at the national level. The record of local government involvement in providing services is, however, very mixed, especially at low levels of national income, when local government spending may compete with social and other central poverty-reducing expenditure. As countries become wealthier, and where overall public expenditure is also greater, there may be less of a zero-sum game.

Financing policy needs, therefore, to be carefully adjusted to context.

- ▶ In LICs, once it is clear what roles local governments should play, it is important to provide financial support primarily using IGFTs that increase the autonomy of local governments. Expectations that revenue can be raised locally should not be exaggerated (or excessively rewarded) as this may lead to regressive taxes and charges and revenue-raising capacities are likely to be low.
- ▶ In MICs, local governments can be progressively brought into broader processes of public-sector reform to enhance their contributions to eradicating poverty, and these contributions can be significant. In such cases, it may be possible to increase IGFTs and more can be expected in terms of local taxation and user fees for certain services. As financial management capacities increase, it becomes an option to borrow as a partial solution for financing infrastructure.
- ▶ In both cases central governments need to be careful in how they structure and incentivise the roles of local governments in terms of their capacities and political capabilities in order to avoid adversely affecting the poorer sectors. This means that building the capacity of local government to provide pro-poor services is a key supporting policy.

While spending by local government can be seen as one route to reach development goals, it is important to recognise from the outset that equalising local government expenditure by providing grants and transfers from central government cannot be expected to correct regional imbalances in highly unequal societies. Addressing such inequalities requires special investments and mechanisms rather than formulas to standardise expenditure across all local authorities.

In conclusion, the question of how local institutions are financed is paramount, but the record of local government performance is mixed, particularly when finance levels are low and there are competing needs. It is therefore essential to ensure that domestic policies regarding the roles of local government are fully worked out and take adequate steps to ensure that local governments are properly equipped to meet their mandates in terms of capacities and regulatory frameworks. Allocations from central government, which may include an element of international as well as domestic public finance, remain the principal source of finance, but there are also positive examples of local governments raising revenue locally, provided that adequate regulatory frameworks and public finance management systems are in place. The scope for raising local revenue should not be exaggerated, however. Finally, at the local level there is perhaps also more scope for private funding through collective user-fee solutions, although their ability to raise funds depends heavily on the levels and distribution of local wealth and ensuring that disadvantaged groups have full access to services is an important criterion of success.

6.2 The role of finance and policies in infrastructure development

The enabling role of infrastructure for sustainable development is widely accepted. According to the IMF's most recent review of the evidence increased investment in public infrastructure is associated with positive output multipliers, both short- and long-term, in almost all countries (IMF, 2014). These effects vary widely, however, across countries and time, depending on economic conditions, the efficiency of such investment and the way in which it is financed. When there is economic slack and monetary accommodation, demand effects are stronger and the ratio of public debt to GDP tends to decline. If the public investment process is relatively inefficient (e.g. due to poor project selection and implementation), the long-term gains are more limited (IMF, 2014:77). Albino-War et al. (in IMF 2014) find that on average emerging economies and developing countries are 10–20% less efficient than HICs.³³

Policies thus influence both the macroeconomic environment and the efficiency of investment.

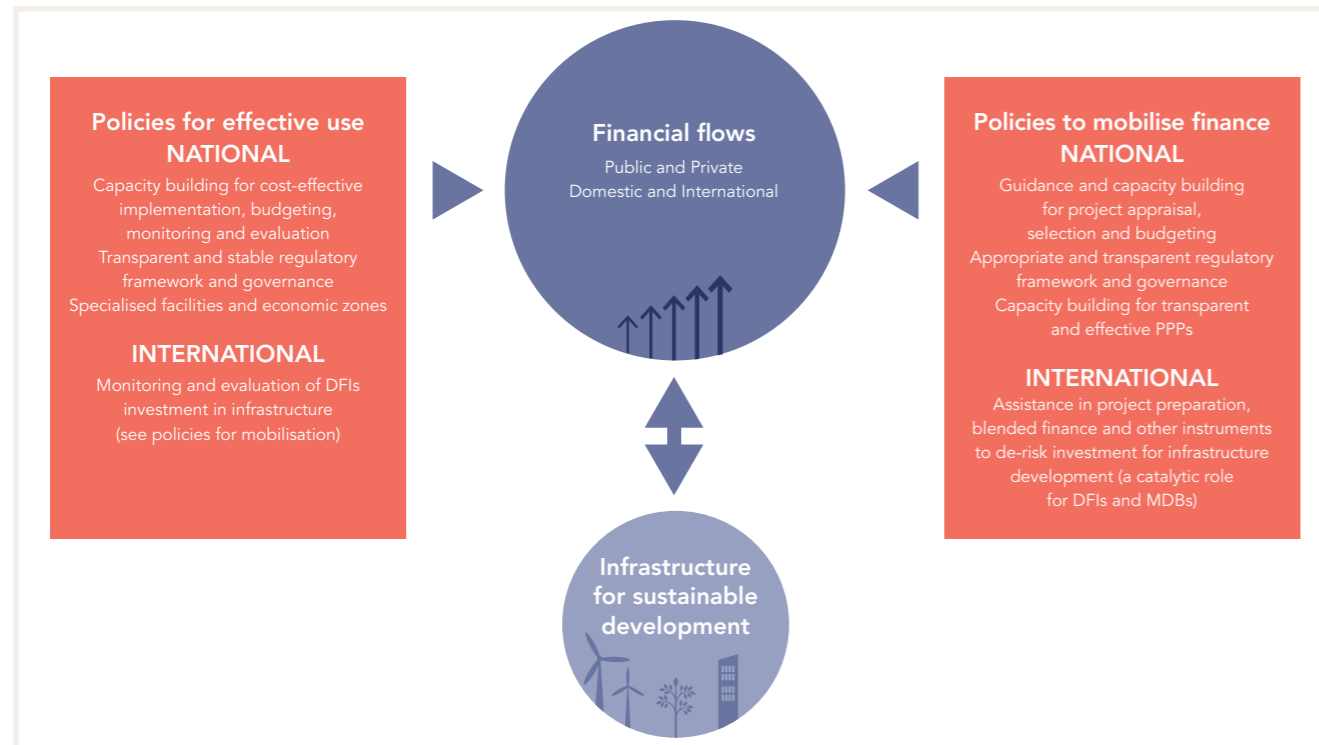
The importance of policies and finance in infrastructure development is also reflected in the CIs. In Bangladesh, infrastructure has been instrumental for productivity-enhancing growth and job creation, but considerable additional finance is needed to meet growing needs. This cannot be mobilised in the absence of supportive national and global policies to ensure greater investment efficiency and the effective use of financial resources (see Box 6.5).

This section discusses the various sources of infrastructure finance and their differential impact on sustainable development (Section 6.2.1) and the links between finance and policies for infrastructure development (Section 6.2.2), drawing out some key implications (Section 6.2.3). Figure 6.2 below summarises the main policy issues in this section.

³³ To be efficient, public investment must meet two conditions: it must be allocated to projects with the highest ratio of benefits to costs and its aggregate level must align with fiscal sustainability. Efficiency entails both the proper allocation of investment and the production of public assets at the lowest possible cost.



Figure 6.2 | The role of policy for mobilisation and effective use of finance for Infrastructure

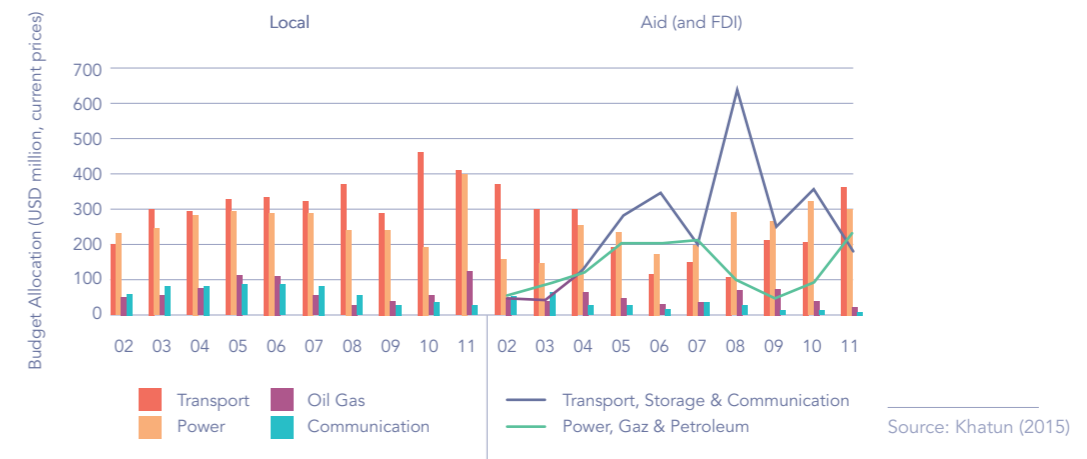


Box 6.5 | Finance and policies in enabling infrastructure investment in Bangladesh

A least developed country (LDC), Bangladesh has undergone significant economic and social development in the last 20 years. Per capita income increased from \$90 in 1973 to \$1,044 in 2013. Improved telecommunications and rural roads, power generation and distribution networks, as well as investment in health and education, and in technology and information, have been vital enablers in the country's development. The improvement of rural road networks, facilitated by larger budgetary and ODA allocations, has created local employment and income opportunities. Poor and landless women and men have found work in road construction and maintenance. Better roads have reduced travel time, increased access to non-rural employment and to social services. As a result, women have been better able to seek employment and to benefit from maternal and child health (MCH) programmes, and school attendance in rural areas has also improved. Better infrastructure has encouraged the development of rural markets through private investment in services such as shops, restaurants, pharmacies, tea stalls and salons. These have created rural employment opportunities. Moreover, greater rural-urban connections have led to a rise in the value of land. By 2011, Bangladesh ranked third among eight countries in the region concerning access to improved sanitation, sixth in telecommunications access and seventh in access to electricity and improved water. Transport remains a major challenge. Bangladesh has only 0.1 km of roads per 1,000 people, the lowest in the region, and only 10% of them are paved. A comparison with South Asian countries and LMICs more widely indicates that Bangladesh still lags behind other countries in the region in most infrastructural indicators, making the development of infrastructure a top policy priority.

Political uncertainty, weak institutions, lack of skilled workers, unreliable energy supply and a cumbersome and opaque regulatory framework have been binding constraints to investment in infrastructure, deterring potential investors. In addition, the availability of suitable land is an acute problem for investment in infrastructure. This is due to the shortage of land and unclear property rights. There are no computerised records of land titles and disputes are common. As a result, acquiring land for investment is a slow and lengthy process. Between 1990 and 2012, Bangladesh attracted only \$10.1 bn from the private sector in the telecommunications and energy sectors, representing 1.1% of GDP (2007–2012) and 2.8% of all private investment in infrastructure. Due to insufficient private investment in transport, water supply and sanitation to meet rising needs, government and public resources had to be mobilised and have risen relatively rapidly in recent years (see Figure 6.5B).

Figure 6.5B | Investment in infrastructure in Bangladesh (\$ mn, current prices) from local, ODA and FDI sources 2002–2011



According to Andrés et al. (2013) Bangladesh will need to spend between \$7.4 bn and \$10 bn a year between 2011 and 2020 (i.e. 7–10% of annual GDP) to improve its infrastructure and to bring its power grids, roads and water-supply systems up to the standards required to serve a growing population. For the transport sector alone, total investment needs up to 2020 are estimated to range between \$36 bn and \$45 bn (Andrés et al., 2012) and for the power sector between \$11 bn and \$17 bn, given that half of the population is not connected to the national grid. To improve water supply and sanitation will require between \$12 bn and \$8 bn and estimates for improving solid waste management, telecommunications and irrigation are between \$2.1 bn and \$4.2 bn, \$5 bn, and from \$7.7 to \$11.6 bn respectively (Andrés et al., 2012).

More investment in infrastructure is needed to respond to the impact of climate change. With very high population density, Bangladesh is also extremely vulnerable to floods, droughts and cyclones. The impact of global warming, manifested in sea-level rise that threatens to flood the country's coastal regions, requires investments in infrastructure and technology to reduce this vulnerability.

The government has taken a number of initiatives to promote investment in infrastructure. Three important bodies have been created to finance and facilitate infrastructure projects: the Infrastructure Investment Facilitation Centre (IIFC), the Infrastructure Investment Development Company Limited (IDCOL) and the Bangladesh Infrastructure Finance Fund Limited (BIFFL). The IIFC, set up in 2000, identifies infrastructure projects to be undertaken by the private sector and helps relevant ministries to identify potential investors (IIFC, n.d.). Established in 1997, IDCOL is expected to bridge the financing gap for developing medium- to large-scale infrastructure and renewable energy projects (IDCOL, n.d.). It extends long-term loans of up to 40% of capital costs provided the project sponsor bears at least 20% of investment costs through equity financing. BIFFL is a public limited company that aims to provide mainly long-term financing for PPP projects through the issuance of bonds, debt instruments and equity offerings (BIFFL, n.d.).

With the support of the World Bank, the government also created the Investment Promotion and Financing Facility (IPFF) in 2006 as a separate unit of the Bangladesh Bank, mainly to finance infrastructure projects to be undertaken by the private sector that the government decides are in the public interest (Bangladesh Bank, 2013). The IPFF provides loans to participating financial institutions at the request of the private investor. Eligible sectors/projects include power generation, transmission, distribution and services; port development; and environmental, industrial and solid-waste management; highway and expressway development, including mass-transit, bridges, tunnels, flyovers, city roads, bus terminals, commercial car parking, etc; airport terminals and related aviation facilities; water supply and distribution, sewage and drainage; industrial estates and parks; social-sector investments, including infrastructure in health and education; and information technology.

SSC investment in infrastructure is relatively new. China helped in the construction of the China-Bangladesh Centre in Dhaka with a loan of \$25 mn. A Chinese company won the contract for the Dhaka-Chittagong Highway expansion project to improve connections between the capital and the port city. China has also submitted the lowest bid for the Padma Bridge River Training Project as part of the proposed Padma Multipurpose Bridge project to connect the south-western region with the rest of the country and facilitate the transmission of natural gas, telecommunications and electricity. This 6.15km bridge will cost \$3 bn (BBA, n.d.). The Chinese company has offered to carry out the training work for \$0.78 bn, but allegations of questionable work ethics and quality of work have hampered progress (Khan and Azad, 2014).

Source: (unless otherwise stated): Khatun (2015)



6.2.1 Financing infrastructure: different sources, different effects

Sources of infrastructure finance

The World Bank (2013a) estimates the undersupply of infrastructure finance in developing economies at around \$1 tr per year through to 2020, with an additional \$200 bn to \$300 bn required per year to ensure that infrastructure is low carbon-emitting and climate-resilient. The financing needs vary across different types of infrastructure and across regions. McKinsey (2013) estimates a funding gap of \$ 57 tr until 2030 simply to keep up with projected global GDP growth. This is 60% more than the \$36 tr spent globally over the last 18 years on transport infrastructure (road, rail, ports, and airports), power, water and telecommunications. Foster and Briceño-Garmendia (2010) estimate that SSA's infrastructure needs to be around \$93 bn a year, subject to the constraints discussed in Chapter 2. Importantly, finance needs depend on the policy context. The costs of building infrastructure could be reduced by using existing

infrastructure more efficiently and improving the quality and management of such projects. A range of practical steps can often boost the productivity of infrastructure by 60%, thereby lowering necessary spending by 40% (World Bank 2013a).

Despite these unmet needs, only about 3% of global FDI has financed infrastructure in SSA while donors have devoted insufficient attention or resources to infrastructure and skills (Page, 2012). Table 6.3 estimates the importance of financial flows to infrastructure development by source. Across the regions shown, national government spending has been the principal source of finance for investment in infrastructure, ranging from 47% annually in Africa in 2012, to 66% in SSA over the 2001–2006 period. Finance for infrastructure from emerging and advanced economies to SSA and to developing countries more generally has been considerably lower. Differences are more pronounced in the case of private-sector participation, which has financed 20–30% of total infrastructure investment in developing countries, but only a small share in Africa (9%).

Table 6.3 | Annual investments in infrastructure in developing countries, by source

	AFRICA, 2012 (ICC DATA)		SSA, 2001–2006 (AICD DATA FROM FOSTER AND BRICEÑO-GARMENDIA)				DEVELOPING WORLD, 2008 (BHATTACHARYA ET AL.)	
	\$ bn	%	CAPITAL ONLY		CAPITAL + O&M		CAPITAL ONLY	
			\$ bn	%	\$ bn	%	\$ bn	%
National government	42.2	47	9.4	38	29.8	66	500–600	60–70
Developed countries	18.3	20	3.6	14	3.6	8	40–60	5–8
Emerging economies	21.4	24	2.5	10	2.5	6	20	3
Private sector	7.9	9	9.4	38	9.4	21	150–250	20–30
Total	89.3		24.9		45.3		800–900	

Sources: UNTT (2013), based on data from ICC (2012); Foster and Briceño-Garmendia (2010); Bhattacharya et al. (2012)

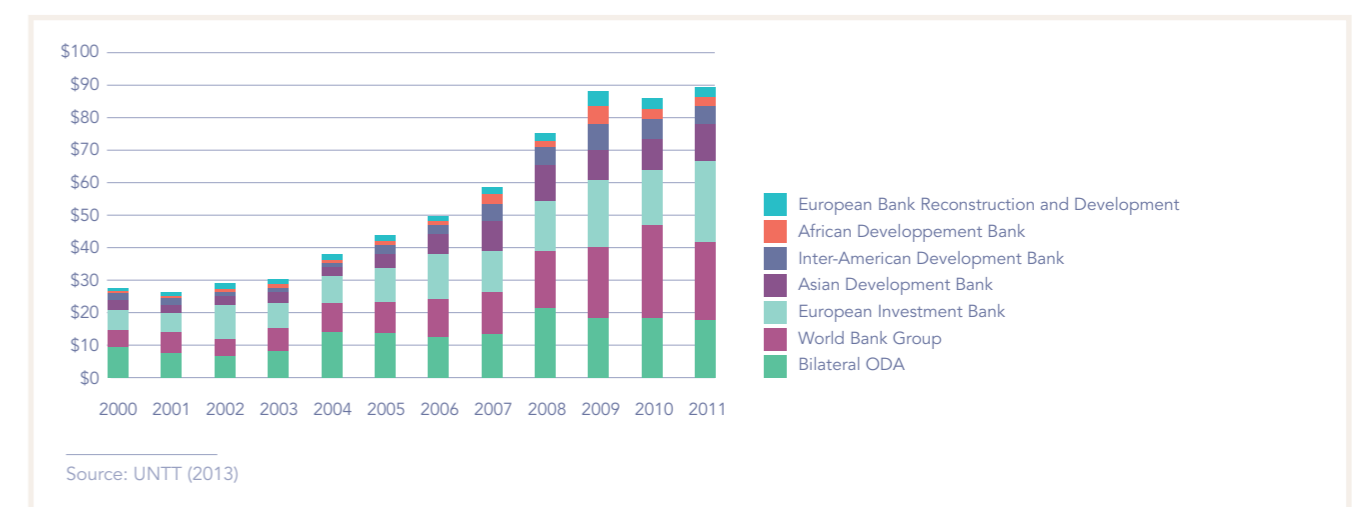
Finance for infrastructure in developing countries provided via bilateral ODA and MDBs grew substantially after 2003, from less than \$30 bn to approaching \$90 bn in 2011 (Figure 6.3). MDB finance has been a large and growing source, while bilateral ODA for infrastructure peaked in 2008 and remained stagnant thereafter. SSC has also increased considerably (UN ECOSOC, 2008). An increasing number of Southern countries (e.g. China, India, Kuwait and Saudi Arabia) and multilateral development organisations (e.g. The Islamic Development Bank, Arab Bank for Economic Development in Africa and Organisation of the Petroleum Exporting Countries (OPEC) Fund) have largely focused on infrastructure (UN ECOSOC, 2008).

In the case of China, economic infrastructure accounts for 61% provided through concessional loans and 19% of development-related projects, while the industrial sector takes 16% in the former and 31% in the latter (commissioned background paper; Uneze, 2015). UNCTAD (2010) further notes that half of China's SSC contribution to infrastructure is in the form of concessional loans and 1% through grants, while Arab countries as a whole disburse only 10.5% of their SSC through grants. This is in contrast to the OECD DAC donors, in which grants account for 91% of ODA disbursements. Another distinct feature of SSC is that it is mainly bilateral and delivered through

national banks. For example, China and India use their respective Export-Import Banks (Ex-Im Banks) to transfer financial assistance. In the case of DAC donors, multilateral institutions (for example, the World Bank) are used, with bilateral aid accounting for a modest share. This pattern highlights two important issues regarding SSC. One is that there is currently limited collaboration and coordination among Southern donors, or interfacing with traditional donors and multilateral institutions, thereby fragmenting the aid process. Second, bilateral aid is used because it can be more closely linked to trade and investment. While tying trade and investment activities with the provision of ODA or SSC provides mutually beneficial cooperation, the drawback is that LICs could be left behind as investment and trade potential with the emerging economies is still evolving. Currently only two LICs (Liberia and Ethiopia) ranked among the top ten recipients of non-DAC aid in African countries, both of which are resource-rich countries.

At the same time, private-sector participation has increased rapidly (Figure 6.4), peaking at approximately \$190 bn in 2010. Most of this was in LAC with SSA and MENA receiving relatively small amounts. In sectoral terms, infrastructure for transport and energy absorbed the larger share of financing from primarily public sources in SSA.

Figure 6.3 | Infrastructure funding from bilateral ODA and MDBs (\$ bn), 2000–2011 source





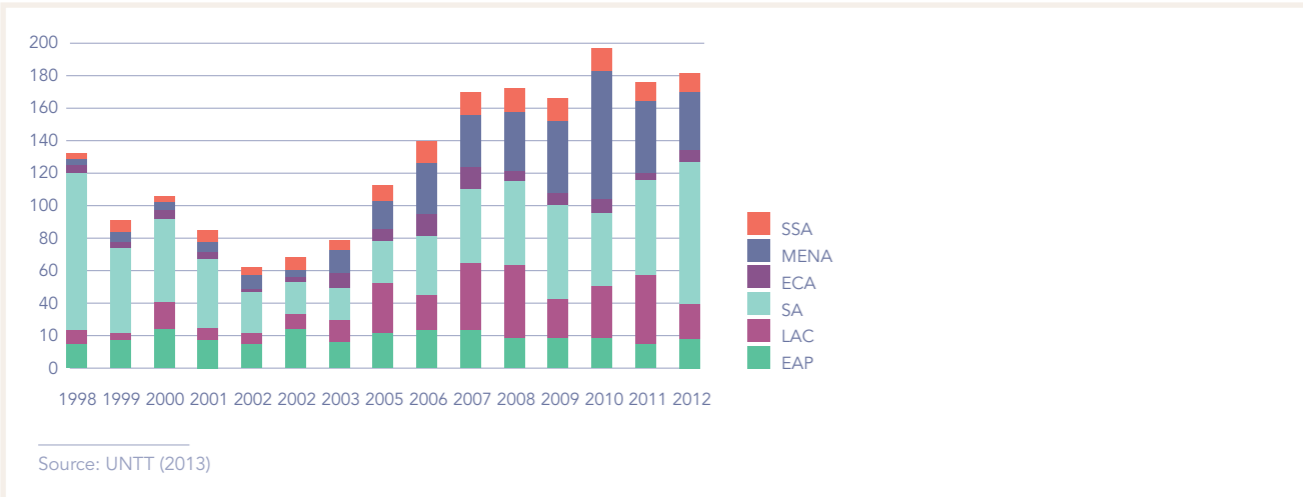
Box 6.6 | The IBSA Dialogue Forum

One of the most recent and interesting experiments in collaboration among emerging economies is the creation of the 'The India-Brazil-South Africa (IBSA) Dialogue Forum'. While its initial mandate focused on fostering political and economic interests of the member countries, the creation of the IBSA Fund in 2004 has assisted LDCs in the Global South to achieve the MDGs. The Fund operates by identifying viable and scalable projects in the Global South. Each member country contributes \$1 mn per annum to the IBSA Fund portfolio, which is managed by a special unit under the auspices of the United Nations Office on South-South Cooperation.

Between 2004 and 2011, the IBSA Fund mobilised more than \$20 mn and about \$8.6 mn has been directed to key development projects with almost 72% allocated to the core MDG sectors – agriculture, livelihoods, waste management, health and water. Existing technology in IBSA member countries was used in the projects thereby developing local capacity and transferring technology to the recipient countries. So far, LDCs in Africa have most benefited from the IBSA Fund (46% of the projects), followed by Latin America (22%), Asia (19%) and Arab countries (13%). An important IBSA initiative is the \$3 mn waste-management system in Haiti that uses local capacity and labour-intensive technologies, thereby creating about 400 direct jobs, while also addressing prolonged communal clashes among the beneficiary communities (UNOSSC, 2013).

Source: commissioned background paper by Uneze (2015)

Figure 6.4 | Private-sector investment in infrastructure by region, 1998–2012



Private finance for infrastructure has traditionally been in the form of loans and bond financing, and has increased rapidly in recent years with a growing number of developing countries now boasting investment ratings and issuing bonds. The number of African nations rated by at least one of the three top agencies – Moody's, Fitch and Standard & Poor's – has risen to 26, up from 15 a decade ago and just one in 1994 (Blas, 2014). Similarly, countries with large diasporas, such as Ethiopia, Kenya and Nigeria, are experimenting with the issuance of diaspora bonds (albeit with mixed success, see below). According to market analysts (see Fatuna, n.d.), the benefits of such bonds are that (a) a successful issue, along with the access to steady new funding, may help to improve a country's sovereign debt rating; (b) buyers may continue to purchase bonds, even when markets are sceptical about a nation's economic outlook (e.g. sales of Israeli diaspora bonds rose during the Six-Day War); and (c) countries in essence receive a 'patriotic' discount when they issue diaspora bonds, as investors are often willing to accept much lower returns than they might on the open market.

Despite the theoretical arguments in favour of diaspora bonds, their issue to date has been met with limited success. Part of the problem has been a lack of awareness of their existence among the diaspora, but also that diaspora communities have been reluctant to bear the risk of buying a product sold by their country of origin. DFIs and MDBs might help to mobilise resources by mitigating and diversifying such risks. African countries that have explored diaspora bonds might consider pooling their efforts and launching bonds via an institution such as the African Development Bank (see Fatuna, n.d. for further discussion). Moreover, as Spratt and Ryan-Collins (2012) note, while private investment in infrastructure is significant, it is also volatile and unable to meet the needs.

The effects differ by source of infrastructure finance: a modelling approach

While there are different sources of finance, the effects vary depending on the sources of finance. MAquette for MDG (MAMS) model simulations in Moldova (see Box 6.7) show that investment in infrastructure is likely to expand private consumption, growth and employment and to create positive effects on household welfare, including the reduction of poverty. As expected, due to the difference in expenditure multipliers and tax wedge effects on final prices, the expansionary effects of infrastructure investment are larger when such investment is financed by public resources relative to taxation. It should be noted, however, that large foreign transfer inflows to finance investment in infrastructure could lead to a real appreciation of the exchange rate hurting exports and increasing inequality through negative distributional consequences for particular income groups (commissioned modelling paper Kinnunen, 2015).



Box 6.7 | Economic and social implications of alternative financing sources for infrastructure development: insights from a modelling study on Moldova

Between 2000 and 2004 annual public investment in Moldova ranged between 2% and 3% of GDP and lacked clear priorities. While public capital spending between 2005 and 2010 increased from 5% to 8% of GDP (IMF, 2005, 2008, and 2012), investment in infrastructure was not a high priority. This is manifested in very poor road conditions and limited Internet access.

The poor quality of Moldova's infrastructure has become a critical binding constraint for promoting its economic transformation as well as for sustaining the social gains achieved through income-supporting transfers from remittances and ODA. The development of infrastructure offers high potential productivity gains.

Assessing the economic and social effects of infrastructure investment and the role of different financial sources on key economic and social variables up to 2030 provides useful insights for Moldova's policy options and trade-offs, especially in view of the recent signing of the Moldovan-EU Association Agreement. This is accomplished through the use of the MAquette for MDG Simulations, a CGE model developed at the World Bank to analyse strategies for medium- and long-run growth and poverty reduction in developing countries, adapted and applied to Moldova's economy (commissioned modelling paper; Kinnunen, 2015).

Sources of finance for infrastructure

Exploring different scenarios, the study focuses on two sources of finance for infrastructure, namely foreign transfers and domestic tax revenues. For the scenario according to which government infrastructure investment is financed from foreign transfers (infra-*fr*), it is assumed that foreign transfers grow, so that their share relative to baseline GDP grows by 1 percentage point. Increased transfers are assumed to finance public infrastructure, which in turn affects industrial productivity. It is further assumed that the largest productivity gains are recorded in agriculture, trade, transport and postal services, as well as telecommunications and IT services. However, all industries benefit from an additional total factor productivity (TFP) gain due to improved infrastructure. Moreover, the additional demand for labour and other inputs needed for infrastructure investment affects the whole economy, thus giving rise to supply and price responses. The source of financing for the additional investment is also relevant.

The same assumptions are made under two alternative scenarios in which financing is provided by domestic taxation (infra-*tax*) and by a combination of tax-based financing and foreign transfers through a gradual increase of the latter (infra-*tax*20, infra-*tax*40, infra-*tax*60, infra-*tax*80).¹ The higher the share financed by increased taxation, the greater is the potential for crowding out other activities through increased tax wedges in product and factor markets (both direct and indirect taxes are raised) and for decreasing the amount of savings available for other private-sector investments. On the other hand, the larger the influx of foreign transfers, especially if the additional investment demand is directed mainly to domestically produced commodities, the higher is the risk of 'Dutch disease' effects, leading to increased domestic inflation, a loss of competitiveness and lower export growth (compared to the development implied by the base scenario). The final outcome thus depends on the relative strength of the different effects in each sector of the economy.

Financing sources matter for social and economic development outcomes

Comparing simulation results of the increased infrastructure investment scenario relative to the base one which reproduces the medium- to long-run trends in the structure of the Moldovan economy (base), GDP growth, exports and private consumption grow significantly as expected. The higher the share of foreign transfers in financing infrastructure investment, relative to financing through tax increases, the higher the growth rate of private consumption and the positive effects on welfare at the household level.

¹ It is assumed that the same infrastructure investments are made but that the growth of foreign transfers amounts to 20%, 40%, 60% and 80% respectively of total financial transfers in the infra-*fr* scenario). It is also assumed that the efficiency of foreign transfers does not depend on their size and that the Moldovan economy fully absorbs the inflows without leakages due to mismanagement or corruption.

Figure 6.7B1 | Growth rate differences to baseline scenario by share of aid, percentage points

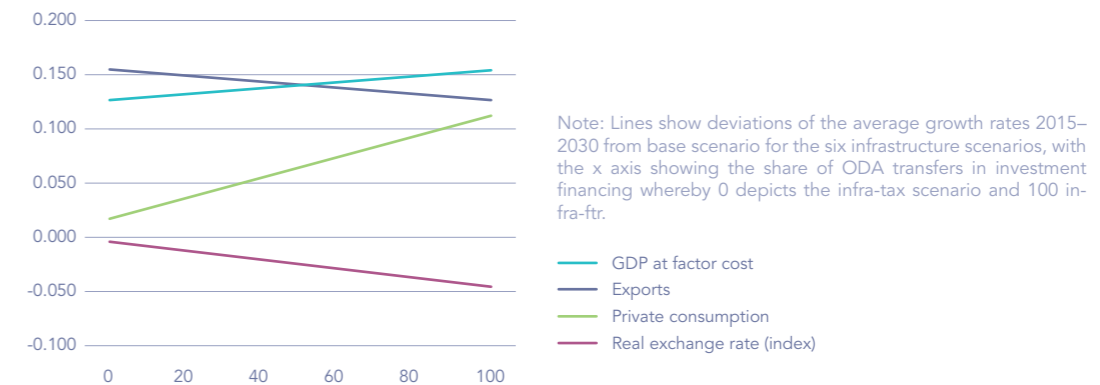
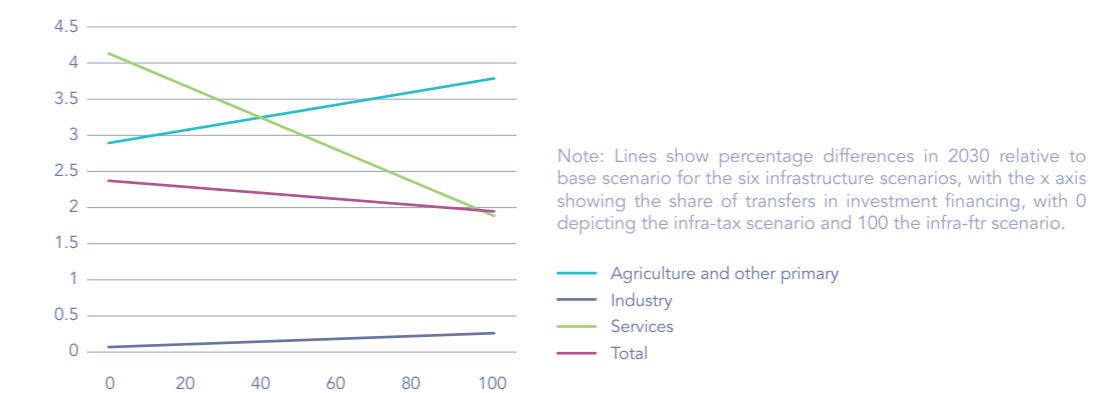


Figure 6.7B1 shows the growth rate differences relative to the base scenario of the Moldovan economy for the varying share of foreign transfers in financing additional infrastructure investments. An increase in infrastructure investment by 1 percentage point (compared to the base scenario), financed through foreign transfers, leads to an increase of 0.15 percentage points in GDP growth (compared to the base scenario with an average GDP growth of 4.27%). While increased foreign transfers lead to higher private consumption and improved household welfare, Moldova's price competitiveness is hampered by domestic prices rising more quickly than foreign prices. This is reflected in an appreciation of the real exchange rate (shown as a decrease of the real exchange rate index, defined as the ratio of local currency units (MDL) and foreign currency units (\$) and smaller export growth rates.

Increasing infrastructure spending under different financing schemes has different implications for different sectors of economic activity especially in terms of real export growth (see Figure 6.7B2). The higher the share of foreign transfers in financing infrastructure, the higher the exports of the industrial and agricultural sectors. In other words, the productivity effect dominates in these sectors. The international competitiveness of the service sector, however, is expected to deteriorate due to its high labour share, which results in high wage growth that exceeds productivity as the share of transfer financing increases.

Figure 6.7B2 | Exports volume growth by sector relative to base in final year (in percentage terms)

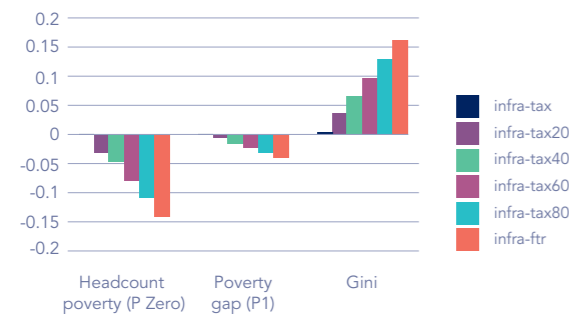




Infrastructural investments, irrespective of the source of financing, have an overall positive effect on household welfare as indicated by private consumption growth in Figure 6.7B1. The poverty rate and the poverty gap decrease as shown in Figure 6.7B3. However, inequality increases in all the analysed scenarios. The worst-off household groups are typically less attached to the labour market, and thus do not automatically benefit from the reforms that increase factor income (either from labour or capital). Given that the analysis assumes that government transfers are kept at base scenario levels, the result of increased inequality is partly an artefact of assumptions.

Thus, this analysis highlights the need to complement growth-inducing investments with appropriate transfer schemes across income groups so that higher growth and absorption does not end up benefiting primarily those who are already better off.

Figure 6.7B3 | Poverty and inequality in 2030 (percentage point deviation from base)



Note: The three indicators are scaled to the range 0-100. The figure depicts the deviations from 2030 base values (not the relative changes) for the indicators. (For example for the poverty rate, the change is measured in percentage points of poverty rate). The poverty gap index (P1) measures the extent to which individuals fall below the poverty line as a proportion of the poverty line.

Source: commissioned modelling paper Kinnunen (2015); IMF (2005, 2008, 2010, 2012)

6.2.2 Links between finance and policies for infrastructure development

A range of supporting policies is essential for the mobilisation of finance for infrastructure and for its effective use.

Mobilising finance for infrastructure

Part of the mismatch between resources and needs relates to the specific nature of infrastructure investment. One element is the large scale of the upfront financing needs and the difficulty of identifying and/or capturing returns over a longer period. Although there are mechanisms to recover costs for public or private investors, these rely on sufficient use in order to make the investment commercially viable. Infrastructure investments

are also characterised by lumpiness, high sunk costs and relatively low returns over long periods. These long gestation periods imply greater financial and political risks. Mobile telephony and IT investments may be exceptions here because of the specific nature of the goods and markets, as evidenced by the large inflows of private finance (in this sector, it is possible to make large financial returns relatively quickly, unlike, for example, in water infrastructure) There is therefore a role for domestic and international policies to de-risk and direct finance for infrastructure, the most important of which are (a) strategic guidance and capacity-building for improved project appraisal, selection and budgeting; (b) an appropriate and transparent regulatory framework and governance; and (c) capacity-building for transparent and effective PPPs. International policies can also play a catalytic

role to expand infrastructure investment through (a) technical assistance for improved project appraisal, selection and preparation; (b) the provision of blended finance instruments (grants and concessional loans); and (c) the provision of incentives and innovative financial instruments for enhanced leverage and de-risking private finance for infrastructure investment.

Strategic guidance and capacity-building for improved project appraisal, selection and budgeting

Policy can address economic and political risks specific to investments in infrastructure. Most infrastructure projects require sizeable frontloaded and irreversible commitments. There is a need to develop the capacity, especially in LICs, to enable projects to be commercially viable. Small, idiosyncratic infrastructure projects as opposed to grid development are not only costly to prepare, but also hard to value (Collier and Mayer, 2014), creating difficulties even at the initial phases of attracting investment. The construction phase of large infrastructure can be very protracted, interrupted and/or costly due to regulatory or administrative delays, ineffective quality-control processes, inadequate coordination or political opposition by those who are negatively affected by the project. Political interference has also been shown to alter the risk and commercial profile of investments (Collier and Mayer, 2014). Such risks dissuade investment in infrastructure development, especially in the transport and energy sectors, where projects have long gestation periods.

In countries with inefficient investment and public-management processes, many infrastructure investment initiatives end up producing few measurable benefits (IMF, 2014). Well-designed institutional arrangements for project selection and appraisal that are embedded in an overall medium-term strategy for infrastructure development and accompanied by solid budgeting of costs and evaluation of risks can play a catalytic role not

only in improving investment efficiency but also in mobilising financial resources. The need to build capacity in project appraisal, selection and budgeting has led many developing countries, such as Bangladesh and Mauritius, to create special bodies or facilities for infrastructure development. Transparent governance of these bodies and international technical assistance could help to improve decision-making quality, with positive effects on resource mobilisation.

Appropriate and transparent regulatory framework and governance

While sources of finance for infrastructure vary across countries and sectors, the large shortfall in relation to infrastructure needs in the lowest-income countries, particularly in Africa, highlights underlying policy and institutional bottlenecks. In most LICs and in the presence of widespread informality, public investment in infrastructure is constrained by a limited tax base and weak tax- and custom-administration systems. Regulatory bottlenecks remain powerful impediments for private finance. According to Collier and Mayer (2014), 'the inability of Africa to finance its infrastructure requirements is not therefore a capacity constraint. It is an institutional and organizational one'. As shown in Box 6.1, the same holds true in Bangladesh and in other countries where unclear property rights and cumbersome land-titling procedures have hampered private investment in land and in infrastructure. Long delays, lack of transparency in resolving disputes through the legal system and widespread alleged corruption in customs, tax and legal authorities have also been cited as major obstacles for mobilising finance for infrastructure in countries such as Bangladesh (CI, Khatun, 2015) and Moldova (CI, Ghedrovici, 2015).

Institutional and regulatory reforms of tax administration, customs and legal systems made at early stages of development can go a long way towards helping to mobilise financial resources.



The investment climate - or even credible commitments to make the necessary reforms - influence both expected net returns and risks on investment and the size, composition and impact of infrastructure finance. Thus, low-income agricultural countries such as Moldova have relied on ODA, remittances and domestic taxes to provide for basic infrastructure (roads, water provision or electricity grids). Once Moldova undertook to make far-reaching reforms in order to remove institutional rigidities and distortions and improve governance under the EU-Association Agreement and the Deep and Comprehensive Free Trade Agreement (DCFTA), international investors, including DFIs, entered the Moldovan market and have shown greater interest in participating in international bids (CI, Ghedrovici, 2015). The experience of Peru is also telling: the introduction of transparent land-titling and clear property rights helped create local markets that gave a boost to investment in infrastructure and project financing from the private sector (Panaritis,

2008). According to the IFC, infrastructure tends to matter more in poorer countries, whose institutions are weaker (e.g. more corruption, fewer skills) and a less competitive environment attains lower growth (IFC, 2012).

Building capacity for transparent and effective PPPs

The need to cover M&O costs throughout a project's lifetime and to develop whole life-cycle approaches to finance for infrastructure have led to a rise in the number of PPPs in the last 20 years (Figure 6.5). Although PPPs have higher upfront costs than public finance, due to the need to secure a return for the private investors, their advantages can make them the preferred means of financing infrastructure in developed countries (e.g. Germany and the UK). Risk is shared with or borne by the private sector, which results in substantial public savings.³⁴ The participation of the private sector can also lead to better project

selection, more cost-effective construction processes, savings in building materials and equipment, and improved governance – all tending to reduce the project's lifetime costs. Even in developed countries, however, there are many instances where outsourcing or PPP arrangements have been associated either with problematic quality of service or very expensive services that limit access to those on low incomes. These negative repercussions are even more likely in countries whose departments of public works have only limited capacity to manage such projects or where governance structures are weak (Mantzoufas, 2014). In order to reap benefits from PPPs, governments need the capacity and the skills to engage with, evaluate and manage such contracts. This suggests that PPPs may be a more useful potential source of finance for infrastructure in MICs and HICs than in LICs. In countries where public investment management is poor or where political capture by private interests is prevalent, PPPs could have deleterious effects since they can easily be used to bypass spending controls, with the result that governments and taxpayers ultimately bear most of the risk.

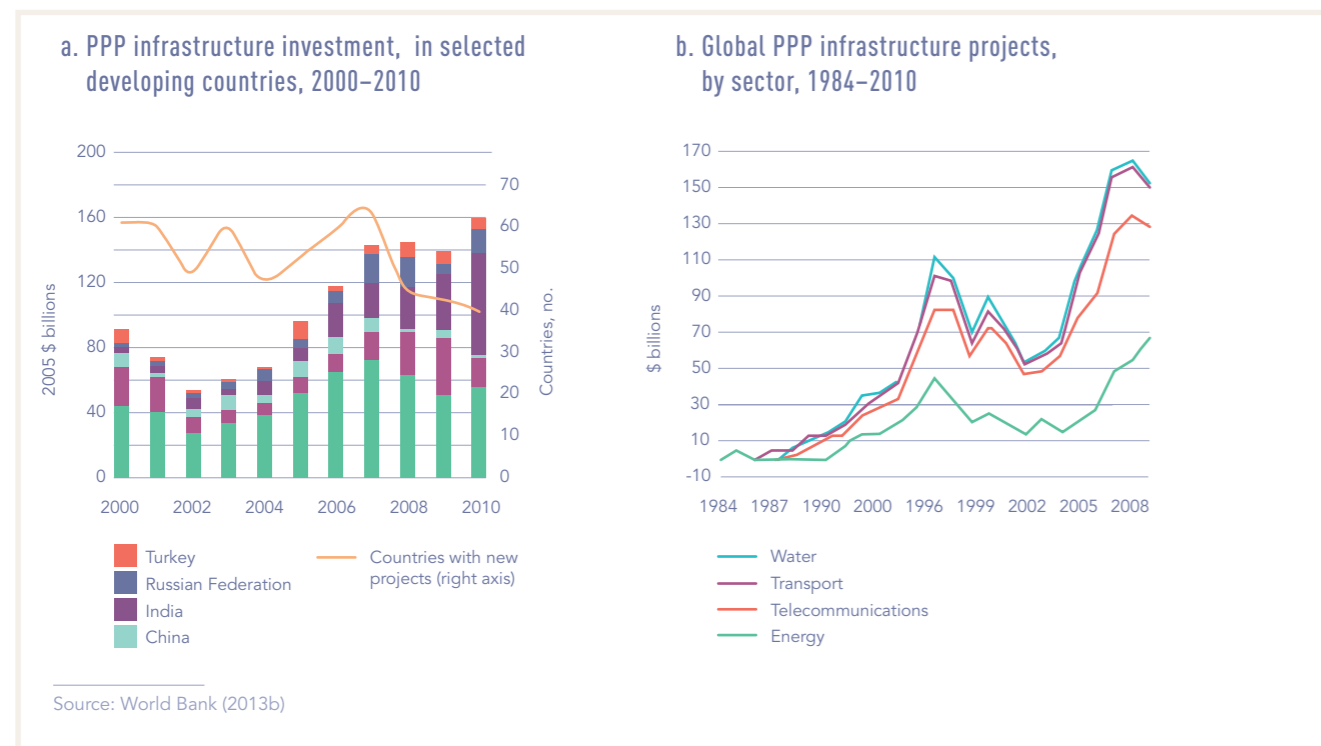
DFIs and MDBs can play a leading role in mobilising the necessary finance for infrastructure projects. They are well suited to pooling resources, providing long-term finance, mitigating risks through appropriate blending and insurance mechanisms and guarantees, providing technical assistance and introducing innovative financial instruments and forms of support. Their size and reach enable them to promote large or regional infrastructure projects and to be credible partners for national governments in supporting their development. Ryan-Collins and Spratt (2013) identify four types of DFI impact 'additionality': (a) financial, through enhanced leverage of additional private finance for infrastructure; (b) design, through influencing project design in order to enhance the impact on growth and/or poverty; (c) policy, through shaping the policy context in order to enhance the impact on growth and poverty; and, (d) demonstration, since the success of a DFI-supported project may stimulate subsequent private-sector projects that do not involve DFIs.

The European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD) spearheaded such initiatives through the EU-Africa Infrastructure Trust Fund (EU-AITF), established in 2007, and the Neighbourhood Investment Facility (NIF) launched in 2008. According to WEF (2014, Section 2), the 'EBRD has taken a gradual approach to financing municipal infrastructure and services, bringing clients to the point of being able to access commercial funds in the market. It has successfully achieved this by offering a broad range of financing instruments while supporting financing, where appropriate, through the use of technical cooperation and investment grants'. Since 2007, a number of similar facilities have been set up. The Asian Development Bank (ADB) has promoted the 'Cities Development Initiative for Asia' and the 'Project Design and Monitoring Facility' in the Philippines. The IFC has focused on addressing the dearth of bankable infrastructure projects and the lack of adequate funding for project preparation in emerging economies and in LDCs via the

Assistance in project preparation, blended finance and other instruments to de-risk investment in infrastructure: a catalytic role for DFIs and MDBs

The mobilisation of finance for infrastructure can be enhanced if projects are carefully designed and bankable and if transaction structures are informed by appropriate legal advice (Kefalas, 2014). Broad consensus-building concerning the choice of project, credible political commitments and solid legal expertise in bidding processes – including contract preparation, concessions and contract provisions – can lower perceived risks. Introducing international benchmarks for transaction structures, as currently exist in the UK for instance, and developing adapted insurance mechanisms and guarantees across different capital sources and stakeholders, could help to mitigate risks (Kefalas, 2014).

Figure 6.5 | PPPs in infrastructure project finance



³⁴ In the case of the construction of seven fire stations in Greece, the costs from unforeseen delays that were borne entirely by the private investor saved the government €5.7 mn of a €26 mn project (Mantzoufas, 2014).



'Global Infrastructure Project Development Fund' (IFC InfraVentures'), established in 2008. Since its creation, IFC InfraVentures has committed \$54.1 mn to support the development of 25 infrastructure projects including a number of solar, wind power, hydropower and water-purification and distribution projects in Georgia, Haiti, Laos PDR, Moldova, Nepal, Pakistan and countries in SSA.

Blended finance is another option. In the EU this involves a combination of grants (usually from the European Commission (EC)) with loans from public financial institutions (e.g. the EIB) and commercial lenders to provide investment grants, subsidised interest rates, risk capital (equity and quasi-equity), guarantee mechanisms and technical assistance. Since the EU-AITF was established, 92 grants have been approved for 69 African infrastructure projects, worth over €497 mn. They are expected to generate investments that are 14 times greater than the value of the grant funding (EIB, 2014). The bulk of investment is in the energy sector (61.5%) and transport (26%), followed by water (8.5%), ICT (3.8%) and multi-sector projects (0.3%). Key to the success of the EU-AITF is its regional focus, flexibility and pre-investment support and the cooperation among financing institutions (EIB, 2014).

The evidence on the impact of DFI-supported infrastructure investments on growth and poverty is still mixed. On the positive side, in a systematic evaluation of the impact of such investment by DFIs and MDBs, Spratt and Ryan-Collins (2012) find that they generate positive development impacts mainly due to financial additionality, the provision of long-term finance, the mitigation of early-stage project risk and the leveraging of additional finance. They also find that DFI-backed loans are less risky than commercial loans as borrowers are reluctant to default because doing so could damage their relationship with the donor. According to the World Bank (2013c), apart from their capacity to leverage additional funds from the private sector, MDBs' preferred creditor status,

technical expertise, prudent risk-management policies, adherence to clear standards in project design, including environmental standards, execution, and corporate governance help to build the confidence necessary to attract commercial funding from a wide range of sources.

There is also increasing evidence of the concrete positive impacts of DFIs' innovative approaches to infrastructure finance. For example, according to the World Economic Forum, the EBRD has achieved notable successes in the water and urban transport sectors in emerging economies through its extension of sub-sovereign direct lending, solid funding arrangements and innovative contractual schemes (WEF, 2014). In particular, its practice of combining a public-service contract (PSC) with a project-support agreement (PSA) in the case of water, or a municipal support agreement (MSA) in the case of urban transport, has made it possible to reduce project cycles from almost 50 months to below 36 months and also to increase revenues. In Romania, for example, the EBRD's loans to water utilities of Brasov, Iasi and Timisoara under a PSC plus PSA contractual scheme increased revenues over an 18-year period by 480% in real terms.

Spratt and Ryan-Collins (2012) argue, however, that while DFIs influence project design and the policy context to boost growth, they seem to have less impact on alleviating poverty unless investments are part-funded by concessional finance. This suggests the need for public concessional finance and government involvement in order to achieve social outcomes beyond the economic returns on infrastructure projects that are designed solely on a commercial basis, thus providing a strong argument in favour of blended finance to promote sustainable development (Ryan-Collins and Spratt, 2013). Thillairajan et al. (2013) also point to trade-offs between enhanced access to infrastructure and project quality. They argue that to protect the public interest, national governments must retain the upper hand over private-sector finance and favour the continuation of public subsidies.

Box 6.8 | The Role and Impact of the African Development Bank

The African Development Bank (AfDB) was established in 1964 to accelerate African development through the provision of technical advice and financial assistance especially to LICs. It also promotes African economic integration by financing cross-border infrastructure. The Bank is supported by the African Development Fund and the Nigeria Trust Fund. The former receives funds from African and other member countries, of which the largest are the USA, Germany and Canada (AfDB, 2007). The Nigeria Trust Fund was established in 1976 by the Nigerian government to enable the AfDB to assist LDCs in Africa by using appropriate and non-stringent criteria such as low interest rates and longer maturity periods. This funding arrangement appears to place the AfDB between triangular cooperation and SSC, although an important difference is that African member countries jointly have 60% ownership and voting rights on the Bank's decisions. The main financial instruments used by the AfDB include project loans, policy-based lending, grants, debt relief, guarantees and equity finance.

The AfDB has a triple-A rating on its long-term senior debt and double-A-Plus on its subordinate debt. There is some evidence that it has expedited the swift release of funds as the time between approval and disbursement was 13 months in 2013, down from 21 months in 2007 (AfDB, 2013). Predictability of disbursement has also improved since it adopted simplified conditions and streamlined procedures. In relation to the quality of aid, the Bank is ahead of most South-South initiatives based on indicators developed from the Paris Declaration on Aid Effectiveness. More progress could be made by relaxing some of the policy conditionalities, which would improve LICs' access to loans and grants and increase support to MDG-related social sectors. The financing portfolio will need to expand in order for the AfDB to remain relevant beyond 2015 since its assistance is less than that provided to the region by the World Bank.

Since 2000, AfDB funding has focused on sectors and projects that promote the MDGs, such as water, education, health, agriculture, food security and infrastructure. For instance, its Programme for Infrastructure Development in Africa (PIDA) mobilises funds for continental and trans-border infrastructure and other sector-specific interventions and represents the largest proportion of its portfolio. Between 1974 and 2012, infrastructure received 42% of grant and loan approvals, followed by multi-sector (21%), and agriculture and rural development (19%).

Of the infrastructure programmes, water has received top priority and the AfDB manages two complementary initiatives: the Rural Water Supply and Sanitation Initiative (RWSSI) and the African Water Facility (AWF). The former supports rural water and sanitation programmes with funding for investment in operation, infrastructure, advocacy and knowledge-building. The AWF provides financial and technical assistance to governments and private investors in investment planning, feasibility studies and collaborating on regional and trans-boundary water projects. The Bank also supports the New Partnership for Africa's Development (NEPAD) Water and Sanitation Programme and the Multi-donor Water Partnership Programme (MDWPP).

In total, the AfDB has committed about \$700 mn to the RWSSI and \$876 mn to the AWF. At the regional level, however, its initiatives have not significantly improved access to water in Africa: the percentage of the population with access to water improved from 64% in 2005 to 69% in 2012. A recent assessment of its operations suggests the various water initiatives have had a positive impact. According to the AfDB Annual Development Review (2010 and 2012), the water programmes have led to the construction of 36,393 boreholes, and 4,109 transmission and distribution pipes, as well as the training of 39,721 individuals in water drilling and maintenance of water facilities. These initiatives were estimated to provide access to drinking water to 22.3 million households between 2008 and 2012 (AfDB, 2010 and 2012).

The Bank's main strategy is to provide an enabling environment for private-led growth through improved access to finance and infrastructure. Its microfinance scheme has been the main pillar of this strategy and between 2008 and 2012, more than 123,000 microenterprises were created and 477,000 microcredits granted (AfDB, 2010 and 2012). This has created 341,000 jobs, while the indirect benefits reached over 25.7 million people.

Source: commissioned background paper; Uneze (2015)



On the negative side, the ICA (2012) finds that there are considerable delays in disbursement either because of a lack of capacity in DFIs or because of blockages in the project pipeline due to a mix of complicated partner arrangements, cross-conditionality and financial planning. Evidence also suggests that complex and especially regional projects are more likely to be delayed than smaller ones (ICA, 2012: 27). Finally, donors' evaluation reports have shown that 63% of IFC and 35% of EIB concessions go to OECD-based companies (Ellmers et al., 2010). In providing infrastructure finance to developing countries, it is therefore important that DFIs seek to maximise development outcomes by supporting capacity-building as well as local companies and stakeholders. There is also a need to pay attention to revenue declaration and taxation given that a significant share of investments (25% in the case of the extractive industries) has a beneficial owner based in a secrecy jurisdiction (Ruiz and Romero, 2011).

To pursue these objectives, there will be a need for better policy cooperation among IFIs, MDBs, national governments and donors to expand activities, make up the regional and national deficits in finance for large-scale infrastructure or national-grid development, and safeguard development outcomes (Thillairajan et al., 2013). Such partnerships would release domestic public resources so that national governments, with the support of bilateral donors and potentially diaspora communities, could concentrate on smaller-scale and/or regional infrastructure projects to support employment creation and/or environmental sustainability. In addition, such partnerships would facilitate structural change by implementing a coherent, strategy for infrastructure development, with aligned incentives, pricing and regulations across relevant parties (World Bank, 2013a).

Promoting partnerships by further engaging DFIs in financing infrastructure will also create incentives for other institutions to invest. Pension funds, for example, could be encouraged to finance the

development of infrastructure (Collier and Mayer, 2014). They would be more likely to do so if they could invest in a well-run Facility Fund managed by a DFI rather than by the government of a LIC. Given the recent decline in returns, infrastructure finance can 'help institutional investors deal with the current low interest rate environment and provide them with a predictable – inflation adjusted – cash flow and a low correlation to existing investment returns' (Inderst and Stewart, 2014). The Dutch DFI, FMO, manages €500 mn from an institutional investor and other DFIs are also thinking of pursuing this option.

Depending on the country in question, the issuance of infrastructure project bonds (also known as revenue bonds or specific purpose bonds), which could securitise future cash flows from the project, could provide an additional means to raise international private finance for infrastructure (Mbeng and Achille, 2012). Such an option, which is critically dependent on the state of the domestic bond market and the credibility of the issuer, appears to be more relevant for higher-income countries.

Effective use of infrastructure finance

Evidence from the CIs suggests that the availability and the effectiveness of financial flows are largely dependent on the nature of the policy environment and the binding constraints in each country. We focus on three policy areas that influence the effectiveness of infrastructure finance: (a) capacity building; (b) the quality of the regulatory framework and (c) the existence of special economic zones (SEZs).

Capacity-building for cost-effective implementation, budgeting, and monitoring and evaluation

Vast resources have been wasted due to inadequate maintenance, poor construction or rent-seeking activities related to infrastructure. As these costs are usually covered through the public-investment

budget, multi-annual programme budgeting and effective monitoring and evaluation (M&E) of project implementation can dramatically enhance the efficient and effective use of resources. The use of public funding, including ODA, to strengthen planning and budgeting processes and improve the quality and standards of public expenditure and planning frameworks in each sector (Foster and Briceño-Garmendia, 2010) can help to reduce costs and improve efficiency and effectiveness. There is also a need for better coordination among donors in order to avoid duplication, create synergies, fill gaps and reduce costs. Proper M&E of infrastructure investment, the removal of regulatory obstacles, including lengthy and costly expropriation and legal procedures, and greater capacity of public works departments and national or local governments to coordinate and manage projects, monitor outcomes and provide quality services all serve to reduce construction and maintenance costs and to make more efficient and effective use of finance. The existence of specialised bodies, facilities or funds for investment in infrastructure facilitates capacity-building efforts as well as the pooling of resources and the effectiveness of technical assistance.

Transparent and stable regulatory framework and governance

Regulatory and governance reforms are often needed in order to make more effective use of private-sector finance for infrastructure. In their systematic review of studies on the impact of private-sector participation in infrastructure, Thillairajan et al. (2013) find that the outcomes are ambiguous unless they are accompanied by corresponding changes in market, institutional and governance structures. Similarly, Cadot et al. (2013) in their review of AfT evaluations point out that while there is some support for the argument that trade costs are reduced via investments in hard and soft infrastructure (e.g. ports and roads or customs), the failure to make complementary reforms – especially the

introduction of competition in transport services – may erode the benefit of these investments. Nonetheless, they conclude that 'when all country controls are included, the quality of infrastructure is significantly and positively correlated with aid to infrastructure' (Cadot et al., 2013). In Moldova, long queues of trucks at customs, delays in the provision of transport documents and lack of transparency in bidding or procurement processes eroded confidence and reduced the development impact and effectiveness of infrastructure finance (CI by Ghedrovici, 2015).

Large gaps in infrastructure reflect market and governance failures and involve complex political economy issues. Participation in bids to undertake infrastructural projects, especially in the risky environment of LICs, is usually limited to a very small number of domestic and foreign companies with close ties to governments and ruling elites. Lack of transparency in concession awards and contract structures, or in pricing and taxation policies, or allegations of preferential treatment, capture or corruption can delay or even cancel project implementation. Whitfield and Therkildsen (2012) find that relationships between ruling elites and entrepreneurs shape economic outcomes through the creation of bureaucratic mechanisms and administrative capabilities that, depending on political incentives, can either expedite or stall the implementation of particular policies. This finding is especially relevant to investments in infrastructure. Canning and Bennathan (2000), for example, find that in 1985, the estimated rate of return to electricity-generating capacity ranged from 100% a year in Bangladesh, Bolivia, China and Kenya to 10% or even negative returns in some countries (Lin and Wang, 2014). Harrison et al. (2012) also note that SSA firms are no less productive than firms in other countries, once allowances are made for the quality of the business climate. Hence, the quality of the business climate and the nature of state-business relations are crucial to the efficient use of investment in infrastructure. This view was also widely shared by the participants in the workshops conducted in Bangladesh, Mauritius and Moldova.

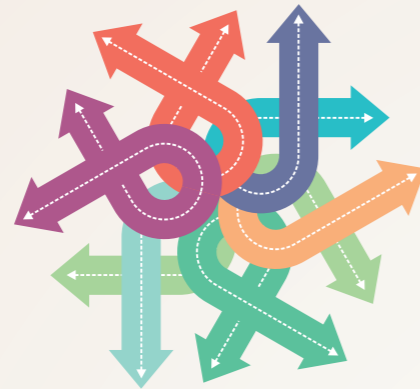
ENABLER: INFRASTRUCTURE

Investment in infrastructure

Infrastructure is a key enabler for sustainable development. There are large, long-term finance needs for infrastructure in developing countries.

Long-term finance requires:

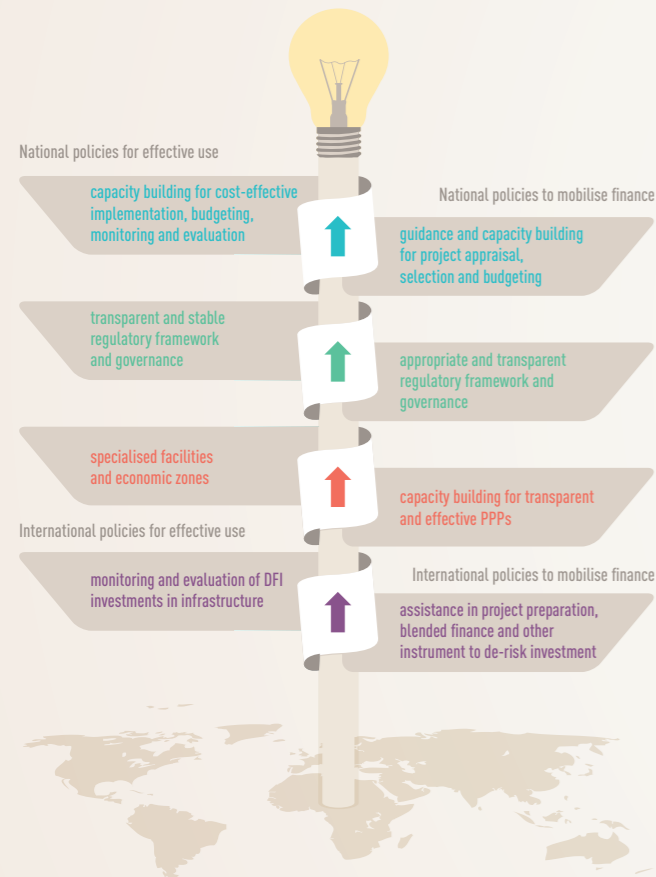
- ▶ the mobilisation of domestic resources
- ▶ the active support of DFIs and MDBs in employing appropriate financial instruments



Blending facilities can help to:

- ▶ pool financial resources
- ▶ mobilise additional private finance
- ▶ enhance the impact and efficiency of finance for infrastructure

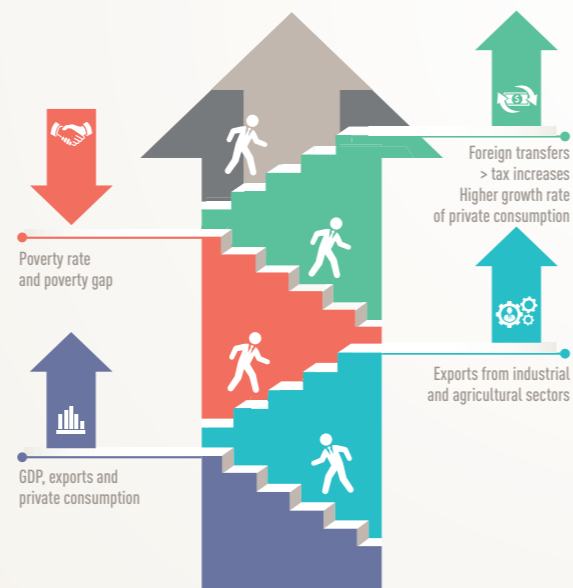
Role of policy for mobilisation and effective use of finance for infrastructure



Alternative financing: Moldova

The poor quality of Moldova's infrastructure is a critical binding constraint for promoting its economic development. An ERD modelling study focused on two sources of finance for infrastructure improvements: foreign transfers and domestic tax revenues.

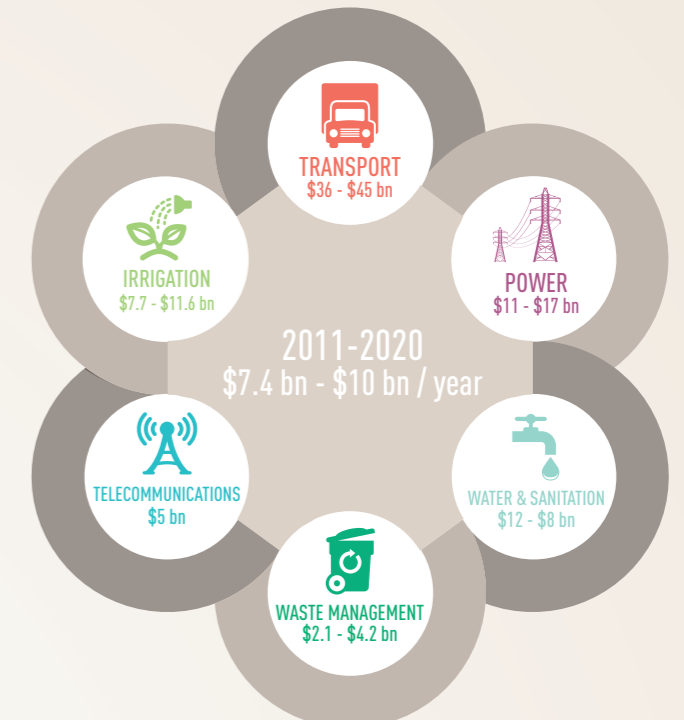
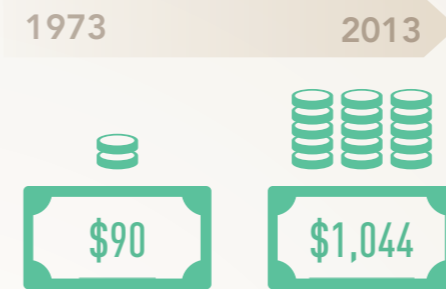
INCREASED INVESTMENT IN INFRASTRUCTURE



Infrastructure investment: Bangladesh

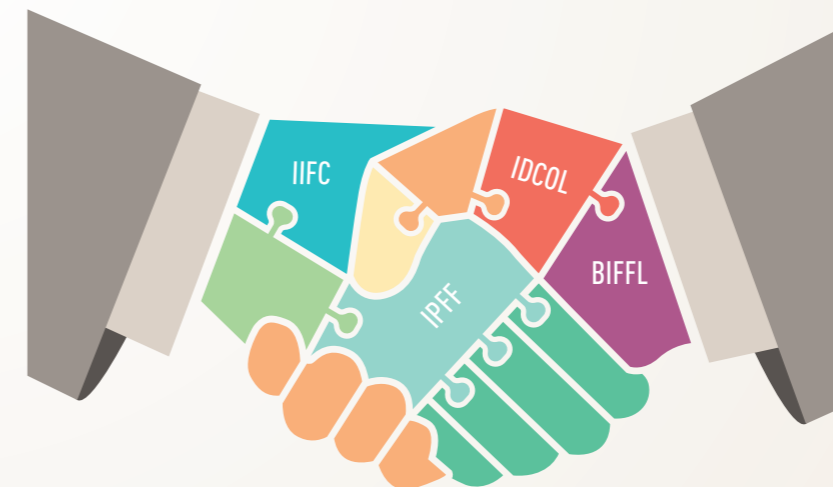


Bangladesh has undergone significant economic and social development with per capita income increasing from \$90 in 1973 to \$1,044 in 2013.



Bangladesh needs to spend between \$7.4 bn and \$10 bn a year between 2011 and 2020 (7–10% of annual GDP) to improve its infrastructure.

Between 1990 and 2012, Bangladesh attracted only \$10.1 bn from the private sector in the telecommunications and energy sectors, representing 1.1% of GDP (2007–2012) and 2.8% of all private investment in infrastructure.



This has resulted in a rapid rise in government and public spending to meet demand. Four bodies have been created to finance and facilitate new infrastructure projects:

- ▶ The Infrastructure Investment Facilitation Centre (IIFC) identifies infrastructure projects and potential private investors
- ▶ The Infrastructure Investment Development Company Limited (IDCOL) bridges the financing gap for medium- to large-scale infrastructure (inc renewable energy) through equity financing
- ▶ The Bangladesh Infrastructure Finance Fund Limited (BIFFL) provides long-term financing for PPP projects
- ▶ The Investment Promotion and Financing Facility (IPFF), supported by the World Bank as a separate unit of the Bangladesh Bank, finances private sector infrastructure projects



Specialised facilities and economic zones

In view of growing infrastructural needs and limited financial resources, exploiting economies of scale by pooling resources, accumulating experience and/or the geographical concentration of productive activities have also proved an effective means to reduce the costs of developing infrastructure. Hurlin (2006) finds that 'the productivity of infrastructure investment generally exhibits some network effects. In particular, he finds that the productivity of investment in infrastructure relative to non-infrastructure investment rises with the available stock of infrastructure. When a minimum network is available, the marginal productivity of infrastructure investment is generally largely greater than the productivity of other investments.

In most LICs and LMICs, including Bangladesh, Mauritius and Moldova, the creation of SEZs and/or Industrial Parks has contributed to more intensive and cost-effective use of investment in infrastructure. It has also facilitated investment in energy-saving and green infrastructure. Similarly, investment in infrastructure to create transport and growth corridors in order to improve regional connectivity or link land-locked countries to sea ports can have high economic and social returns. In Bangladesh, for example, several mega-projects in the transport, communications, and power and energy sectors have improved connectivity and reduced inter-regional disparities. For example, the Jamuna Multipurpose Bridge connects the eastern and western parts of the country. By facilitating the transport of passengers and freight, as well as the transmission of natural gas, telecommunications and electricity, the Bridge has contributed both to economic growth and also to employment and social development in previously deprived regions (CI, Khatun, 2015).

6.2.3 Conclusions and implications regarding investment in infrastructure

There are large, long-term finance needs for infrastructure, a key enabler for sustainable development. Despite the greater volume of ODA and private finance in developing countries, it is not nearly enough and is not always spent well. Long-term finance in developing countries, especially for infrastructure, requires both the mobilisation of domestic resources and also the active support of DFIs and MDBs in employing appropriate financial instruments. Blending facilities such as the EU-Africa Infrastructure Trust Fund or the Neighbourhood Investment Facility can help in pooling financial resources, mobilising additional private finance and enhancing the impact and efficiency of finance for infrastructure. DFIs and MDBs have played and could continue to play a leading role in promoting the greening of infrastructure investments and in providing the necessary technical assistance and risk-mitigation instruments. Governments, in close cooperation with DFIs and MDBs, can mobilise domestic and international public resources, including ODA and remittances, to finance smaller-scale infrastructure projects (especially in rural areas) that can facilitate structural change, employment creation and poverty reduction while preserving biodiversity and environmental sustainability. Better delivery systems, as well as transparent mechanisms and appropriate M&E procedures, can improve development outcomes especially if they are supported by appropriate policies and regulatory frameworks to reduce transaction costs and risks. The development of infrastructure, especially in LICs and LMICs, cannot be left solely to the market. Sustainable development that adequately addresses the social, economic and environmental considerations of development can be achieved if national and international stakeholders join forces to produce guiding principles for sustainable finance for infrastructure.

6.3 The role of finance and policies in the development of human capital

Human capital – basically a healthy and educated workforce – is central to all dimensions of sustainable development. Governments play a crucial role in developing human capital since the main effort has to be at the national level. They need to take relevant policy measures (such as on job creation, decent work, social assistance, land tenure and inheritance) over an extended period of time (since such change is never immediate) and take budgetary decisions that ensure that the maximum level and share of government budgets efficiently reach those who are poor and vulnerable (World Bank, 2013b). Equally, governments need to achieve a 'political settlement' or national political consensus on the objectives of social development.³⁵ Other actors thus also have important roles to play: national elites (e.g. on taxation), CSOs and social movements (e.g. on articulating popular voice, land tenure, gender equality, transparency), the private sector (e.g. on labour standards, education and vocational training, providing employment opportunities for the poorest), local authorities and external actors such as donors (e.g. by taking long-term perspectives in their support) or the international community (e.g. by increasing transparency of financial flows).

The policies required to eradicate poverty and to reduce inequality are in many ways very similar. Essentially they revolve around three objectives (a) tackling chronic poverty; (b) supporting the means to overcome poverty; and (c) stopping impoverishment. In line with economic policies designed to create productive opportunities and decent employment, they lead to a focus

principally on three components of human capital development: education, health and social protection (CPAN, 2014b). This trio of social policies is critical to the eradication of poverty and the reduction of inequality, and has been identified by the ILO as a 'social protection floor' (ILO, 2008; ILO, 2011a, 2011b)³⁶, and by the World Bank as a set of integrated services (World Bank, 2008). Sound post-primary and technical education are important because they create links for the poor into the labour market; universal health coverage (UHC) prevents some of the most common causes of impoverishment; and social protection³⁷ is needed to tackle chronic poverty and prevent impoverishment, which will safeguard productive assets.

Education is a particularly important asset in overcoming poverty: it builds resilience, capabilities and networks; it can improve earnings from self-employment and increase access to salaried work. 'The economic and nation-building projects of successful MICs are almost always supported by substantial investments in education' (CPAN, 2014a).³⁸ While creating productive opportunities will largely rely on domestic and international private finance, financing health and education services as well as social protection requires substantial and stable national budgets. Taxation is thus of central importance, but ODA can also be used for focused inputs, as can other types of financing (e.g. private-sector investment, especially with respect to labour markets; or migrant remittances, which are often used to support education or out-of-pocket (OOP) expenses on health).

This section discusses the sources of human capital finance and the different effects the different sources might create; the link between finance and policies for human capital development and future implications. Figure 6.6 summarises the main policy issues in this section.

³⁵ See Chapter 2 for an explanation of the term 'political settlement'.

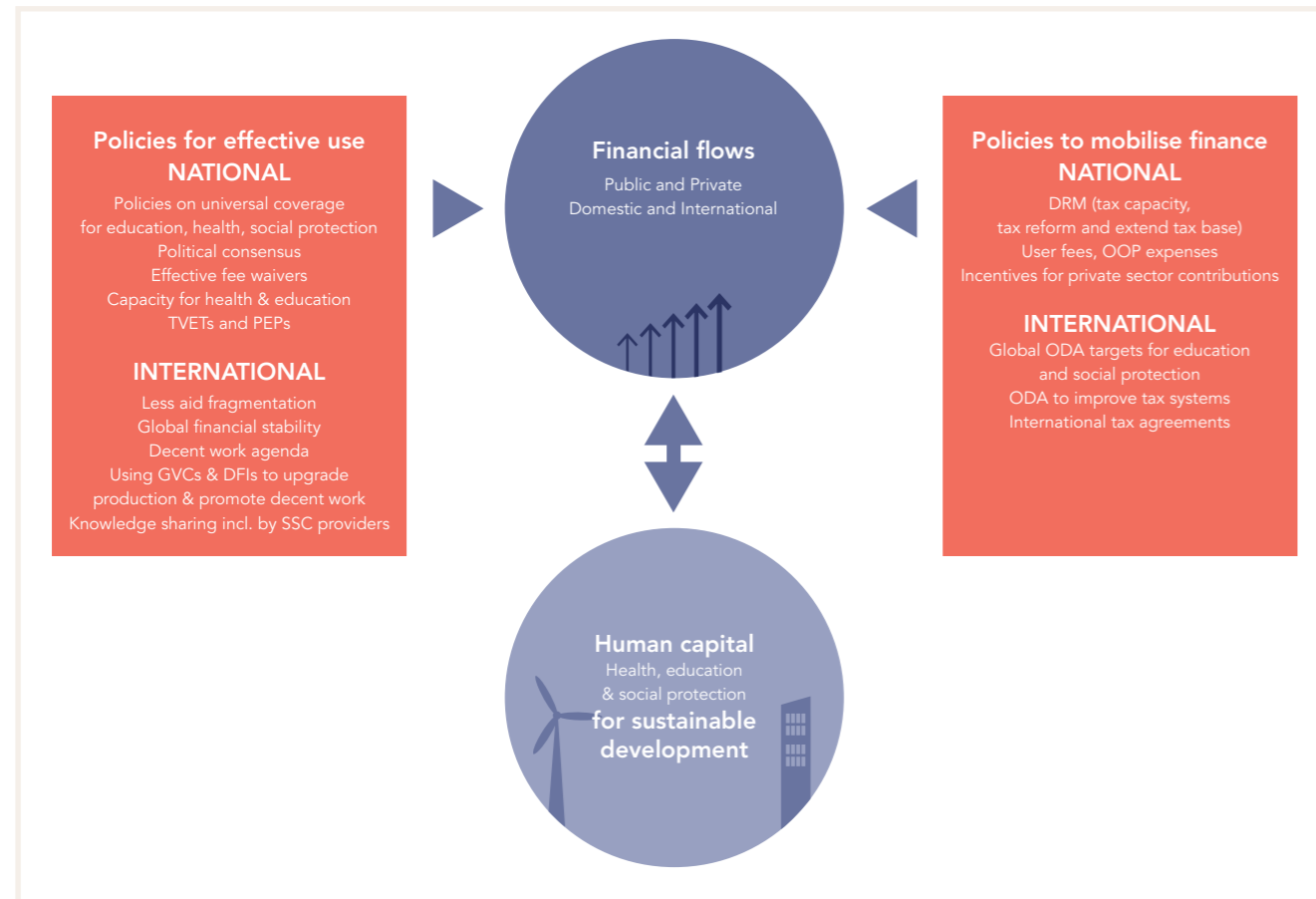
³⁶ The ILO's 'social protection floor' approach advocates an integrated set of social policies designed to guarantee basic income security (in the form of various social transfers) and access to essential and affordable social services for all (in the areas of health, water and sanitation, education, food security, housing etc.) (Bachelet, 2011).

³⁷ The ERD 2010 on 'Social Protection for Inclusive Development' defines social protection as '... a specific set of actions to address the vulnerability of people's life through social insurance, offering protection against risk and adversity throughout life; through social assistance, offering payments and in kind transfers to support and enable the poor; and through inclusion efforts that enhance the capability of the marginalized to access social insurance and assistance.'

³⁸ The successful East Asian countries all invested heavily and at an early stage in education, including early childhood, primary and post-primary schooling. The Latin American 'third way' successes were also built on massive public investment in education (CPAN, 2014a).



Figure 6.6 | The role of policy for mobilisation and effective finance for human



6.3.1 Financing human capital: different sources, different effects

In discussing the financing of the enhancement of human capital, and particularly the access of the poorest to the conditions for obtaining and retaining the employment they need to overcome and stay out of poverty, we examine three areas: universal health coverage, education and skills systems, and social protection.

National-level education and health sectors require large expenditures, beyond what the governments of most developing countries currently invest, if they wish to ensure that poorer

members of society can obtain the employment they need to overcome poverty. The Chronic Poverty Report (CPAN, 2014b:128-131) shows that although public spending in developing countries overall tripled between 2000 and 2011 this rise conceals huge variations. Thus around 2.5 billion people live in multidimensional poverty in countries where governments spend less than \$1,000 per person per annum and of these around 540 million live in 44 countries where the governments spend less than \$500 per person per annum, mainly in SSA and South Asia. Levels of public expenditure in these 44 countries are not projected to increase adequately by 2030. Looking towards 2030 the Chronic Poverty

Report suggests that some countries with large populations, such as India and Indonesia, will by then see a doubling of government expenditure per person and will face major challenges in scaling up services. For others, and particularly for countries in SSA with large numbers of poor inhabitants, government spending is likely to remain severely constrained over the period. For such countries external support will be particularly important.

The main implications are, first, that it is paramount to improve tax efficiency. Second, that improving tax incidence equity is also important in more unequal societies. Lastly, if the finance is available, it will also be vital to increase know-how to operate on a large scale. Among the CIs commissioned for this Report, Mauritius invested early (1976) in universal secondary education, which enabled those from poor families to obtain work in the manufacturing and services industries in the 1980s and 1990s, showing that is possible for a LIC/LDC to make such investments for the future (CI, Treebhohun and Jutliah, 2015). Ecuador's social development (see Box 6.9) also involved major investment in universal education up to tenth grade, well beyond the primary level, as well as in free health care (CI, Borja and Ordóñez, 2015). Education has enormous potential to contribute to tackling chronic poverty, stopping impoverishment and sustaining emergence from poverty (CPAN, 2014b). Improved access by the poor and vulnerable to good health services is the main universal means to prevent impoverishment. Health-related expenses remain the most important reason why households fall back below the poverty line, even in some of the fast-growing Asian economies, such as Bangladesh, China and Vietnam (Van Doorslaer, 2006).

International discussion and initiatives on health financing have focused very strongly on inclusion by reducing the informal and formal payments needed to obtain access to health services. In contrast education financing has only recently begun to adopt such an approach. At the political level, education has in many countries been a priority sector, part of the leading political development 'project' of national elites. Countries that succeeded in tackling chronic poverty, for example, invariably gave a high priority to education early in their development trajectories. Many of the same countries are only recently giving priority to massive public expenditure on health, and this too has sometimes been in response to actual or potential social conflict. This is especially true in East and Southeast Asia (CPAN, 2014a). Interestingly, in the EU's own development cooperation programmes, health is rarely a top priority (Particip et al., 2012).



Box 6.9 | Financing social development – lessons from the Ecuador Country Illustration

Ecuador underwent a major experiment in social development under the leadership of President Rafael Correa, who has been in office since 2007.

The CI identifies a number of enablers including (a) a strong and lasting political settlement around the person of the president, backed up by a clear vision and development philosophy entitled ‘Buen Vivir’ or ‘Sumak Kawsay’, which critically includes the country’s large indigenous population; (b) the enhancement of human capital through better education and health policy coverage; (c) improved quality of public institutions, in particular the tax revenue system and organisations implementing health, education and social-protection policies; and (d) trade, in particular the sustained rise in international oil prices and revenues (apart from a dip in 2009) and the overall stability of the US economy.

The results of this effort have been substantial. Inequality has dropped in both urban and rural areas (Gini index down from 0.505 to 0.487 between 2006 and 2010). Poverty and extreme poverty have also declined (from 60% to 53% and 17% to 13% respectively in the same period). There is also greater equality and fewer pockets of poverty. The coverage of the national Conditional Cash Transfer programme (the Bono de Desarrollo Humano, which provides \$35 per month, conditional on 75% school attendance and monthly health check-ups of the beneficiaries’ children) has increased from 1.1 to 1.8 million of the country’s 13 million inhabitants. Social security has been extended to 55% of workers employed in the formal economy, which is about half of all employment. Primary and middle education (grades 1–10) is now free of charge and access barriers (fees, uniforms, etc.) have been eliminated. As a result education up to 10th grade is now universal. The employment of children aged between five and 17 years has fallen from 30% to 17% of the labour force. Health care is also offered free to all citizens.

The financing of this major effort in social development has been achieved largely by a substantial improvement in tax collection, the careful management of external debt and the use of reserves (international monetary reserves and sovereign stabilisation funds). External sources, including ODA (0.5% of GDP), remittances (going mainly to better-off families) and FDI (although foreign investors have been reticent following the renegotiation or nationalisation of the oil-extraction industry and mobile telephone companies) have been negligible in providing finance for development, although China has provided up to \$6 bn partly in loans and partly through oil purchases. Following the national financial crisis in 1999, value-added tax (VAT) was increased (from 10% to 12%) and coverage substantially extended, and income tax rose from around 1.5% to 4.5% of GDP between 2000 and 2012. These improvements in tax revenues were helped by specific policies for DRM based on a thorough overhaul of the tax service in the 1990s and the renegotiation of licenses for oil extraction and for mobile telephony, giving the government a much greater share of the revenue in both sectors. Tax coverage has been greatly extended by improving efficiency, systematic enforcement, legal action against tax evasion and simplified processes for small traders and producers to bring more of the informal economy into the system. In terms of expenditure, social spending increased from 2.9% of GNP in 2000 to 9.7% in 2010 and, while in the first half of the decade the government devoted 19% of its budget to social services, in the latter half this figure rose to 27%.

A key policy for the effective use of finance was the decision to use the US dollar as the national currency following the 1999 crisis. This stabilised the economy and controlled inflation, but it also removed the government’s ability to use macroeconomic policy instruments and increases the importance of fiscal instruments in managing the economy. The ‘dollarisation’ policy carries potential risks, as does the continued heavy dependence of the economy on oil extraction and the need to make loan repayments to China.

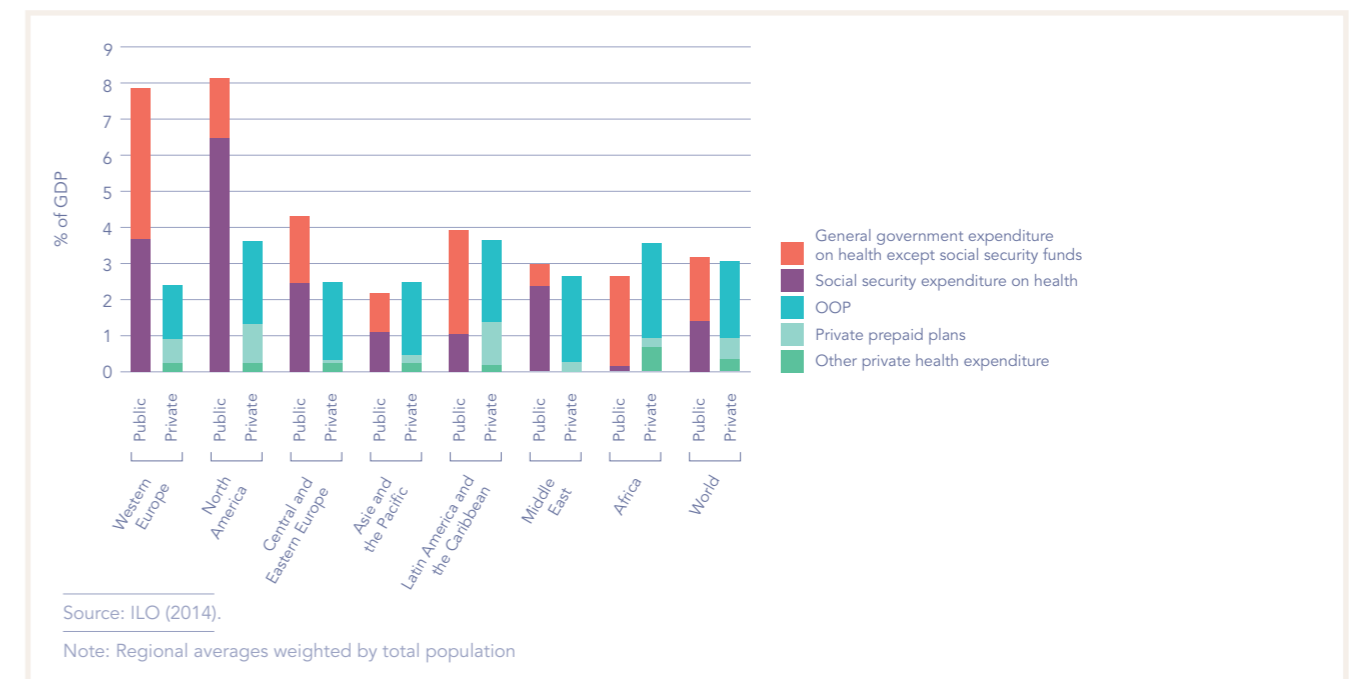
Source: CI by Borja and Ordóñez (2015)

Financing health care for human capital

As Figure 6.7 shows, there are huge regional variations in the patterns of public and private financing of health care. In Western Europe and North America public expenditure on health is more than twice as high as private expenditure, whereas in other regions the two are more even,

and in Africa and in Asia-Pacific private finance outstrips public spending. Within private finance OOP payments that undermine poverty-reduction efforts and increase impoverishment, are consistently more important than private pre-paid plans, but the difference is particularly marked in regions that have a larger number of developing countries.

Figure 6.7 | Sources of healthcare financing by region, 2011 (as a percentage of GDP)



The World Health Organization (WHO) has played a strong role in developing the international consensus reached in 2008 that UHC can be achieved only with a massive increase in public expenditure, whether into an insurance-risk pool to which both public and private providers contribute or into a publicly funded service. The 49 LICs need to raise public expenditure from \$32 to \$60 per person to achieve UHC. ‘The practical difficulties in collecting tax and health insurance contributions, particularly in countries with a large informal sector,

are well documented. Improving the efficiency of revenue collection will increase the funds that can be used to provide services or buy them on behalf of the population. Indonesia has totally revamped its tax system with substantial benefits for overall government spending, and spending on health in particular’ (WHO, 2010). The importance of this is also stressed in the Indonesia CI, while the CIs on Ecuador and Tanzania underline the need to reform and strengthen taxation in order to raise domestic revenue.

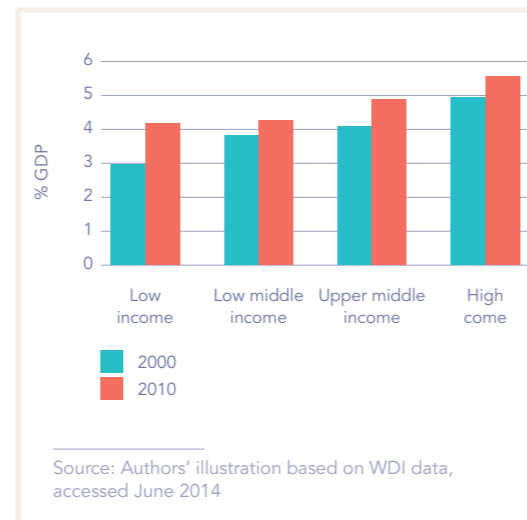


Financing education for human capital

Most governments recognise that education is critical to economic success, and may therefore be more inclined to invest public resources in this sector rather than in health or social protection (CPAN, 2014b). Ecuador, Indonesia and Tanzania, for instance, have explicitly chosen to spend tax revenue on education and health in order to develop their national human capital. Despite the greater commitments made by many governments to education compared to health, there remains a major funding deficit for education, and many children in countries that spend significantly less than UNESCO's estimate of basic education costs are deprived of a decent education.

In general, countries raise revenues for education from public, private and international sources (Vegas et al., 2011). The largest share comes from the public sector (central, regional, local) (Saavedra, 2002; Figure 6.8). Public financing includes both direct public expenditure on education and subsidies (e.g. scholarships, tax reductions, loans). According to the Leading Group on Innovative Funding for Development (2010), governments in developing countries typically spend 4% of their GDP on education. Increasingly, national governments are decentralising the responsibility for raising and managing education funding to subnational levels (Vegas et al., 2011), although 'without central government-led equalization schemes to compensate for varying fiscal capacity across jurisdictions, fiscal decentralization can lead to wide disparities in resources available for learning' (Vegas et al., 2011). Furthermore, 'requiring local governments to raise all their own revenue for education is likely to result in an unacceptably high degree of inequality in pupil spending' (Vegas et al., 2011). The role of local government in social spending is discussed in more detail in the next section.

Figure 6.8 | Public spending on education in country income groups in 2000 and 2010



Private sources represent close to 20% of total national educational finance (Saavedra, 2002). These sources include households, communities, CSOs (including some that are faith-based), and the private sector.

Household expenditure is a crucial component of education finance. Households incur direct costs (e.g. tuition fees, transport, uniforms, materials, student loans) and indirect costs (such as the opportunity cost of having children in full-time education rather than in productive employment) (Saavedra, 2002). While fees constitute a major source of revenues for the education system, in many LICs they also represent a large share of total household spending, particularly for the poor, and so place a disproportionate burden on them (Vegas et al., 2011). It has been argued, however, that abolishing school fees can result in a drastic decline in the quality of schooling in the absence of alternative sources of funding (Ladd and Fiske, 2008).

The private sector also plays a prominent role in providing basic education in many developing countries, although it seldom helps to reduce poverty or inequalities directly (CPAN, 2013). Some private schools are fully or partially publicly funded while others are exclusively privately funded. In LICs, fragile states and post-crisis countries, domestic financing of education may be limited due to limited fiscal space and state capacity. In such cases, ODA may be crucial (Vegas et al., 2011).

Aid to education represents 8.5% of gross bilateral ODA, but has declined recently (Development Initiatives, 2013; Global Campaign for Education, 2013). The proportion allocated through public budgets has also fallen while the share of ODA that is channelled via general or sector budget support, the most effective form of support, has remained below 5% and has also fallen recently. Finally, ODA for the education sector is remarkably uneven among countries. Rose (2013) calculated that the cost of providing primary education is around \$130 per child, whereas LICs on average allocate \$41 from their own budgets and receive \$16 from donors. Even around this low average there are huge variations. 'For instance, while aid to basic education in 2011 was \$39 per child in Afghanistan, it was only \$4 in Chad, which has some of the poorest education indicators in the world' (Rose, 2013). Support for basic education is also plummeting, including in LICs. The bulk of ODA for education goes to secondary and post-secondary education, although this includes scholarships and imputed student costs incurred by donor countries hosting them (Global Campaign for Education, 2013).³⁹

The level of decentralisation and source of public finance affects distributional outcomes. Part of the challenge is that education financing is often decentralised. In both Kenya and Thailand, for instance, this helps to explain why education outcomes have been quite regressive. The typical policy response is to standardise spending per pupil. However, this is not strong enough to

counter the biases against children from poor backgrounds or in poor regions, or the cost differences between different school areas, as was found in the USA (Li and Wang, 2014). Equity can be defined as service provision that meets a minimum absolute standard, where educational resources and outcomes are within an acceptable range, or where they are not affected by an area's wealth.

The focus of progressive policy-making has typically been on improving enrolment, improving gender equity, and, linked to this, providing conditional or (more rarely) unconditional cash transfers to encourage children from poor families to remain in school longer. Although the policy focus on access to primary education is very important 'the sheer act of enrolment does not by itself help children or their families emerge from poverty' (CPAN, 2014b). To achieve upward mobility, several years of post-primary education and the acquisition of skills that are useful in the labour market are critical (Shepherd, 2011). In many countries, however, the focus on the interventions required to make education a real motor of poverty eradication (access by underprivileged children to pre-school education, helping children from poor families to complete primary and lower-secondary education and then into paid work) has been weak, with the exception of the above two issues. Moreover, 'if education is of poor quality, it greatly constrains its utility [...]. Where demand for labour is low or labour markets are discriminatory, education may not make as much a difference as it could' (Shepherd, 2011).

Education equity is a relatively recent policy discussion in many developing countries. Mauritius introduced universal education in 1976, but in Ecuador this choice was not made until 2007. Similarly, China formulated its first education equity policy only in 2004/5 in response to growing disquiet over the excessive fees charged by some largely urban private educational establishments, the under-funding of rural schools, and the inadequate educational

³⁹ Largely because higher levels of education per student cost so much more than basic education.



facilities for internal migrants. This focused on reducing the inequitable allocation of resources within counties, including the quality of teachers, and on controlling switching between schools by those who were wealthier or better informed. By 2010, the need to redistribute resources across wider territories (provinces) was recognised, and grants to schools from central and provincial coffers are rising. 'By 2012, a full system of national education standards had been put in place to monitor the progress of education equity in the counties and provinces. For the first time, the central government clearly delineates the required education equity standard based on a composite measure of resources for schools within a county', and equity is supported by a Fund Guarantee Mechanism (Li and Wang, 2014). Few other developing countries have such explicit policies on educational equity.

UNESCO has recently begun to assume the leadership on expanding access to and improving the quality of education that WHO has already shown in the field of health. The discussion on education financing has generally focused little on equity, however, even in the context of the MDGs, but rather on bridging the funding gap, mainly through DRM. There is relatively little analysis of equity in financing, and where this has been researched the results have not been promising, for example in Thailand (Cuesta and Madrigal, 2014) or Kenya (Watkins and Alemayu, 2012).

Financing social protection to maintain investment in human capital

Social protection 'is an essential investment that contributes to economic growth and makes growth more pro-poor while directly reducing poverty' (OECD, 2009). Social-protection measures reduce vulnerability to poverty and climate-related hazards, and act as a bridge between humanitarianism and development and a link between disaster risk reduction and climate change adaptation (World Bank, 2011). Since the long-term anti-poverty effects of social protection

are substantially achieved by enabling those living in poverty to have access to health and education services, it is vital to avoid reducing the financial resources allocated to those sectors in times of economic shocks. In fact, governments may have little scope to reallocate spending, particularly in LICs where 'budgets are small, needs are great, and competition for resources from other sectors is intense' (World Bank, 2012). This means that the challenge of obtaining finance to eradicate poverty and reduce inequality is to dramatically increase resources for all three – health, education and social protection. The main sources of financing for social protection which ideally need to be in a form that is sustainable over time are: (a) domestic public: revenues of national governments⁴⁰; (b) private, including OOP payments, private insurance premiums or services provided by the corporate sector, community and NGO financing (including full privatisation and PPPs), household savings and OOP expenditure; and (c) international public aid (Bastagli, 2013; Hagen-Zanker et al., 2010).

Although domestic resources are growing in developing countries overall they remain low in many countries. The Chronic Poverty Report (CPAN, 2014b) calculates that 86% of people who are multi-dimensionally poor live in countries where government spending per person per year is less than \$1,000. South Asia and sub-Saharan Africa are the two regions with both the highest number of poor (500 mn and 350 mn respectively in \$1.25 a day poverty) and the lowest levels of government spending. For instance in 2011, government spending in India (with 269 mn extreme poor) was \$860 per person per year while in Bangladesh (65 mn poor) it was \$250. In Nigeria (88 mn poor), with one of the highest levels of government spending in Africa, it was at \$650, while in DRC (50 mn poor) and Ethiopia (25 mn poor) it was \$200 per person per year. Increasing domestic public resources in these regions is thus a key challenge for financing the post-2015 agenda and while estimates suggest this is likely to happen in South Asia, sub-Saharan African

countries, with the largest number of extreme poor and high projected population growth rates for decades to come (ERD 2013), are likely to experience only slow growth in public expenditure up to 2030. At the same time, international public finance currently accounts for 65% of the resource inflows in countries with public expenditure levels of below \$200 per person per year, so ODA will continue to be a vital source for them not least as a catalyst for improving the mobilisation and use of resources (CPAN, 2014b).

Despite the scale of this challenge the ILO's Advisory Group on Social Protection points out that various populous middle income countries such as China, Indonesia, Brazil, India and Thailand have introduced and expanded large-scale social floor programmes in the last 15-20 years. Even poorer countries such as Ethiopia have done so, albeit with external support (Box 6.14). Examining various costing studies thus leads the Group to conclude that even the poorest countries can afford to implement nationally defined social protection 'floors' (Bachelet, 2011). The ILO's costing studies on a basic package of social protection for a selected set of LICs and MICs in SSA and Asia show that the cost of a cash-benefit package, including old-age and disability pensions and family allowances, but excluding health care, is between 2.2% and 5.7% of GDP (ILO, 2008). Even in the absence of high growth, it is possible to enhance fiscal space if the prevailing political settlement supports this. The debate on affordability has generated significant interest in the international development community. Affordability is not an absolute but rather a question of political preferences and trade-offs among competing goals in a context of limited resources (Hagen-Zanker et al., 2010; World Bank, 2012).

6.3.2 The role of policies and finance for human capital development

Sufficient finance for human capital will not be mobilised without significant complementary

policies. We discuss the importance of tax policies, budget targets e.g. for health, international support, micro-insurance and SSC. We then look at the effectiveness of finance for human capital, which can be enhanced through various policies including the following: fee-waiver systems for OOP payments for health services; less aid fragmentation and more long-term investment; active employment and training policies; public employment programmes; productive safety nets; and the promotion of human capital through GVCs and TNCs.

Policies to mobilise finance for human capital

Strengthen the tax base

Policies to mobilise domestic resources and broaden fiscal space include: (a) freeing resources by cancelling debt; (b) using revenues from natural resources to finance social programmes, and reallocating expenditure; (c) making tax-collection systems more efficient (Bachelet, 2011; commissioned background paper by Brun and Chambas, 2015); and (d) broadening the tax base and extending statutory social insurance by promoting formal employment (Bastagli, 2013; commissioned background paper by Brun and Chambas, 2015). Other policies open to countries where it is too difficult to extend the tax base in the medium term include (e) applying tariffs on commodity exports (although this has efficiency implications), land and property taxes, urban property taxes and agricultural marketing boards (DiJohn, 2011); (f) reducing tax exemptions (commissioned background paper, Brun and Chambas, 2015); and (g) reallocating resources away from more inefficient social-protection interventions such as general price subsidies on food or fuel, which tend to be regressive and benefit the non-poor more than the poor. The greatest challenge for many countries is to broaden the tax base, particularly in contexts with a high level of informal labour, weak institutional capacity for tax collection, and unclear social contracts – the lack of a political settlement including effective social-

⁴⁰ The African Union's Social Policy Framework for Africa, agreed by Ministers in 2010, is clear that national budgets are the primary source for funding social development.



protection coverage, lack of social support, limited middle-class buy-in to a pro-poor development agenda, incomplete citizenship whereby users of public services see themselves as beneficiaries with few rights (Laboratoire Citoyennetés, 2009). There are dangers, for example, when social spending commitments exceed revenue-raising capacity, perhaps due to demographic changes (commissioned background paper, Brun and Chambas, 2015) or when the design of social-protection schemes fail to take account of additional needs when there are unpredicted co-variant shocks against which the government has to protect the population.

International support for social protection

International support for social protection can help to unlock these political or practical constraints in the short term. However, in addition to financing start-up costs, social protection requires sustained financial support over long periods of time, which can be very difficult for donor governments that have electoral cycles of four to five years. Developing a specific international funding mechanism for social protection (see Box 6.10) could even out these funding cycles and provide more continuity and predictability.

Box 6.10 | Global fund for social protection

The United Nations Special Rapporteurs for the Right to Food and for Poverty and Human Rights, Olivier de Schutter and Magdalena Sepúlveda respectively, have proposed creating a Global Fund for Social Protection (GFSP) (Canavire-Bacarreza et al., 2012). The GFSP would stabilise and guarantee international support for poor countries to have the maximum available resources to implement rights-based social-protection systems. The GFSP would involve the establishment of:

A support fund to close the shortfall between what LDCs can reasonably pay and what it costs to provide a social-protection floor.

A re-insurance mechanism to provide temporary funding if a crisis or shock causes an increase in the number of people in need of the social-protection support.

Beneficiary countries would need to adopt a set of commitments such as including social protection for informal workers, extending coverage, devoting maximum available resources, taking steps to reduce the dependence on external funding for social protection, adopting policies to reduce the risk of shocks, and committing to the institutionalisation of social protection in national law.

The GFSP could also provide non-financial services (such as technical support) to assist LDCs in strengthening their basic commitments to providing social protection.

Source: Canavire-Bacarreza et al. (2012)

Health budget targets

Health ministries need to develop better relationships with ministries of finance, and to help ensure that health is allocated a significantly higher proportion of government expenditure. In April 2001, African Union governments pledged to increase funding for health to at least 15% of total spending, and urged bilateral donors to increase support. To date, only one African

country has reached that target. Overall, 26 have increased the proportion of government expenditure on health since 2001, but 11 have reduced it. In another nine, there is no obvious trend. Current ODA varies from \$115 per person in one country to less than \$5 per person in 12 others (WHO, 2011). This illustrates the size of the gap to be bridged in order to bring the political commitment to health into line with that given to education.

Micro-insurance

Micro-insurance has been used in health care and social protection in a number of countries for well over a decade. It involves small user payments but on a much more predictable basis than OOP expenditure. It also offers scope to involve the private sector if managed carefully. The literature suggests, however, that it is mainly used as a mechanism to extend the coverage of government social-protection schemes where these do not achieve universal coverage and specific attention needs to be given to making schemes pro-poor. Often these are community-based schemes for specific groups and/or areas and, particularly if they complement a government scheme, are usually closely regulated. Thus, although micro-insurance schemes can extend coverage when governments lack resources they are often seen as a temporary approach until universal coverage can be established (Wiechers, 2013; Jacquier et al., 2007).

South-South Cooperation

SSC will continue to be important beyond 2015 because of the extra options it offers developing countries, although perhaps not because of its scale which, in grant terms, is still limited. So far there is little information on whether non-DAC donors are likely to channel grants or loans into social spending beyond investment in infrastructure. Earmarked loans can free up budgets for social expenditure. Ecuador, for instance, borrowed some \$6 bn from China in the period 2005–2010, during which time around 25% of the budget went on social expenditure. On the other hand, there is solid potential for South-South policy learning given similarities in implementation conditions and constraints and the fact that some major proponents of SSC such as Brazil, China and India have direct experience of running large-scale social-protection schemes, some with considerable success (e.g. the Bolsa Familia in Brazil or the Chinese Minimum Living Standard Scheme; Bachelet, 2011).

Policies for effective use of finance for human capital

Fee-waiver systems for OOP payments for health services

In the absence of public funding, people have to pay for their own health care (as shown in Figure 6.8), which can be a major burden on poorer members of society. There has therefore been serious analysis of the impoverishment effects of OOP payments – payments made on receipt of a service – which represent between 30% and 85% of all health spending in the poorest countries. Evidence in LICs and LMICs suggests that direct OOP payments represent 50% or more of total health expenditure and even up to 86% of private expenditure on health (UNTT, 2013; WHO, 2010). Complementary policies to ensure the best use of finance and reduce OOP payments have received considerable attention. Whereas public funding and insurance contributions can be progressive in terms of impact – although this may be true at primary school level but not at secondary or tertiary levels (Mtei et al., 2012) – OOP payments are generally regressive since poorer people pay proportionately more than richer people (O'Donnell et al., 2007; 2008) (see Box 6.11). In Tanzania this was partly because the fee-waiver system did not work well (Mtei et al., 2012). Reducing or eliminating cost-sharing and fees are therefore important UHC objectives. 'It is only when direct payments fall to 15–20% of total health expenditures that the incidence of financial catastrophe and impoverishment falls to negligible levels' (WHO, 2010). This is a tough target. 'The countries in the WHO South-East Asia and Western Pacific Regions recently set themselves a target of between 30% and 40%' (WHO, 2010).

Eight case studies of schemes to cut OOPs demonstrate this results in greater use of maternal health services, with the exception of the community health insurance scheme in Guinea, although it is not possible to explain why



because of limitations in the study design. Some schemes with good benefits had surprisingly low uptake, reflecting the importance of non-financial barriers and issues relating to the quality of the services. At best, there was a significant drop in costs per birth, but they were not eliminated.

None of the programmes had demonstrable effects on achieving greater equity, nor was targeting a strong element in six of them, and few improvements in health outcomes could be attributed to them (Fabienne et al., 2010).

Box 6.11 | Out-of-pocket (OOP) payments: Ghana, Tanzania and South Africa

OOP payments are consistently regressive in OECD countries, but progressive in several Asian countries because poorer people simply cannot afford to use services. OOP payments are regressive in Tanzania and Ghana, where they still constitute a large share of total health expenditure. Levels of spending are so much greater in Ghana than in Tanzania and South Africa because of the long history of high user fees at public facilities. Ghana has generated the highest levels of user-fee revenue in Africa equivalent to 15% of total government recurrent expenditure in the 1980s. People who are not yet covered by national health insurance continue to bear the consequences of these high fees. In South Africa, most OOP payments are co-payments made by people with private insurance cover. Although these tend to be among richer groups, such payments can nonetheless be catastrophic and deserve attention. All countries have mechanisms for exempting vulnerable groups from user fees at public facilities, but household survey data suggest that not all eligible persons were exempt (11% in Tanzania and about 25% in Ghana and South Africa). A key factor was patients' lack of awareness of their entitlements.

Source: Mtei et al. (2012)

There has been extensive research on extending skilled attendance at childbirth and improving maternal health, with many different approaches tested in a variety of settings. Some have sought to address financial barriers experienced at the household level, while others have looked at complementary policies such as incentives to health workers or aid mechanisms that reward good performance of the health system as a whole. 'No single strategy is best for all contexts, but some important lessons for implementation have emerged from our case studies. The experience of countries that have seen sustained improvements in maternal health, such as Malaysia and Sri Lanka, show that the key ingredients for the long term are local commitment, perseverance and adaptability over time, a holistic approach that addresses demand- and supply-side barriers, and a focus on universal coverage as the ultimate, if not immediate, goal' (Fabienne et al., 2010).

Remove discrimination in provision of health services

In addition to continuing to extend coverage geographically and across health services, a number of additional measures will be vital to achieving UHC so that it meets the needs of the poorest. In particular, inequalities need to be addressed; especially the discrimination faced by women and by ethnic and other minorities and migrants in obtaining access to and using health services. Health workers may need to be trained to behave respectfully towards patients whom they may regard as inferior, and affirmative action can be a useful means to recruit health workers from these groups. Services need to be located, scheduled and organised in such a way that people feel comfortable using them. Issues of quality are also extremely important it is often critical to provide a 'one-stop' comprehensive service, backed by good and accessible referral services. If these aspects are not addressed poor

people will continue to use the often poor and weakly regulated, but convenient, private services (Genberg et al., 2009; Nayar et al., 2014).

Less aid fragmentation and more long-term investment.

International financing has radically changed over the past 10–15 years with the introduction of vertical funds and a major increase in philanthropic donations, much of this in response to the MDGs. Looking at the current landscape of health financing from a domestic angle, however, it is important to streamline ODA to avoid absurd reporting requirements: 'Viet Nam reports that in 2009 there were more than 400 donor missions to review health projects or the health sector. Rwanda has to report annually on 890 health indicators to various donors, 595 relating to human immunodeficiency virus (HIV) and malaria alone while new global initiatives with secretariats are being created' (WHO, 2010). The proliferation of vertical international health programmes focused on single or selected diseases has not contributed to developing the capacity of health systems as a whole. For example, the investment in human resources made by the Global Alliance for Vaccines and Immunisation (GAVI), the Global Fund and the World Bank was almost entirely in short in-service training and supplementary allowances rather than systemic improvements.

'There is relatively little investment in expanding pre-service training capacity, despite large health worker shortages in developing countries... the majority of GAVI and the Global Fund grants finance health worker remuneration, largely through supplemental allowances, with little information available on how payment rates are determined, how the potential negative consequences are mitigated, and how payments are to be sustained at the end of the grant period' (Vujicic et al., 2012)

Active employment and training policies

Obtaining and retaining employment can be critical to overcoming and staying out of poverty (Baulch, 2011). Unskilled work (often casual, intermittent, and performed in exploitative conditions) is often not enough to take a household out of poverty: having greater and more appropriate skills and qualifications will make a significant difference to the quality of paid work that a person can obtain. It is very hard for poor, uneducated people to acquire skills through formal channels: formal TVET can be exclusive and expensive, as well as producing disappointing results unless employers are involved to ensure that the training is relevant. Examples of successful TVET schemes in China, Colombia and Tunisia are reviewed in Box 6.12 b.



Box 6.12 | Examples of programmes to enhance skills for employment

In 2009, facing high graduate unemployment, the **Tunisian** government launched a graduate employment programme to foster self-employment and entrepreneurship. Instead of writing an academic thesis, students could participate in an entrepreneurship track that required them to produce a professional business plan. In order to do so, they received business courses (*Formation Création d'Entreprise et Formation des Entrepreneurs*) at local employment offices and individual mentoring from their university professors. Finally, students had to defend their business plans before a panel and were invited to participate in a national competition. The best plans were awarded start-up capital of between \$2,000 and \$10,000. Results suggest that some of the beneficiaries of the programme became self-employed rather than seeking wage employment.

China systematically evaluated a retraining programme for workers who had been retrenched due to the reforms of state-owned enterprises (SOEs) in the cities of Shenyang and Wuhan. The results suggest that retraining can increase both employment and real wages, although there was variation between the two locations. In Shenyang, participation in the programme did not result in more employment, but did increase the earnings of those who found work. In Wuhan, participants were more likely to find employment but their earnings did not improve. The variation is explained not only by differences in programme design (with a more practical content in Wuhan), but also by the business environment in both cities.

The government of **Colombia** subsidised vocational training (*Jóvenes en Acción*) for disadvantaged adolescents. Training consisted of three months of classroom training and provided the necessary skills for occupations in office administration, IT or trade. After completion of the course, participants obtained internships at local firms to acquire first-hand work experience. There was found to be a significant impact on formal employment and real wages, although women benefited significantly more than men.

Sources: CPAN (2014) based on Attanasio et al. (2011); Bidani et al. (2009); Premand et al. (2012)

The financing for TVET depends on cyclical and structural changes. Social expenditure has been under pressure from austerity policies and has been focused on basic social services, while the quality and relevance of TVET provision have come into question. It is commonly believed that skills training should be financed (at least in part) by the individual who will benefit. The limited funds available can translate into a stimulus for the involvement of the private sector, and the creation of more relevant training institutions (Gomes, 2009).

The big change in the financing of TVET in recent years has been the development of PPPs, with employers, employers' associations and sometimes also NGOs establishing partnerships with governments, reflecting the necessary interface between the supply and demand sides of investing in a more highly skilled workforce

(Kingombe, 2012; Walther, 2009; Jager and Buhner, 2000). At the same time, the risk is that private or NGO providers will aim for complete (or significant) cost recovery, which will exclude poor people unless their full costs are met by the government. Box 6.13 describes the experience of Mauritius in financing TVET.

It is also important to understand how finance can support the development of human capital in ways that are relevant for creating jobs. This needs to be done through better coordination between the demand for and supply of education and training. In the coming years, new jobs will increasingly be 'green' or in services underlining the close interlinkages between the economic, environmental and social dimensions of sustainable development. For instance, the New Climate Economy report argues that the political viability of a low-carbon transition will depend on

Box 6.13 | Financing TVET in Mauritius through a levy-grant system

In the early 1990s, Mauritius introduced a 1% training levy on the basic wage bills of all private companies. This was meant to complement the government's financial contribution to TVET and to improve productivity. The levy was paid to the Ministry of Social Security, whose system had proven effectiveness. To encourage them to invest in training their employees and to pay the levy, employers could obtain a grant refund of the training expenses incurred. The private sector was involved in all decisions related to the use of the levy and in the review of the grant system. The fact that the employers were paying the levy encouraged them to be interested in the outcomes (Dubois and Balgobin, 2010).

The grant-refund formula was revised on a rolling basis in order to ensure that it continued to be effective. In 1996 the government decided to remove the 200% tax rebate on the training levy and to treat the training costs in the same way as other expenses. In order to maintain the incentives for employers, the ceiling of the grant refund was raised, and costs incurred to study overseas or to bring in external expertise were also eligible for a refund. The existence of the levy helped the Industrial and Vocational Training Board to secure loans from the World Bank and the *Agence Française de Développement* (French Development Agency), as it was seen to be a sustainable source of funds and served as a warranty for the secured loans. The levy-grant system has allowed over half of the Mauritian labour force to benefit from some form of training. Various factors have contributed to the success of the system: private-sector ownership, the method of collecting income, and constant M&E.

Source: Dubois and Balgobin (2010)

governments' efforts to support and compensate retrenched workers and communities affected by the declining coal and energy-intensive industrial sectors. These measures may include 'direct financial assistance, retraining and reskilling, and investment in community economic development' (Global Commission on the Economy and Climate, 2014). The Indonesian CI identifies the need to support the sustainability transition by improving the skills and capabilities of the labour force (CI, Damuri et al., 2015).

Atchoarena (2009) argues that the 'impact of globalization and technological change, the concern for flexibility in the labour market and for employability, the ageing of the population and the search for more active forms of citizenship are contributing to a growing demand for youth and adult education and for a new functioning of education systems'. Ever more children are attending school, but the links between education and the labour market, and the availability of jobs, have not kept pace. This mismatch risks creating a backlash against education and suggests that

its provision is not always seen in a transformative context.

Public employment programmes (PEPs)

PEPs are key elements of social-protection strategies and can contribute to building national social-protection floors by providing temporary employment and a certain level of income for people of working age but who earn very little; they can also be used to upgrade or construct social-service infrastructure. PEPs involve governments creating employment in two main forms: public-works programmes, which may offer cash or for food for work, and employment-guarantee schemes or long-term rights-based programmes that offer some level of entitlement to work. In India, for example, according to official statistics, the National Rural Employment Guarantee Act (NREGA), a PEP established in 2006, has provided employment to about 50 million of the poorest households a year. Half of the employees are women, and it has greatly increased public awareness of the national minimum wage, the



Box 6.14 | Ethiopia's Productive Safety Net Programme

The Productive Safety Net Programme (PSNP) is one of the world's biggest social-protection initiatives (Save the Children, 2008). The World Bank (2013a) advocates the PSNP as an important example of a large-scale rural safety net in a low-income, drought-prone setting. With 80% of Ethiopia's population dependent on rain-fed agriculture, the country is particularly vulnerable to weather-related food shortages (World Bank, 2013a). The Government of Ethiopia introduced the PSNP in 2005 as part of the Food Security Programme to address food security in a proactive and sustainable manner, and overcome traditional ad-hoc responses to food crises.

The PSNP operates from February to August when the rural population is not engaged in farming activities (HPN, 2012). Transfers are provided in the form of food or cash in food-insecure woredas (districts), either in exchange for employment in public works (schools, roads, soil and water conservation, water development, etc.) or as direct transfers for labour-scarce households comprising elderly or disabled people who are unable work (Gilligan et al., 2008).

The PSNP is managed almost entirely by the government, with the Ministry of Agriculture and Rural Development and Disaster Risk Management and Food Security Sector having oversight over the programme and the Ministry of Finance and Economic Development in charge of its financial management (World Bank, 2013a). Programme management and implementation are delegated to regional and local administrations, using community-level mechanisms to identify beneficiaries and promote local accountability and ownership (World Bank, 2010). Food-insecure woredas are identified by the lowest administrative levels in Ethiopia, with eligibility based on three years of continuous dependence on relief; the community also identifies the types of public works to engage in (Koohi-Kamali, 2010).

In financing the PSNP, the Government of Ethiopia aimed to direct funds that would otherwise be allocated to the annual emergency appeals (an average of \$265 mn a year) while using the existing capacity and infrastructure of the system of emergency appeals to administer the PSNP (World Bank, 2013a). International public resources have been the dominant source of funding, mainly in the form of grants and a smaller number of concessional loans, alongside low levels of domestic public finance, primarily in the form of civil-servant costs, and these funds are provided through a World Bank-administered Multi-Donor Trust Fund (World Bank, 2010, 2013a).

Sources: as cited

indirect impact of which has gone far beyond the scheme itself. Perhaps inevitably for such a large scheme, NREGA has been subject to criticisms, chief among which is its inadequate accountability (Drèze and Sen, 2013). As the ILO points out, however, 'Public employment programmes will only help to alleviate poverty in the long term if they are designed to provide decent work, including an adequate level of wages, an integral skills development component and full respect for the occupational safety and health of workers, while also ensuring beneficiaries are covered by existing social security schemes' (ILO, 2014).

Productive safety nets

Despite the challenges, almost a billion people in developing countries are now covered by some form of social assistance. Progress has been especially rapid in Latin America and South Asia, with East and Southeast Asia catching up rapidly. Sub-Saharan Africa faces the biggest challenge, although Ethiopia's Productive Safety Net Programme (PSNP) is a bright spot (see Box 6.14). To be sustainable in the medium to long term governments need to provide the main funding for social protection, but the substantial start-up costs could be supported by external finance. Governments in LICs may be persuaded not to

embark on major social-protection programmes because of the long-term nature of the financial commitment: donors thus need to be willing to make long-term financial commitments in order to unlock this constraint.

Promoting human capital through GVCs and TNCs

TNCs can contribute to the development of human capital, but the linkages between FDI and education are complex. They can be both direct and indirect, but since they tend to be aimed more at skilled than at unskilled workers they can potentially increase rather reduce inequalities. There is evidence that TNCs provide more training than their local counterparts (Iyanda and Bello, 1979; Gerschenberg, 1987). Tan and Batra (1995) found that firms are more likely to offer training for their employees when they are large, have a highly educated workforce, invest in R&D, are export-oriented and use quality control. All these characteristics are associated with foreign ownership (see Dunning, 1993).

FDI also has indirect effects on human capital through its dynamic effects on increased growth and productivity. Higher growth can lead to more (private and fiscal) resources, some of which can be used to pay for providing education. It is generally acknowledged that FDI is associated with higher incomes in developing countries, provided the appropriate policies are in place (e.g. education, infrastructure) (UNCTAD, 1999; Borensztein et al., 1998; Xu, 2000). Te Velde and Morrissey (2004) argue that inward FDI raised the relative demand for skilled workers in Thailand, and their wages rose accordingly.

Countries with greater human capital and a skilled labour force benefit most from FDI and also see their human capital improve the most (Te Velde and Xenogiani, 2007). Supporting policies in education can enhance the impact of FDI on growth and hence the resources needed to provide education. Econometric evidence shows that

educational achievement in developing countries is correlated with FDI inflows (Noorbakhsh et al., 2001).

Firms can also enhance their human capital by engaging more with GVCs and on better terms, and this policy is complementary to other sources of finance. The GVC literature is increasingly focused on social upgrading, understood as 'the process of improvement in the rights and entitlements of workers as social actors [...] which includes access to better work, which might result from economic upgrading (and) involves enhancing working conditions, protection and rights' (Barrientos et al., 2010). GVCs can in some cases be used for social upgrading and promoting decent work (Bernhard and Milberg, 2011), see Box 6.15.

Firms could also be encouraged to adopt labour standards (see Box 6.16). The observance of minimum labour standards allowed Cambodia to obtain access to the US market.



Box 6.15 | GVCs in Africa – capturing the social gains in economic development

Compliance with the horticultural standards set by international supermarkets is often a double-edged sword – especially in African countries (for a summary of the debates, see Jaffee and Masakure, 2005). On the one hand, it offers a substantial opportunity for producers to upgrade to higher value-added activities (examples of products, processes, cold chains, and functional upgrading can be found in Kenya's horticultural value chains), and in some cases, increased social protection for workers (examples of more permanent employment contracts, unionisation and collective bargaining can be found in Uganda's cut-flower chains). On the other hand, it limits participation to producers who can make the investments required for compliance. The high costs associated with stringent European standards have been cited as a growing contributor to the expansion of the South–South horticultural trade and African regional horticultural value chains (Bamber and Fernández-Stark, 2013; Evers, 2014). Compared to European standards, the latter are less stringent, tend to cover far fewer elements and compliance thus tends to be less expensive and time-consuming (Barrientos and Visser, 2012).

In both the Kenyan and Ugandan cut-flower markets, the sexual harassment of workers has become less prevalent thanks to (a) civil-society campaigns that led to the appointment of gender committees, greater awareness among those working in flower farms, and unionisation; and (b) an increase in the number of permanent contracts, making it less likely that supervisors will demand the sexual favours associated with hiring casual workers.

Source: Goger et al. (2014)

Box 6.16 | ILO Better Factories Cambodia: A blueprint for promoting international labour rights?

The ILO launched the Better Factories Cambodia (BFC) project in 2001 to improve working conditions in garment factories participating in global supply chains. The project combines third-party factory-level monitoring of working conditions with a vigorous outreach and education programme. There is sufficient evidence to say that the BFC has benefited all stakeholders – management, labour and buyers – by increasing transparency, fostering cooperation, and providing training and outreach, and providing credible documentation of gradual factory-specific and industry-wide improvements in labour conditions (Hall, 2010). Compliance with provisions regarding child labour and health and safety regulations has improved and is well documented. According to the Center for Global Development, 'ten years on, the experience of BFC has shown that such an innovative and ambitious project, based on the principle of social dialogue among national and global stakeholders, can deliver significant improvements in industrial relations [...] and contribute to the creation of the institutional space for industrial relations to develop' (Rossi and Robertson, 2011). Based on this experience, the ILO and the IFC jointly established the Better Work Initiative, a public–private programme to assess compliance with labour standards in selected economic sectors in Haiti, Indonesia, Jordan, Lesotho, Nicaragua and Vietnam.

Other research suggests, however, that wages and basic job security have in fact declined for Cambodian garment workers, and that genuine collective bargaining remains elusive (Stanford Law School, 2013). The 'Better Work/Better Factories' approach lacks a specific enforcement capacity, and therefore makes any improvements fragile and probably temporary, particularly in contexts where the judicial system is deficient, and subject to corruption and political influence (Hall, 2010).

Sources: Hall (2010); Rossi and Robertson (2011); Stanford Law School (2013)

The ILO (2006) detects a dramatic rise in private systems for assessing the labour standards of private (and sometimes public) enterprises. Although voluntary codes can act as a catalyst to strengthen labour laws and their enforcement (ODI, 2013), the ILO warns that 'some private monitoring initiatives might undermine the public inspection function, create enclaves of good practices with few linkages to the rest of the economy and divert attention and resources from other sectors that do not necessarily produce for export' (ILO, 2011c). DFIs are also increasingly recognised as important actors in the Decent Work Agenda: their investments create and sustain significant number of jobs and commitments to uphold labour rights – their clients are required to adhere to ILO core labour standards and occupational health and safety standards as a precondition of investment (Ergon, 2010). Unconventional labour inspections (e.g. CSO and media watchdogs) are therefore the subject of growing attention as they may be able to fill gaps in the formal inspection system (Deshingkar, 2009; CPAN, 2014a).

6.3.3 Conclusions and implications for investment in human capital

The section on the **enhancement of human capital** highlighted the vital role of adequate capacity in education and health systems, social assistance, and decent work that are required in order to make effective use of finance in this area. The costs of implementing such policies are high and have to be sustained over a long period of time. As a result, **domestic public finance** is generally the main source even in poorer countries. Various options were identified for the involvement of domestic and international private finance, (such as in education and health services), but while these options might be appropriate for richer sectors, the charges involved tend to exclude the poorest. One exception to this appears to be the growing interest in and scope for micro-insurance, where PPPs could be a viable solution to sharing costs and extending the coverage of government services. **International public finance** generally

plays a minor role although it is still important in LICs where domestic public resources are limited. If well used and focused ODA can also be catalytic in the initial stages of establishing government services in these areas, but cannot provide the sustainability they typically require, and can continue to support the further development of social policies in LMICs. The **global system and policy environment** also affects government revenue and spending capabilities both in terms of being able to ensure global financial stability and in terms of its ability to regulate international finance flows and increase transparency.

While the political commitment to education is often stronger than that for health and social protection all three are vital for the development of human capital and the eradication of poverty, and each country needs to develop its own context-specific balance. The health sector has developed a more sophisticated discourse on the inclusion of hard-to-reach population groups (e.g. on OOPs and on the manner in which services are provided) that could usefully be applied to the education sector. There is also an incipient but growing consensus concerning publicly funded UHC, and that governments must work out their own context-specific steps towards achieving it; but there remains little consensus in relation to how to include the poorest in education, and how to use private sources of finance to achieve equitable education provision as economies develop. There is also broad agreement that it is not just the length of compulsory education that matters, but also its quality and appropriateness. The quality of education depends on the focus of support, i.e. beyond primary education, and involving the private sector in making vocational training programmes more effective (e.g. in Mauritius). Apprenticeships can be effective in raising employment and earnings provided that they are well targeted and supported by policies in relation to the business environment. As GNP rises, it becomes more feasible to include poor people in formal training schemes.



ENABLER: HUMAN CAPITAL

Investing in human capital

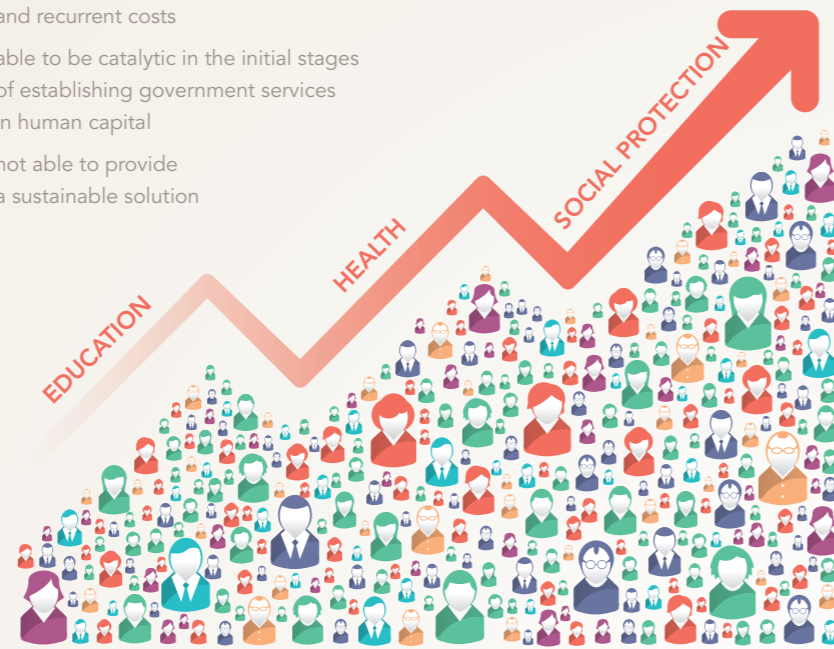
The development of human capital and the eradication of poverty requires political commitment to education, health and social protection

Financing **enhancement of human capital** means:

- ▶ the high costs of implementing appropriate policies must be sustained
- ▶ **domestic public finance** is the main finance source (even in poorer countries)
- ▶ involving domestic and international private finance may involve higher charges
- ▶ however, in micro-insurance systems PPPs can help share costs and extend coverage
- ▶ **International public finance** plays a minor role but is important in LICs where domestic public resources are limited.

Here ODA is:

- ▶ able to help with both investment and recurrent costs
- ▶ able to be catalytic in the initial stages of establishing government services in human capital
- ▶ not able to provide a sustainable solution



Health and Education – not the same solution

There is a growing consensus that Universal Health Care should be:

- ▶ publicly funded
- ▶ achieved by governments working through their own context-specific steps.

There is no similar consensus in education, but there is broad agreement that:

- A** what matters is not only the length of compulsory education, but also the quality and appropriateness
- B** private finance may have a role in achieving equitable education provision as economies develop
- C** involvement of the private sector can make vocational training programmes more effective, raising employment and earnings as GNP rises, more people can be involved in formal training schemes
- D** inclusive

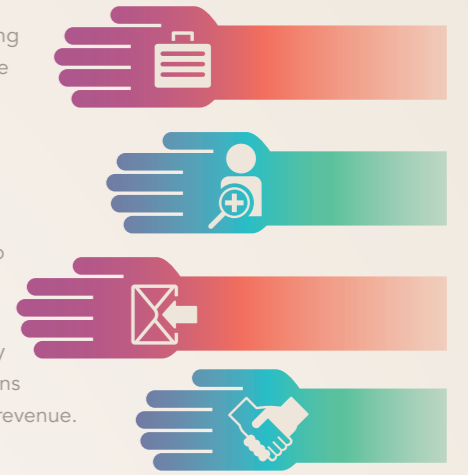


Generating domestic resources to support human capital solutions



Domestic revenues are currently inadequate in many developing countries. But a range of supporting policies can mobilise more resources including:

- ▶ more efficient tax collection
- ▶ extending the tax base
- ▶ new taxes
- ▶ ODA that aims to boost tax revenues and provide start-up costs for social protection, and budget support for health and education
- ▶ Many donor agencies, official and non-government, enjoy substantial tax exemptions. Suspending these exemptions would help partner governments to enhance their tax revenue.



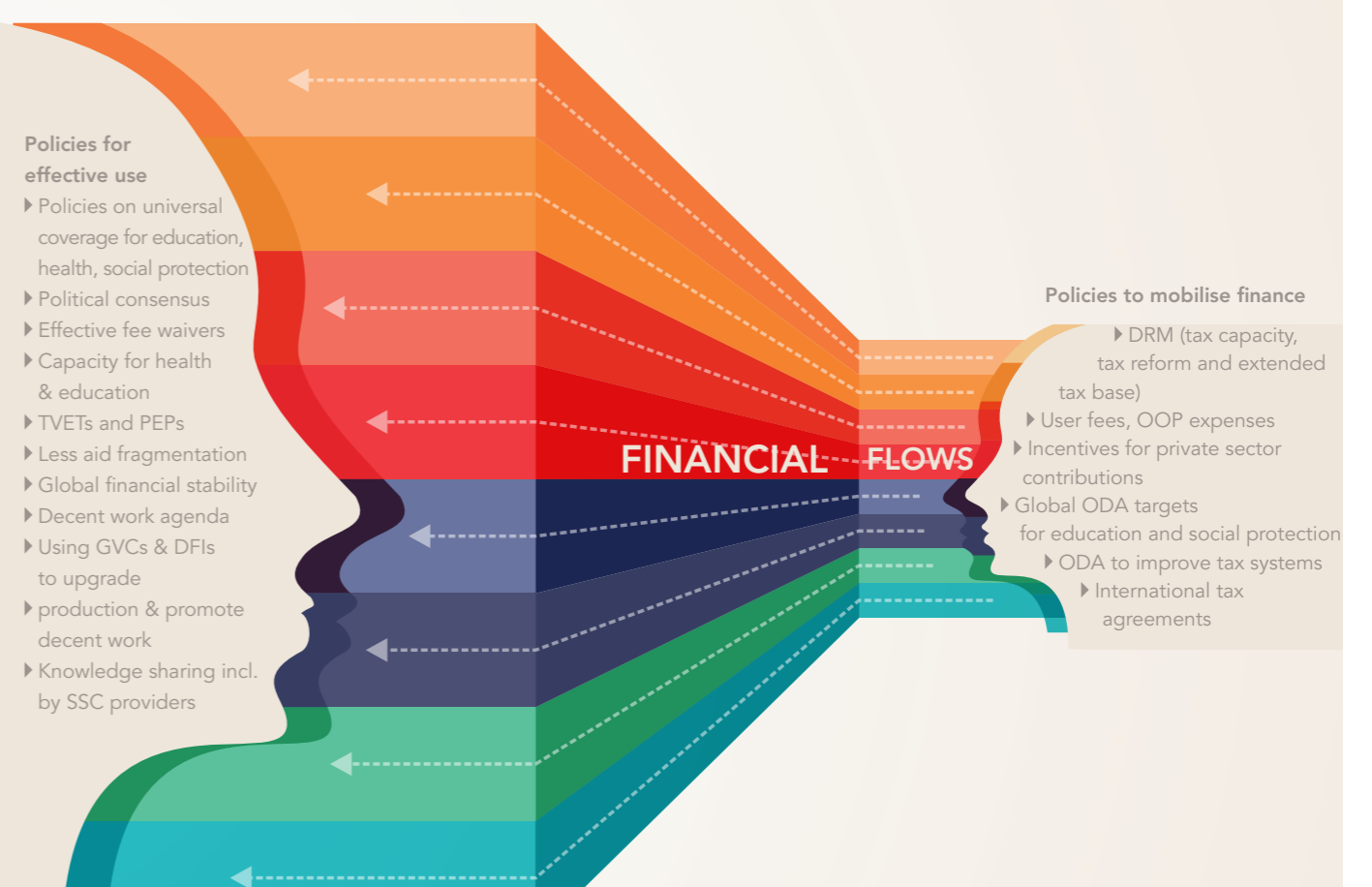
Role of policy for mobilisation and effective use of finance for human capital

Policies for effective use

- ▶ Policies on universal coverage for education, health, social protection
- ▶ Political consensus
- ▶ Effective fee waivers
- ▶ Capacity for health & education
- ▶ TVETs and PEPs
- ▶ Less aid fragmentation
- ▶ Global financial stability
- ▶ Decent work agenda
- ▶ Using GVCs & DFIs to upgrade production & promote decent work
- ▶ Knowledge sharing incl. by SSC providers

Policies to mobilise finance

- ▶ DRM (tax capacity, tax reform and extended tax base)
- ▶ User fees, OOP expenses
- ▶ Incentives for private sector contributions
- ▶ Global ODA targets for education and social protection
- ▶ ODA to improve tax systems
- ▶ International tax agreements





Considerable advances have also been made to introduce social protection in many developing countries, with the exception of SSA and LICs.

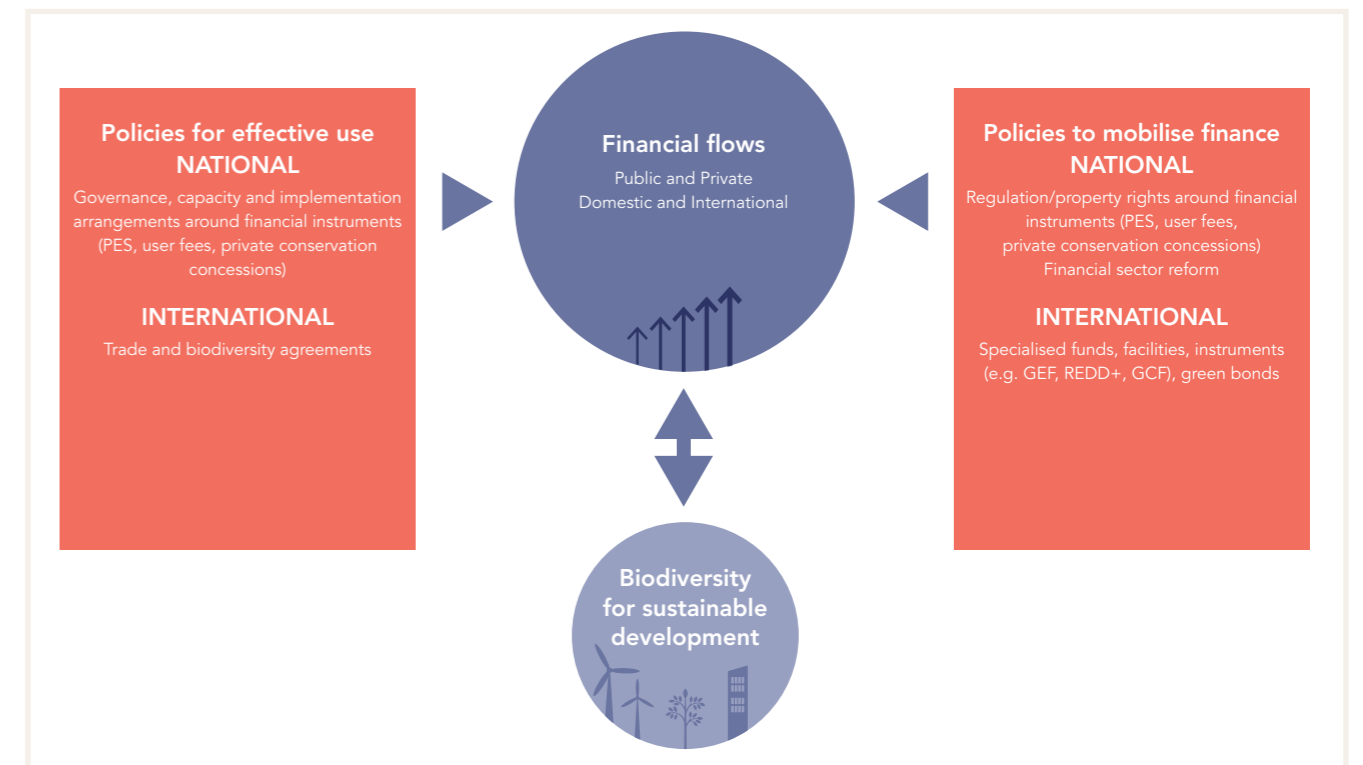
In terms of obstacles encountered and solutions to them, domestic revenues are currently inadequate in many developing countries, but there is a range of supporting policies to mobilise more resources. These include more efficient tax collection, extending the tax base, new taxes, and ODA that is aimed at boosting tax revenues as well as providing start-up costs for social protection, and budget support for health and education. Budget support has dwindled as a result of austerity policies in donor countries, and enthusiasm for it needs to be rekindled. ODA can help with both investment and recurrent costs especially, but not only, in LICs. Equally ODA will still have a substantial role to play in LICs by supporting health, education and social-protection services in the long term until governments can generate sufficient revenues to pay for them. The same will be true in some LMICs. On a more critical note Brun and Chambas (commissioned background paper, 2015) point out that many donor agencies, official and non-government, enjoy substantial tax exemptions, e.g. on VAT, and suspending these would be another way for donors to help partner governments enhance their tax revenue. The net financial gain might not be large since effectively it would involve a transfer from project aid to budget support, but it would enhance government ownership and probably help to reduce possibilities for fraud.

6.4 The role of finance and policies for biodiversity conservation

Financing for the conservation and sustainable use of biodiversity faces constant challenges and is not sufficient to meet the needs. Most of the ecosystem services provided by biodiverse forests, for example, have public or common-good characteristics in that they can be consumed and depleted without adequate payment for their use and regeneration. In addition, many of the benefits of biodiversity cannot be readily quantified. While the valuation and pricing of benefits in the form of consumables such as timber, bush meat, tourism, or genetic information is technically feasible (though not always practical), this holds to a lesser extent or not at all for other benefits of forest biodiversity. These involve non-consumables such as water purification, erosion regulation, flood protection or spiritual and cultural values; option values such as the future benefits of genetic information; bequest values (the value of biodiversity and functioning ecosystems being available to future generations); and existence values (the value emanating from the knowledge that forest ecosystems exist) (OECD, 2013: 26). Thus, many of the benefits of biodiversity are invisible to market transactions and given the complex and sometimes fragile interplay of ecosystem factors, an unsustainable use of forest resources can result in high environmental, economic and social costs that are not captured by market mechanisms.

A range of national and international instruments has been designed to attract both public and private finance for biodiversity. These instruments require complementary policies to be implemented effectively. This section discusses the sources of biodiversity finance, the link between finance and policies for biodiversity and future implications. Figure 6.9 summarises the main policy issues.

Figure 6.9 | The role of policy for mobilisation and effective use of finance for biodiversity



6.4.1 Financing biodiversity conservation: different sources and instruments

Because current market prices are distorted, they are a poor mechanism to mobilise and channel financing for biodiversity as they do not accurately reflect the value of public benefits stemming from biodiversity, or the social opportunity costs of degradation and biodiversity loss (OECD, 2013). In turn, biodiversity goods and services are undersupplied and underfunded. The total costs of biodiversity loss are difficult to estimate, but approximations range between \$2 tr and \$4.5 tr annually (OECD, 2013; TEEB 2009). The biodiversity financing gap is aggravated by the fact that the world's most biologically diverse forests and 'biodiversity hotspots'⁴¹ are in developing countries, where population pressure may be high, incomes are low, and governance capacity and regulatory frameworks are often

weak. While local populations have to bear much of the cost of biodiversity conservation, many of the benefits of intact ecosystems are global in nature, climate regulation being an example that serves to underline the importance of international biodiversity-financing mechanisms.

Total biodiversity funds are estimated to amount to \$51–53 bn a year, of which only \$21 bn is spent in developing countries (commissioned background paper, Büge et al., 2015). To put an end to the loss of biodiversity the level of finance needs to be six to eight times higher than is currently available (commissioned background paper, Büge et al., 2015). It is not easy to obtain a complete picture of financing for biodiversity. Much of the finance flows through specialised instruments. Table 6.4 summarises national public, international public, and other instruments that mobilise and channel finance for biodiversity conservation.



Table 6.4 | Instruments to mobilise and channel finance for biodiversity conservation

		SHORT DESCRIPTION OF INSTRUMENTS	SCALE/IMPACT	RELEVANCE OF SUPPORTING POLICIES IN MAKING INSTRUMENTS EFFECTIVE
National public or private	PES	Payment for ecosystem services	No assessment for developing countries available; but by 2011 the total value of transactions with regard to watershed PES was \$8–10 bn	Property rights; governance policies; financial and physical Infrastructure
	EF	Environmental funds are widespread mechanisms for funding biodiversity	At least \$800 mn has been invested in biodiversity projects in LAC, Africa and Asia via Environmental Funds (EFs)	Property rights; governance policies; financial and physical Infrastructure
	Environmental Fiscal Reform	Environmental fiscal reform refers in particular to taxation models and fiscal incentives to foster biodiversity	No impact assessment available, but possibilities for strong effects on other development dimensions, e.g. poverty eradication	Tax policies; government capacities
	Biodiversity offsets	Biodiversity offsets compensate the destruction of natural capital	No assessment for developing countries available; but illustrative best cases in developed countries	Government capacities; anti-corruption rules; technical assistance; awareness
	Entrance and use fees for national parks and protected areas	Fees according to the 'user and beneficiary pays' principle	Contribution to funding of PAs, which remain underfunded (e.g. LAC funding gap between \$314 mn and \$700 mn)	Government capacities; anti-corruption rules; technical assistance; awareness
	Private conservation concessions	Market-based policy mechanism for private investments	Case-based / no overall assessment available	Property rights; governance capacities; anti-corruption rules; PPPs
International public or private	GEF	Financial mechanism of the three UN Rio conventions	Total Investment of almost \$3.5 bn, leverage of more than \$10 bn in co-financing	All support policies that strengthen international public mechanisms
	BIOFIN	UNDP mechanism to unlock resources for meeting the Aichi targets	Budget: \$8.5 mn, 12 partner countries	All support policies that strengthen international public mechanisms
	REDD+	Result-based payment mechanism to prevent deforestation and forest degradation to reduce emissions	In the absence of agreements no scale/impact yet, but strong potential	All support policies that strengthen international public mechanisms
	GCF	Major fund for financing climate mitigation and adaptation activities under the UNFCCC	\$35 mn, strong potential	All support policies that strengthen international public mechanisms
	ODA	Bilateral or multilateral assistance	\$6.1 bn annually	All support policies that strengthen international public mechanisms
	FDI	FDI, e.g. in eco-tourism	No total volumes/impact assessment available	Policies in infrastructure and governance

Sources: CBD (2012); UNDP (2012, 2014); GEF (2014); OECD/DAC (2014); GCF (2014)

National biodiversity financing instruments

Payments for ecosystem services

Payments for ecosystem services (PES) are made to landowners whose land-management practices contribute to providing environmental services. PES are commonly defined as (a) a voluntary transaction where (b) a well-defined ecosystem service (ES) (or a land use likely to secure that service) (c) is being 'bought' by a (minimum of one) ES buyer (d) from a (minimum of one) ES provider (e) provided the ES provider secures ES provision (conditionality) (Wunder, 2005:3).

Very few PES schemes feature all five of these characteristics, but those that feature at least some could be defined as PES-like schemes (Southgate and Wunder, 2009). Wunder (2012) acknowledges the gap between theory and practice and argues that the most important characteristic of a PES is that payments are conditional on the provision of ecosystem services.

Today, PES is a prominent mechanism for conservation (Porrás et al., 2011). Starting out as scattered and mainly privately funded projects, many focus on protection of watershed services (e.g. Nyangena and te Velde, 2013), and PES is part of many international and national conservation policies worldwide. According to Bennett et al. (2012), by 2011 the total value of transactions with regard to watershed PES was \$8–10 bn, and it is growing fast.

Environmental funds

Environmental funds (EF) are among the most popular mechanisms for funding the conservation of biodiversity and ecosystem services (Xiang et al., 2007:2). These funds may be public, private or arranged through PPPs. Many EFs have a permanent endowment that has been capitalised by grants provided by the national government or donors. EF may also manage sinking funds created through debt-for-nature swaps or revolving funds

financed through user fees or taxes that are earmarked for conservation (Xiang et al., 2007:3).

A survey of 36 conservation trust funds, 49% from LAC, 28% from Africa and 25% from Asia and other countries, indicated that they managed the equivalent of over \$672 mn (CBD, 2012). An earlier survey of some 20 funds observed that the total amount contributed by donors probably exceeds \$1.2 bn, of which around \$800 mn had been disbursed as grants for biodiversity conservation, environmental protection and sustainable development, mostly in LAC (CBD, 2012).

The potential of water funds to contribute to biodiversity conservation is of paramount importance in relation to economic efficiency. Water funds (watershed-oriented PES projects based on a trust-fund model) have acquired great momentum, especially in northern Andean countries (Goldman-Benner et al., 2012). Similar to PES, water funds are often implemented with a lack of impact measures (Goldman et al., 2010:10)

Some of these funds are supported by fees paid, for example, by water users, and it is therefore important to address how imposing such fees may affect poor communities.

Environmental fiscal reform

Environmental fiscal reform refers to a wide range of adjustments to a country's fiscal system, particularly taxation and fiscal incentives, in order to reflect the true values and importance of biodiversity and ecosystem services in national economies (CBD, 2012).

According to the report developed within the scope of the environmental fiscal reform (EFR) work programme of the OECD-DAC ENVIRONET Forum (World Bank, 2005), the following mechanisms are part of a fiscal reform for a better environment: taxes on natural resource use (e.g. forestry and fisheries), user charges or fees and environment-related taxes to make polluters,



e.g. industries, motor vehicles, waste generators pay for the 'external costs' of their activities. An important issue regarding environmental taxes is that they should be earmarked for investment in conservation in the areas where they are levied. In addition, it is important to consider tax exemptions or deductions for a range of activities that maintain or improve biodiversity (e.g. maintaining forests on private lands, adopting technologies to address water pollution to maintain aquatic biodiversity). In addition, good fiscal reform will change environmentally harmful subsidies in certain economic sectors (e.g. agriculture, fisheries, mining and energy) and can free up public funds to promote conservation and the sustainable use of natural resources (TEEB, 2011).

A recent GIZ report (2013:1) argues that well designed environmental fiscal reform helps to reduce poverty by generating resources for pro-poor investments, for example in health and education. Where regressive impacts are a concern, especially in environmental taxation, flanking measures are needed to protect the socially vulnerable from the impact of higher energy or resource prices. It is therefore important to ensure that environmental fiscal reforms do not displace investment in health and education. Reducing corruption also needs to be addressed as part of fiscal reform.

Biodiversity offsets

A biodiversity offset is a mechanism that allows agents (e.g. real-estate developers or oil companies) to compensate for the damage they cause to a natural habitat, for example due to the construction of infrastructure, either by creating a new natural habitat elsewhere or by funding conservation projects in an existing natural habitat (e.g. a protected area). The compensatory work is preferably undertaken by paying private developers, guided by environmental organisations.

Most information on biodiversity offsets comes from developed countries, although the

mechanism is increasingly being explored in developing countries (Bull et al., 2013). The US Wetland Banking and the Australian Bio Banking are two of the best-known examples. Wetland and stream offsets in the USA are created via restoration, enhancement, creation, and preservation in the same watershed (EPA, 2006); indirect offsets (e.g. to fund research) are not allowed. The Environmental Law Institute (ELI, 2007) reports that in the USA private and public expenditure under this mechanism is around \$3.8 bn a year.

Biodiversity offsetting has been criticised by various conservation groups because there is only a narrow range of circumstances in which impacts on biodiversity can be offset with any kind of certainty (Gibbons, 2011; Robertson, 2006).

Entrance and user fees for national parks and protected areas

Protected areas (PAs) are considered to help to reduce biodiversity loss and to provide significant contributions to global efforts to conserve biodiversity. They cover about 13% of the land surface, up from 8.8% in 1990 (UNDP 2012). In addition, PAs support the provision of a range of ecosystem services, such as water purification, erosion control, reduced flooding, etc., increase adaptation capacity with regard to environmental risks and hazards, and sustain health and food security by maintaining species diversity (TEEB, 2011). Despite the growing number of PAs, the loss of biodiversity has not been curtailed.

The current funding mechanisms for PAs are inadequate. Across LAC, for instance, the funding gap ranges from \$314 mn to approximately \$700 mn per year (UNDP, 2011). Governments provide core funding, meeting over 60% of the costs (UNDP, 2010), but entrance and user fees are the most common means of generating revenue. Examples include entry fees to parks, recreational permit fees, surcharges on airports, cruise ships and hotel rooms, and fees and royalties paid by

the extraction industries. Such fees are based on the 'user or beneficiary pays' principle and are widely viewed as a fair way to assign responsibility to the users or consumers of biodiversity and ecosystem services. They effectively contribute to the conservation of biodiversity only if they are earmarked for PA and are not diverted to other purposes (Spergel, 2001), but these and other self-generated revenues contribute on average only 11% of the necessary funds. Only very popular PA can sustain a steady income from fees (e.g. the Serengeti National Park in Tanzania) (Mansourian and Dudley, 2008). Furthermore, there are some risks to charging fees. Politically it can be difficult to introduce fees for the use of resources that were previously treated as public goods i.e. that were freely accessible. In addition, the income stream is not necessarily secure since, for instance, tourism may decline because of political or economic crises or because certain species or attractions are lost (Spergel, 2001).

Private conservation concessions

Private conservation concessions are a market-based instrument to enable private investment in biodiversity conservation and climate-change mitigation. The first concessions were established in the 1990s in the USA and are also now found in Brazil, Chile, Guyana and Peru as well as Sierra Leone and Indonesia. Conservation concessions are an opportunity to lease out state land, in particular forests, to private entities. The concession holder has the exclusive right to use the allocated land to promote biodiversity conservation and to restrict biodiversity-unfriendly use (Wolman, 2004: 860). Conservation concessions are time-bound permits that range from 20 to 100 years. This implies that if the permit expires the area might again be available for resource exploitation, meaning that the loss of biodiversity is simply postponed (Rice, 2003). Setting areas aside for conservation on a temporary basis may make it easier for governments to establish PAs in order to prevent the areas being re-opened for exploitation (Nielsen et al., 2004:

139). Furthermore, conservation activities, e.g. in the case of logging concessions, may increase the economic value of the trees growing in the concession area, which might be an additional incentive for decision-makers to designate only short-term permits.

The basic concept is that conservation is defined in the same way as any other use of state-owned land for which a permit is required, such as logging, agriculture or mining. This means that private actors who are interested in conservation have to compete with commercial entities such as logging or agribusiness companies (Ellison, 2003; Wolman, 2004: 860). As is the case for other concession types, the permit must be obtained from the responsible state agency or current concession holder, and its issue is often based on the opportunity costs of competing uses (Wolman, 2004: 860; Nielsen et al., 2004: 138). In principle, the cost of the concession should cover the forgone income from other commercial uses, although the price, especially if the concession is bought from a state agency, should also reflect the benefits of conservation. These may include watershed-protection services, pollination and regulatory effects on local climate conditions (Wolman, 2004; Nielsen et al., 2004).

The concession holder has to finance and manage the planned conservation activities. Concession holders usually seek to generate funding for conservation activities from donations, donor agencies, philanthropists and conservation NGOs, commercial investment in corporate social responsibility (CSR), ecosystem service markets (e.g. voluntary carbon market, PES, conservation banking), marketing of non-timber forest products, and eco-tourism.

Conservation concessions aim to create value for conservation activities on areas of high conservation value (Rice, 2003: 1). Consequently, ecosystem services and biodiversity are defined as specific tradable and non-tradable commodities produced by the concession holder (Merkl et al., 2003: 3).



Box 6.17 | Private ecosystem restoration in Indonesia: a role model for private-sector engagement?

In 2004 the Indonesian Ministry of Forestry issued regulation 18/2004, which for the first time delegated authority for conservation activities to non-state actors (Walsh et al., 2012). The formulation and adoption of the regulation was largely the result of strong lobbying by the NGO Burung Indonesia (the Indonesian branch of Bird Life International) (Hein, 2013). Concession holders may apply for additional permits that allow the production of non-traditional forest products and transactions of ecosystem services.

The first ecosystem-restoration concession was issued in 2008 for the Harapan Rainforest project, literally 'Forest of Hope', run by the conservation company Restorasi Ekosistem Indonesia (REKI). REKI was founded by the NGOs Burung Indonesia, the Royal Society for the Protection of Birds and Bird Life International. The project achieved a high international profile and received funding from Danida and the German Climate Initiative. The concession is now mostly funded by NGOs and a private trust fund, and future funding via a voluntary carbon market is envisaged. Despite continued land conflicts among rural migrants and indigenous groups regarding access to and control of the concession area (Hein and Faust, 2014), the ecosystem-restoration model is an increasingly popular means to promote conservation in Indonesia and has attracted domestic and international private investment. In 2013 the Ministry of Forestry issued seven concessions covering a total area of 268,353 hectares (ha) in seven provinces on Sumatra and Borneo, and has said it will issue ecosystem-restoration concessions covering 2.5 million ha up to 2015. This ambitious plan will probably not be achieved (Walsh et al., 2011) but at least three more permits more are being processed (Ministry of Forestry of the Republic of Indonesia, 2014).

The Indonesian-Singaporean pulp and paper company, Asian Pulp and Paper, which is one of the world's largest, is investing in ecosystem-restoration activities. The company has recently received a 60-year concession covering 20,256 ha in Riau province and is investing \$7 mn in conservation activities (Mongabay, 2013). Furthermore, the company recently announced a zero-deforestation policy (APP, 2013). On the island of Borneo, in the province of Central Kalimantan, Infinite Earth, a Hong Kong-based carbon-trading company, runs a voluntary REDD+ project using an ecosystem-restoration concession. The company received financial support from the oil giants Gasprom and Shell and sold voluntary carbon credits to the German insurer Allianz.

The concept of ecosystem-restoration concessions has attracted private investment in conservation in Indonesia. Studies conducted by the Agricultural University of Bogor indicate that despite start-up investments of approximately \$14–18 mn for the first six years, the concession model could become financially sustainable (Idris, 2010 cited in Walsh et al., 2011), although the business models of the companies involved, such as Shell or Asian Pulp and Paper, are still based on the unsustainable exploitation of natural resources. Unsustainable exploitation remains a major risk for conservation. In some cases ecosystem-restoration concessions overlap with land claimed by local communities and indigenous groups, leading to conflicts that pose a major obstacle to conservation activities. Unfortunately, the legal framework for ecosystem-restoration concessions offers no clear guidance on how to engage local communities in such projects.

The concept can be viewed as an attempt by governments and environmentalists to mobilise new and additional private finance for biodiversity and the conservation of ecosystem services (Jenkins et al., 2004).

Major problem areas are, first, that conservation concessions are most appropriate in remote and relatively unpopulated areas that are not suitable for commercial purposes (Nielsen et al., 2004: 140). In areas with high economic potential or high population density the political costs of

designating additional conservation areas might be too high. Second, conservation areas seldom offer local employment, and the restriction of non-commercial (and illegal) logging activities and other informal activities might reduce earnings for already marginalised frontier communities (Hein, 2013). The payments made by the concession holder accrue to the government, and may not benefit those who are negatively affected by the conservation intervention. To pre-empt this, the concession holder should consider investing in alternative income sources for local communities,

which is what the conservation company implementing the Harapan Rainforest project in Indonesia chose to do (Walsh et al., 2012; Hein, 2013) (see Box 6.17). Third, conservation concessions do not address the wider patterns of consumption that are the underlying cause of deforestation and biodiversity loss (McGregor 2010: 30). Fourth, commercial funding opportunities such as markets in ecosystem services, marketing of non-timber forest products and eco-tourism may not raise sufficient finance to manage larger conservation concessions. Finally, private conservation concessions as a means to encourage private investments in biodiversity should not lead to the reduction of public expenditure on conservation (Wolman, 2004).

International biodiversity financing instruments

Global Environment Facility (GEF)

The GEF is the financial mechanism for the three Rio conventions. Biodiversity projects are the largest of the GEF portfolios, representing 36% of the total (GEF, 2014). Overall, the GEF has invested \$3.46 bn on biodiversity projects and has leveraged co-funding of \$10.04 bn. More than 1,200 projects in over 155 countries have been funded and the GEF represents the largest source of finance for PAs: 3,277 PAs totalling 856 million ha have been protected thanks to \$2.3 bn in GEF funds and an additional \$6 bn leveraged (GEF, 2014). The biodiversity projects are conducted in conjunction with ten UN specialised agencies and development banks.⁴² Its Small Grant Fund (SGF) allows up to \$50,000 to local communities, indigenous peoples, NGOs and community-based organisations for biodiversity and related projects (SGP, 2014b). These grants have totalled over \$240 mn for biodiversity projects, and \$190 mn for the protection, rehabilitation and sustainable use of forest ecosystems (SGP, 2014a).

Biodiversity conservation has strong inter-linkages with other development goals such as the reduction of poverty, community development,

climate change adaptation, the reduction of desertification and other environmental, economic and social objectives. At the same time, however, biodiversity-protection measures may have adverse social or economic impacts on local communities. For example, from a policy coherence perspective it is crucial that biodiversity projects do not lead to the involuntary displacement of local communities or undermine their livelihood by preventing them from using forest resources. Thus, in addition to organising, financing and managing biodiversity-protection projects, it is possible to strengthen biodiversity or stem biodiversity loss by establishing complementary policies in other fields of development cooperation, and measures to protect biodiversity can (and should) be expanded to include wider development objectives.

An example of mainstreamed development cooperation is the 'Community Action to Conserve Biodiversity' programme that receives funding from the SGF. Together with local community-based biodiversity enterprises, it addresses several objectives besides ecosystem conservation. It aims to (a) foster additional livelihood benefits (e.g. health, gender equity and empowerment, education, poverty alleviation); (b) sustain the intervention beyond the project's principal objective (e.g. enhancing awareness, improving policy and legislation, developing institutional and technical capacity; securing financing mechanisms and private-sector involvement); (c) improve environmental management (e.g. innovative technological applications; linkages with other environmental goals); and (d) extend the approach to biodiversity conservation (e.g. mainstreaming biodiversity in production, landscapes, and sectors; catalysing the sustainability of PAs) (GEF, 2012).

This programme has financed, for example, community-based certification projects in Costa Rica and Mexico and organic produce in Bolivia. Overall, it is estimated that it has generated more than 500,000 jobs through

⁴² Asian Development Bank (ADB), African Development Bank (AFDB), European Bank for Reconstruction and Development (EBRD), the Food and Agriculture Organization (FAO), Inter-American Development Bank (IADB), the International Fund for Agricultural Development (IFAD), the United Nations Development Programme (UNDP), the United Nations Environment Programme (UNEP), the United Nations Industrial Development Organization (UNIDO) and the World Bank.



'training for the production, implementation, and commercialization of renewable energy and energy efficient technologies and systems [...] management, recycling, composting, and safe disposal of solid waste in rural and urban areas; testing and application of innovative methods of managing sustainable fisheries and other natural resources; and participation in the co-management of protected areas' (GEF, 2012: 112). While biodiversity conservation can conflict with other short-term economic and social benefits, for instance when forests are cleared to make way for agriculture, the SGF programmes show that the different policy dimensions can be addressed coherently and that biodiversity-protection mechanisms can also create employment, foster sustainable livelihoods, finance microcredit schemes, provide access to markets via certification schemes and promote security of land and resource tenure (GEF, 2012: 112).

The Biodiversity Financing Initiative (BIOFIN)

UNDP's biodiversity portfolio is the largest in the UN system, covering more than 500 projects. It is financed by the GEF (\$1.5 bn) and other sources (\$3.5 bn). In 2012, in partnership with the EU and the governments of Germany and Switzerland, UNDP launched the Biodiversity Financing Initiative (BIOFIN) in order to meet the Aichi targets.⁴³ BIOFIN aims '(i) to develop a methodology for quantifying the biodiversity finance gap at national level, (ii) to improve cost-effectiveness through mainstreaming of biodiversity into national development and sectoral planning, and (iii) to develop comprehensive national resource mobilising strategies, through an inclusive process led by national stakeholders' (UNDP, 2014). The initiative has a budget of \$8.5 mn and an additional \$3.1 mn from GEF-funded UNDP projects (GEF, 2012). Twelve countries⁴⁴ contribute to developing and piloting this initiative.

REDD+

Since around 12% of global GHG emissions are caused by deforestation, REDD+⁴⁵ was developed under the umbrella of the UNFCCC as a results-based payment mechanism to prevent deforestation and forest degradation in developing countries (UNFCCC, 2008). First proposed by a group of tropical countries headed by Papua New Guinea at the UNFCCC's 11th Conference of the Parties in 2005, the idea is to increase the market value of intact forest ecosystems and to compensate for the economic opportunity costs of deforestation. The Eliasch review (Office of Climate Change, 2008) estimates financial requirements for halving emissions from the forest sector by 2030 to be in the order of \$17–33 bn per year, but there are also different estimates. REDD+ consists of three stages: readiness and capacity-building, development and implementation of policies and measures, and results-based payments to developing countries.

Some observers argue that REDD+ represents a huge opportunity to protect forest cover, but to date there are no agreements regarding the trading of REDD+ credits in international compliance markets. The main obstacles are difficulties with measuring, reporting and verification; the risk of leakage (deforestation elsewhere); the lack of permanence, which refers to the risk that carbon may simply be emitted later as a result of forest fires or changed policies; and the absence of binding emission targets and hence the lack of international emission markets (Streck and Parker, 2012). Without a carbon market, the finance for results-based payments has to come from public funds.

REDD+ aims to reduce emissions rather than to protect biodiversity protection as such. In the absence of coherent strategies, its contribution to biodiversity protection may be suboptimal in social, economic and environmental terms.

In addition, there are social concerns about local communities that used but did not have formal ownership of forest ecosystems being denied access in the name of forest protection. Safeguards have been developed to ensure that all these issues are addressed before payments can be made, but their application remains imperfect.

Green Climate Fund

Under the auspices of the UNFCCC, the Green Climate Fund (GCF) was established to finance climate change mitigation and adaptation activities. The GCF is meant to leverage private-sector funding but also depends on substantial public financing. Pledged support from several donor countries is around \$35 mn in 2014, far short of the UNFCCC's objective of \$100 bn by 2020 (Climate Fund Update, 2014). The GCF aims to contribute to a transition to low emissions and resilience to adverse climate impacts. Although the GCF does not have a biodiversity focus, it will potentially lead to large financial flows for low-carbon development (e.g. hydropower plants) and climate adaptation (e.g. coastal protection), and therefore has the potential to make positive impacts on biodiversity or provide opportunities for biodiversity co-benefits. It is therefore vital to mainstream biodiversity in GCF-financed activities.

Official Development Assistance (ODA)

Bilateral or multilateral ODA refers to grants and concessional loans, i.e. with a grant element of at least 25% (at a 10% discount rate). It excludes most SSC from non-OECD members. Biodiversity-related ODA steadily increased in the last decade (OECD/DAC, 2014) and now represents some \$6.1 bn annually (5% of total ODA from OECD

DAC members), compared to a little more than \$3 bn in the 2004–2006 period (Figure 6.10).

ODA includes funds channelled via multilateral agencies, apart from core contributions to the GEF, the World Bank or the RDBs. Major donors are Japan, Germany and the EU, which provide together almost half of biodiversity-related ODA. There are, however, large differences at the national level – less than 3% of ODA provided by Austria, Greece, Luxembourg, New Zealand, the Netherlands and South Korea,⁴⁶ but more than 10% of ODA from Australia, Finland, Iceland and Norway; there is no information on the US contribution. Africa, Asia and Latin America receive similar levels of biodiversity funding and major recipient countries include Brazil, China, India, Indonesia and Vietnam. The three key sectors that attract the highest share of biodiversity-related ODA – a combined 80% – are general environmental protection; agriculture, forestry, fishing and rural development; and water supply and sanitation. Forestry receives almost half of biodiversity-related ODA (Figure 6.11) and in 2013 two-thirds of total ODA in the forestry sector was dedicated to strengthening biodiversity and the sustainable use of forest ecosystem resources (OECD/DAC, 2013). As an overall trend, the OECD notes that donor countries are '...increasingly exploiting the synergies between biodiversity and climate change adaptation, mitigation, and desertification and integrating biodiversity into development co-operation portfolios – and this nexus may be driving the upward trend in total biodiversity-related aid' (OECD/DAC, 2014).

⁴³ In 2010, the 10th meeting of the CBD's Convention of the Parties took place in the Japanese city of Nagoya, the capital of the Aichi Prefecture. At the Convention, a Strategic Plan for 2011–2020 was presented, including the Aichi targets, the central goals of which are to: (i) Address the underlying causes of biodiversity loss by mainstreaming biodiversity across government and society; (ii) Reduce the direct pressures on biodiversity and promote sustainable use; (iii) Improve the status of biodiversity by safeguarding ecosystems, species and genetic diversity; (iv) Enhance the benefits to all from biodiversity and ecosystem services; and (v) Enhance implementation through participatory planning, knowledge management and capacity-building.

⁴⁴ Botswana, Chile, Costa Rica, Ecuador, Indonesia, Kazakhstan, Malaysia, Peru, Philippines, Seychelles, South Africa and Uganda.

⁴⁵ 'Reducing Emissions from Deforestation and Forest Degradation, and the role of conservation, sustainable management of forest and enhancement of forest carbon stocks in developing countries'.

⁴⁶ ODA that focuses on meeting the objectives of the Rio Conventions is monitored in the OECD/DAC's Creditor Reporting System. This system uses 'Rio markers' to differentiate between aid for biodiversity, desertification, climate change mitigation, and/or climate change adaptation, defined by principal objectives, significant objectives and non-targeted objectives.



Figure 6.10 | Trends in biodiversity-related bilateral ODA (three-year averages, 2004–2012, \$ bn, constant 2011 prices)

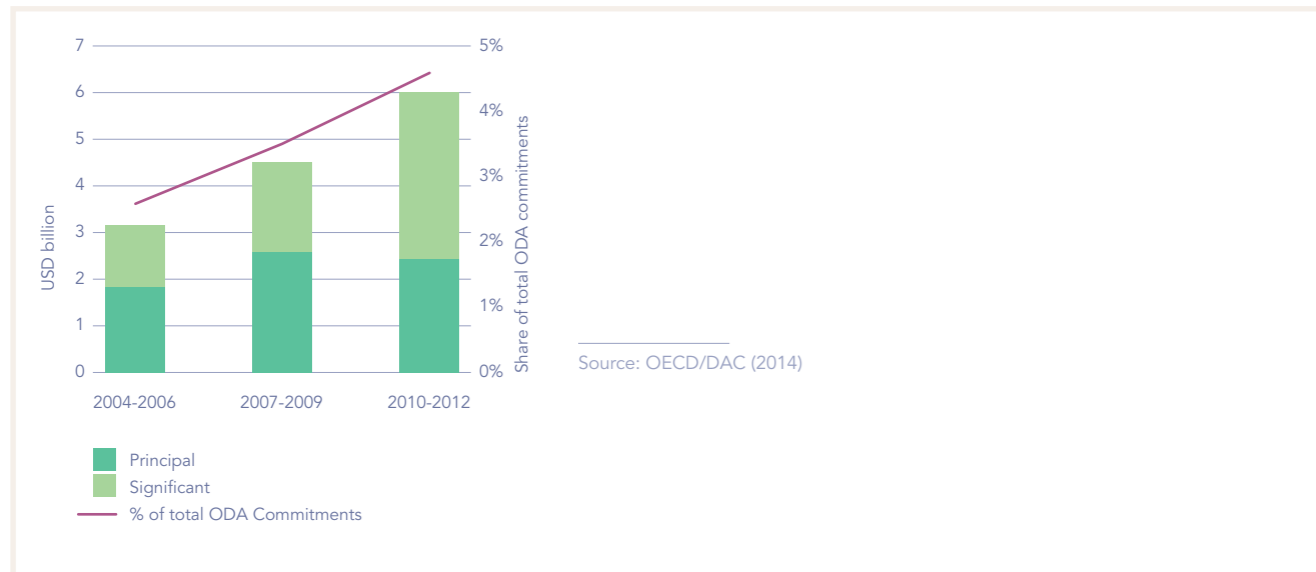
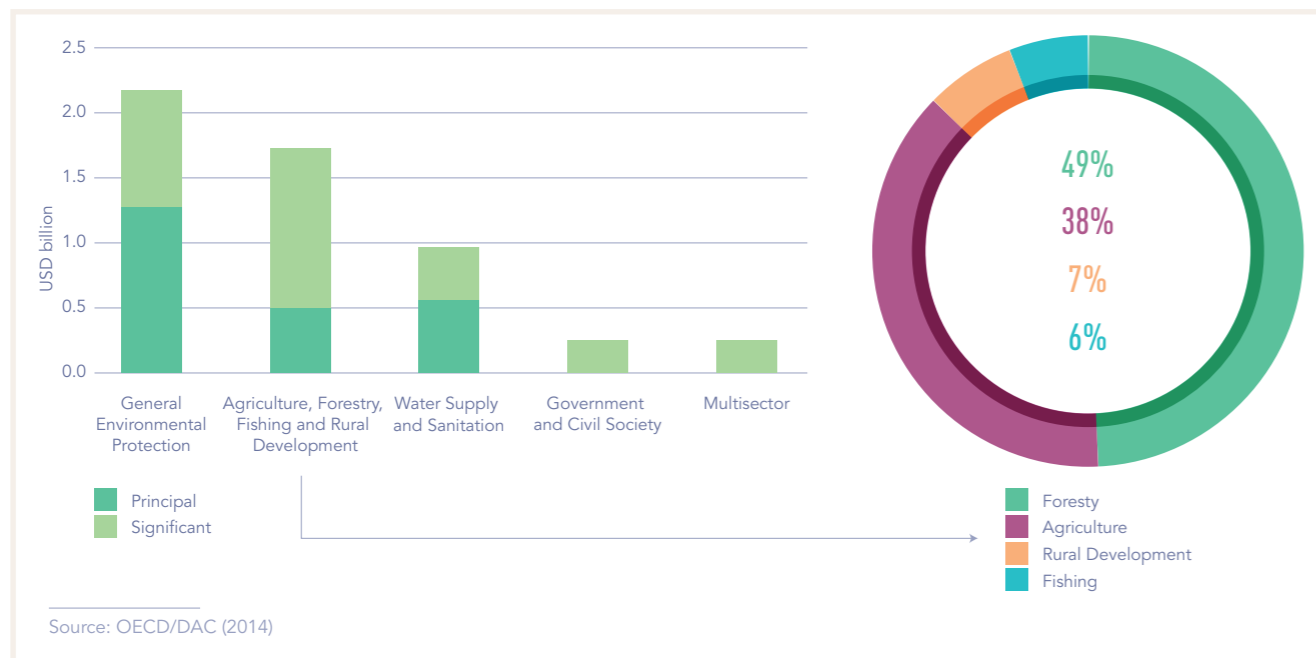


Figure 6.11 | Five main sectors receive 91% of biodiversity-related ODA (average 2010–2012, bilateral commitments, \$ bn, constant 2011 prices)



47 Multi-sector projects include urban development and management, and multi-sector education, training and research.

Other public, public-private, and private financing mechanisms

Other international biodiversity financing includes public, public-private and private mechanisms. Debt-for-nature swaps, for example, allow developing countries to shift their foreign debts into funds for biodiversity conservation or other environmental and ecological projects. Two types of swaps predominate (AGF, 2012: 72). Commercial debt-for-nature swaps (also known as three-party debt-for-nature swaps) are where public or private donors – often NGOs – purchase debt titles on financial markets. They transfer these titles to the debtor country, which in turn enacts legislation on protecting biodiversity or endows government bonds that finance biodiversity projects. Bilateral or multilateral swaps are where one or more creditor governments agree to cancel or discount a portion of debt on condition that the indebted government commits to finance biodiversity conservation. For example, a recent bilateral agreement between the USA and Indonesia will generate approximately \$28.5 mn a year, which will finance activities to conserve Indonesian forests (AGF, 2012). Debt-for-nature swaps have also been used in conserving pristine ecosystems in Bolivia, Brazil and Costa Rica. In Madagascar, an agreement with France resulted in tripling the size of the country's protected areas (AGF, 2012). Fewer debt-for-nature swaps are taking place at present, mainly because international debt cancellation and debt-restructuring programmes have considerably reduced the debts owed by developing countries (AGF, 2012).

National and international (public-) private investment is another potential source of biodiversity financing. Commercial investors require a return on investments. For biodiversity such returns can come from sustainable forestry, organic farming, eco-tourism, commercial hunting or carbon sequestration. Investment funds include green bonds, commercial loans, private equity, risk-mitigation instruments and conservation trust funds. Private investment in commercial

biodiversity projects can yield low profits and financial returns, but high economic returns and total value creation, e.g. by creating employment or providing public goods. They represent an example of PPPs or public subsidies to encourage private investment.

Büge et al. (commissioned background paper, 2015) give an example of public expenditure encouraging private investment flows in the case of Peru. The country is biodiversity-rich and hosts almost 10% of all floral species. Private co-financing of PAs is enabled via administration contracts and service concessions for eco-tourism and private conservation areas. Agreements between Peru's National Service for Protected Areas and private contractors have mobilised \$20 mn for ten PAs compared to the government's contribution of \$5 mn (World Bank, 2012). FDI also increasingly targets the production of certified products and it is estimated that by 2020 certified products 'could generate new and additional biodiversity finance of around \$10.4–30 bn annually to compensate farmers for implementing more sustainable agricultural practices' (Parker et al., 2012). Peru's experience serves as an argument for PPPs or public subsidies to encourage private investment.

6.4.2 The role of policies and finance for biodiversity

Several complementary factors determine the successful use of national and international instruments to finance the preservation of biodiversity. They include regulatory reform and clear property rights, the presence of capacity and appropriate governance arrangements and financial and physical infrastructure. We highlight three complementary policies for mobilisation of finance: regulatory and governance reforms, mainstreaming biodiversity issues, and financial-sector development, and two policies for the effective use of finance: governance and capacities and trade policy.



Mobilising finance for biodiversity

Regulatory reforms (property rights)

The effectiveness of financing provided to developing countries to actually protect biodiversity is dependent on an effective institutional setting, a sound policy framework at the national level and capacity within institutions. Forest policy directly impacts forest biodiversity and can be supportive or destructive. Ever since the Rio declaration of 1992 a number of UN initiatives have promoted sustainable forest management that also addresses biodiversity concerns. Many countries have adjusted their forest policies and laws to better protect forests and control deforestation. In 2007 the UN signed a non-legally binding instrument on all types of forests. The International Model Forest Network is an example of a worldwide initiative that promotes sustainable forest management via networking and support of on the ground initiatives (IMFN, n.d.).

In addition to the policies directed at forest management there are a number of broader regulatory reforms that can contribute to enhancing the effectiveness of – and might even contribute to increasing – biodiversity financing. These include the establishment of clear and secure property rights⁴⁸. Property rights are a prerequisite for mid- and long-term investment in ecosystem services; they are a means to protect indigenous populations from being displaced, for instance by illegal cut-and-burn and the expansion of industrial agriculture; they can secure capital from international funds (e.g. REDD+); and they can enhance the engagement of traditional forest owners and forest resource users not to revert to unsustainable use and over-exploitation of forest biosystems (Oakes et al. 2012); finally they can ensure certain types of activity (e.g. logging, hunting) are not allowed (background commissioned paper, Büge et al., 2015). The establishment of forest-friendly procurement rules is yet another policy tool for governments

(and private organizations) to contribute to biodiversity conservation and to reward and thus facilitate investment in the sustainable use of forest ecosystems. National Planning and Co-ordination can be a strong policy device to mainstream technology implementation, biodiversity conservation and other development objectives, to identify financing gaps and the need for technical assistance, and to reduce transaction costs of multiple project governance. By bringing together government agencies, private sector actors, non-profit organizations and other external stakeholders, transparency can be improved, planning horizons for green technology or biodiversity projects can be reduced and, potentially, synergies with other government policies can be exploited, thereby reducing financing needs. Finally, subsidy reform represents yet another avenue to reduce biodiversity-adverse incentives: ‘Subsidies to key sectors (i.e. agriculture, fisheries, mining and energy) are currently running at around one trillion dollars per year. Collectively, subsidies represent 1% of global GDP yet many of these contribute directly to biodiversity and ecosystem damage’ (TEEB 2011: 32). If subsidy reform results in redirecting funds towards the enhancement of biodiversity, the reform’s positive effect is twofold: First, biodiversity finance is directly increased. Second, by reducing harm the need for financing is indirectly lowered.

Mainstreaming sustainability in infrastructure policy

Infrastructure and economic development are key drivers of deforestation and the loss of biodiversity, but the adverse effects can be reduced if they are carefully managed and mainstreamed with biodiversity-conservation objectives. Frameworks for mainstreaming biodiversity conservation into infrastructure or other development projects include impact assessment and mitigation plans and the enhancement of ecosystem services. The former can reduce the harmful impacts of private and public investment.

Many donors and private investors apply sustainability rules to their investment decisions. Strategic Environmental Assessments and Environmental Impact Assessments serve to inform decision-makers – both public (e.g. development banks) and private (e.g. investment funds) – of potential negative impacts and externalities of their investment strategy on the environment, such as in commercial or development-oriented infrastructure projects. After projects have been completed, their adverse impacts may be reduced or compensated via environmental management plans and biodiversity offsets. A different approach focuses on ecosystem services. For example, pristine mangrove forests represent biodiversity reservoirs and carbon sinks, and also provide flood protection and prevent coastal erosion in many tropical and subtropical countries. Enlarging a mangrove forest can therefore be a cost-efficient and biodiversity-friendly alternative to building concrete flood-defence walls. This type of ‘green adaptation’ and ‘green infrastructure’ simultaneously meets development or infrastructure and climate-adaptation objectives, while also providing ecosystem and biodiversity benefits.

Reform of the financial sector

Domestic and international public bodies have a wide array of tools to address market failures and to invigorate the financial sector. Private investment in commercial but ecologically sustainable forestry, farming or tourism can be strengthened by public co-investment. Co-finance by (national or international) public institutions in the form of concessional loans or equity can improve the return-to-risk ratio of environment-friendly projects. In this way it can enhance the returns to private investors or absorb possible losses, making the project more attractive in capital markets. In addition, the public institution can provide political or technical expertise. Credit guarantees are another means to reduce the commercial risks of forest-friendly projects, in particular improving SMEs’ access to capital

markets. In this arrangement, the guarantor agrees to repay a creditor all or part of the debts against the risk of default. For example, USAID’s Development Credit Authority has issued credit guarantees for SMEs in the forestry sector, thereby improving agricultural productivity by allowing for better irrigation systems and access to quality inputs (Oakes et al., 2012; USAID, 2012). Forward contracts are agreements on a future exchange between a vendor, e.g. of certified timber, and a buyer. Volumes, prices and transaction dates are agreed in advance, reducing the risks for investors. For example, the World Bank’s Bio Carbon Fund specialises in concluding forward contracts in the acquisition of forest carbon credits (Oakes et al., 2012: 125). Forward contracts can also appeal to buyers from the private sector, for instance timber funds, since they reduce the risk of undersupply. More generally, policy reform can encourage the private sector to take account of biodiversity through financial means such as subsidies for desired behaviour or taxes/sanctions on undesired behaviour (commissioned background paper, Büge et al., 2015).

Effective use of finance for biodiversity

Governance, capacity and implementation of financial instruments

National and international financial instruments cannot be deployed effectively without additional policies. For example, some PES enabling conditions include: (a) an identified environmental problem related to an ecosystem service, for which its users are willing to pay; (b) an intermediary willing to bring together providers and buyers; (c) a clear relationship between land use and ecosystem changes in order to make a case for PES; (d) governments should support less wealthy buyers; and (e) governments should ensure that PES negotiations do not affect the livelihood of those providing the services.

Although PES was originally conceived as a mechanism to address conservation issues, it has

⁴⁸ Property rights can be private or collective. As many aspects of biodiversity are common property or public goods, as outlined in Section 2, collective rights may often be more helpful than private rights.

ENABLER: BIODIVERSITY



Finance for biodiversity

Various national and international financial instruments are being used to finance the preservation of biodiversity.

Supporting domestic and international policies are necessary to take a transformative approach to biodiversity.

National policies for effective use

- > governance, capacity and implementation arrangements around financial instruments (PES, user fees, private conservation concessions)

International policies for effective use

- > trade and biodiversity agreements

International policies to mobilise finance

- > specialised funds, facilities, instruments (e.g. GEF, REDD+, GCF), green bonds

National policies to mobilise finance

- > regulation / property rights around financial instruments (PES, user fees, private conservation concessions)
- > financial sector reform

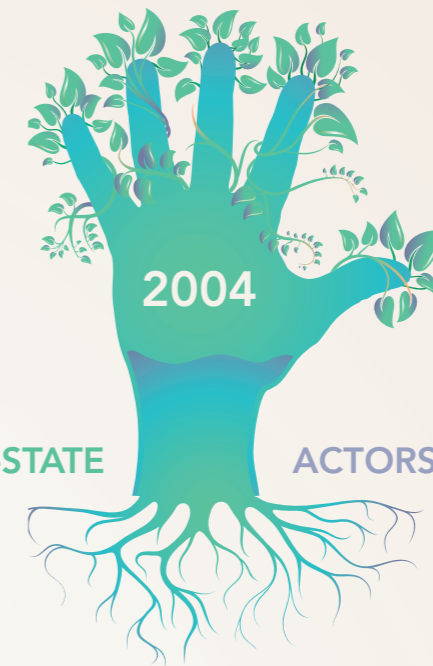
FINANCIAL FLOWS

The role of policy for mobilisation and effective use of finance for biodiversity



Concessions in Indonesia

In 2004 the Indonesian Ministry of Forestry delegated authority for conservation activities to non-state actors. Forestry concession holders could apply for permits to allow the production of non-traditional forest products and the transaction of ecosystem services.



The first ecosystem-restoration concession was issued in 2008 for the Harapan (Forest of Hope) Rainforest. The project run by the conservation company Restorasi Ekosistem Indonesia (REKI) founded by the NGOs: Burung Indonesia, the Royal Society for the Protection of Birds (RSPB) and Bird Life International.

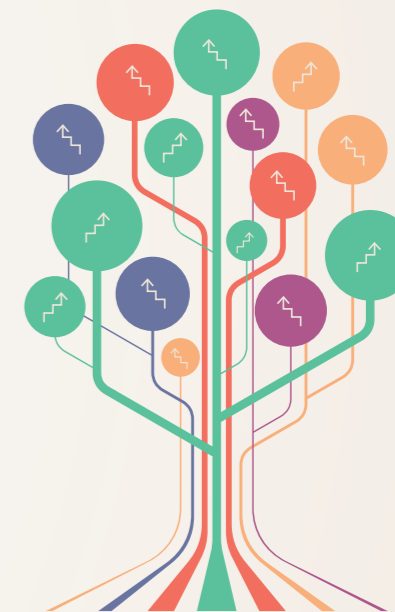
Initial funding was from Danida and the German Climate Initiative. It is now mostly funded by the NGOs and a private trust fund.

2013 - 2015



A role for the private sector?

In 2013 the Ministry of Forestry issued seven concessions covering a total area of 268 353 hectares (ha) in seven provinces on Sumatra and Borneo. It plans to issue ecosystem-restoration concessions covering 2.5 million ha up to 2015.



DESPITE IMPORTANT START-UP INVESTMENTS, THE CONCESSION MODEL COULD BECOME FINANCIALLY SUSTAINABLE.

Ecosystem-restoration concessions have attracted private investment in conservation in Indonesia.

Asian Pulp and Paper is investing in ecosystem-restoration activities. The company has received a 60-year concession covering 20 256 ha in Riau province (Sumatra). It is investing \$7 mn in conservation activities and recently announced a zero-deforestation policy.

In Borneo, Infinite Earth, a Hong Kong-based carbon-trading company, runs a voluntary REDD+ project that uses an ecosystem-restoration concession. It has financial support from Gasprom and Shell and has sold voluntary carbon credits to the German insurer Allianz.



been also viewed as a means to reduce poverty. PES can be a useful income source for people living in valuable ecosystems, provided that they perceive benefits for their efforts (FAO, 2011).

The limited monitoring of the socio-economic impacts of PES on providers (Bennett et al., 2012) suggests that presenting PES as a win-win mechanism is more of an assumption than an empirically proven fact. Indeed, a growing number of studies show that PES can be problematic for providers, including elite capture (Lee and Mahanty, 2009); that poor communities are forced or tricked into participating in conservation projects (Granda, 2005), lose control over their resource base (Rodríguez-de-Francisco et al., 2013), and experience increased competition and conflict over the remaining land resources (e.g. conservation areas for carbon, biodiversity or water protection) (Hein and Faust, 2014); or that socio-cultural practices and values that serve as safety-nets against poverty are weakened (Boelens et al., 2014).

PES is not a 'one-size-fits-all' mechanism and its deployment should be predicated on a clear understanding of the context, and on its potential environmental, social, cultural, economic and equity impacts. Otherwise, it may backfire, creating or reinforcing inequity, or environmental and social degradation. This requires governance and policy coordination regarding the financial instruments.

Similar issues need to be addressed in order that entrance and user fees become an effective conservation-financing tool. These include establishing the fee on the basis of willingness-to-pay studies, ensuring a transparent means of collecting fees, earmarking the revenue generated by fees, and tackling corruption (UNDP, 2012).

Trade policies and certification

As Oakes et al. (2012) underline, direct or indirect trade laws and voluntary partnerships can play an important role in tackling illegal forest

commodities by increasing the price of legal and sustainably produced ones. For example, the EU Timber Regulation (Regulation 995/2010) regulates timber imports into the EU. Since March 2013, any company that places timber or timber products on the EU market for the first time must ensure that they have been legally produced. The Timber Regulation (a) prohibits the placing of illegally harvested timber and products derived from such timber on the EU market, whether they are of domestic or imported origin; (b) only timber accompanied by a Forest Law Enforcement, Governance and Trade or Convention on International Trade in Endangered Species licence is accepted as legal. In all other cases, operators must exercise 'due diligence' when they sell imported and domestic timber or timber products; and (c) traders (who follow the operators in the supply chain) must keep records of their suppliers and customers. In this way the operators can always be traced. Thus, the EU's trade rules represent a supporting policy for effective use of biodiversity financing within and beyond the EU.

6.4.3 Conclusions and implications of environmental finance

Various national and international financial instruments are being used to finance the preservation of biodiversity. The appropriate financing mix of domestic and international sources is highly specific to each country and context. Newly created international facilities have still to be adapted to the practical challenges, and financial instruments require a range of complementary policies to make them work. The preservation of biodiversity can be supported by policies such as regulatory reforms (property rights) and governance, infrastructure policies, reform of the financial sector, and trade policies in order to mobilise finance and facilitate its effective use. It is necessary to use supporting domestic and international policies in order to take a transformative approach to biodiversity.

6.5 The role of finance and policies in the diffusion of green energy technology

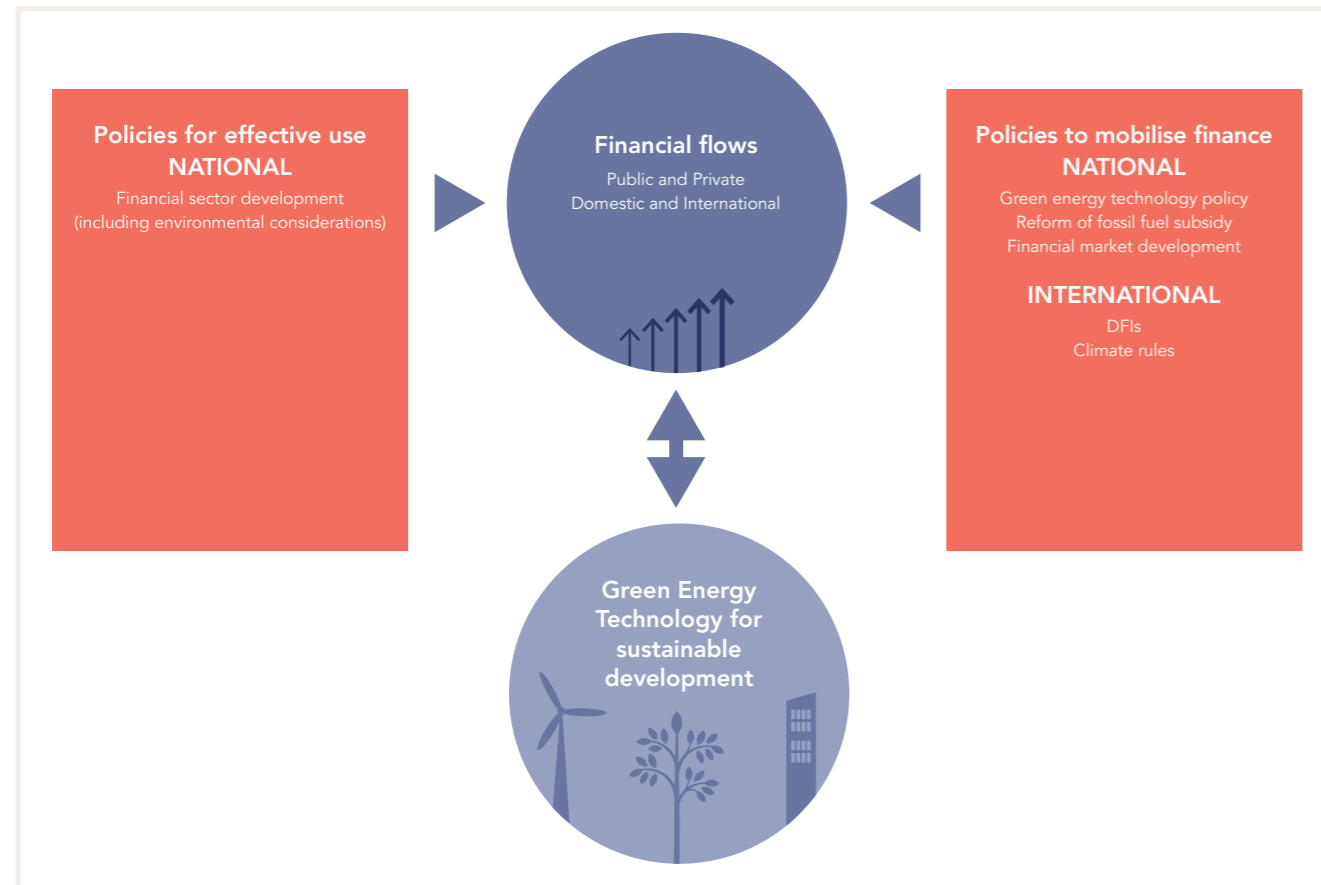
The development and adoption of green energy technologies is crucial to fostering green growth, but is hampered by the lack of finance, the wrong price incentives and the absence of complementary policies and institutions. While developed countries use more energy per person in fossil-fuel-intensive energy grids, leading to greenhouse gas (GHG) emissions, future economic and population growth in developing countries will increase their demand for energy and will produce the largest increases in GHG emissions in the coming decades. In the context of rapidly growing economies, governments and public bodies may come under pressure to invest in low-risk and low-cost projects in order to meet the rising demand for energy, and give less priority to or even neglect long-term investments in innovative and green-energy technologies (see, for instance, Bazilian et al., 2013). While limited access to energy is a key constraint for economic development in most LICs, the failure to deploy green energy sources hinders sustainable development in all countries.

This section defines green energy technologies as those that harness renewable energy resources, such as solar, wind, hydropower and biomass. It focuses on green energy technology transfer, including the role of innovation, finance and policies. In a broad sense, technology encompasses the corporate capacity to operationalise, apply and make effective use of scientific and engineering knowledge in production (see Cantwell, 2009). It therefore includes 'the potentially public element of technology, encompassing codifiable items as presented in scientific publications and engineering blueprints and designs, and the tacit implicit element relating to firm-specific competence in production' (Pueyo and Linares, 2012: 7). Green energy technologies exhibit aspects of public goods (such as a reduction in GHG emissions) that the market cannot adequately provide. Since green energy technologies reduce harmful externalities in the form of GHG emissions and support the safeguarding of biodiversity, they warrant public support and domestic and international public finance.

This section discusses the sources of finance for green energy technology and the relevance of each for sustainable development, the link between finance and policies for green energy technologies and the future implications. Figure 6.12 summarises the main policy issues in this section.



Figure 6.12 | The role of policy for the mobilisation and effective use of finance for green energy technology



6.5.1 Financing green energy technology: different sources

Global finance

Globally, over \$1,600 bn was invested in energy in 2013, of which \$250 bn was dedicated to renewable resources (IEA, 2014). New investment in renewable energy, excluding large hydroelectric projects, fell by 14% in 2013 to \$214 bn (see Figure 6.13). This decline reflects the reduction in photovoltaic (PV) costs, and expectations that investors would make more commitments to green energy systems have not been met. Some observers in the financial sector have noted that solar technology may be competing with

conventional oil-fuelled technology in emerging economies, based on 'pure economics', i.e. without subsidies, demonstrating its increased commercial viability (Evans-Pritchard, 2014).

Despite a drop in 2012 and 2013, new global investment in renewable energy in current US dollars rose substantially in the last decade (Figure 6.13). In addition to the main macroeconomic factors behind this investment trend, such as global economic growth and the rising price of fossil fuels, there has been a policy response to popular demand for a cleaner environment. Furthermore, the reduced costs of green energy technologies have been spurred by low interest rates and R&D expenditure leading to further

49 HICs refer to OECD countries excluding Chile, Mexico and Turkey.

technological progress. For example, regarding solar panels the worldwide levelised cost of solar energy, which has fallen by 53% since 2009, means that while investment declined in dollar terms, installed generation capacity increased. This development was especially pronounced in HICs, which accounted for two thirds of investment in solar energy in 2013 (commissioned background paper, FS-UNEP, 2015; Figure 6.13).

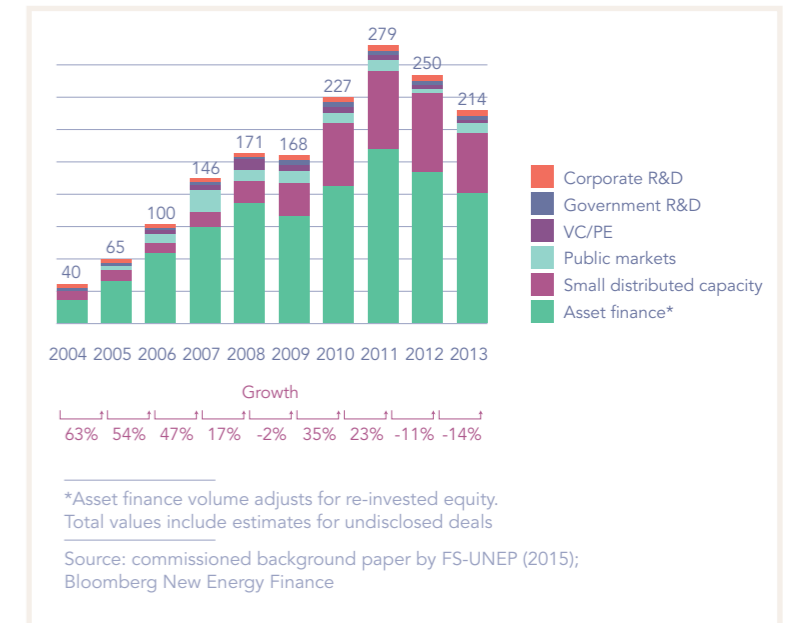
International private finance

The private sector is increasingly involved in financing green energy technologies. A promising medium-term signal is the turnaround of clean energy stocks, which rallied in 2013 following an almost five-year decline. An index of almost 100 renewable energy stocks gained 54% over the course of the year – indicating that many wind and solar manufacturers are returning to profitability (commissioned background paper, FS-UNEP, 2015). There are also promising signs that long-term institutional investors – commercial banks, pension funds, insurance companies and major corporations – are increasingly financing wind and solar projects. There is also an ongoing deepening of the climate-themed bond market, which has seen major growth of new issuances, growing by 12% in 2013 to \$95 bn. Of the more than \$500 bn in outstanding climate-themed bonds, about \$75 bn is dedicated to the low-carbon energy sector, with wind and solar accounting for 18% and 15% respectively (Climate Bonds Initiative, 2014). Despite the fall in investment in 2012 and 2013, evidence of strong demand from the first two quarters of 2014 suggests a broad upswing across sectors, markets and investment sources (see also commissioned background paper, FS-UNEP, 2015).

International public finance

In order to leverage funding to facilitate green technology transfer (GTT) to and in developing countries a range of opportunities should be explored. Bilateral ODA that stresses 'climate-compatible development' as set out

Figure 6.13 | Global new investment in renewable energy (\$ bn) by asset class, 2004–2013



in the UNFCCC and the Kyoto Protocol can be combined with Climate Innovation Centres (CICs). Renewable energy projects qualify for a plethora of multilateral financing sources (see Table 6.5 for an overview) ranging from regional infrastructure funds to UNFCCC adaptation programmes. While the amounts pledged and allocated to these facilities are substantial and in many instances not drawn, the capacity of absorbing the available funds, i.e. the extent to which project developments are capable of effectively and efficiently spending allocated means, is considered crucial. Complementing policies that shape appropriate incentive structures for setting up feasible business cases are decisive factors.

In addition to multilateral and global funding sources, networks of CICs in developing countries could coordinate GTT and capacity-building activities and complement short-term hardware financing by identifying appropriate national and international opportunities.



Table 6.5 | Sources of multilateral finance for renewable energy

Fund	ASEAN Infrastructure Fund (AIF)	Climate Technology Initiative (CTI) Private Financing Advisory Network (PFAN)	EIB Post-2012 Carbon Credit Fund	EIB-KfW Carbon Programme II	ClimDev-Africa Special Fund (CDSF)	Global Climate Partnership Fund	Global Energy Efficiency and Renewable Energy Fund (GEEREF)	MDB Clean Technology Fund (CTF)
Total Amount	\$485 mn in initial equity contribution	\$140 mn (2010 total investment)	Fund assets of € 125 mn	€100 mn	\$136 mn	\$200 mn	€108 mn	\$4.5 bn pledged by donors (Australia, France, Germany, Japan, Spain, Sweden, UK, USA)
Financing Mechanisms	Loan	Risk management Technical assistance	Carbon finance	Carbon finance	Co-financing Grant Other	Co-financing Loan ODA Risk management Technical assistance	Co-financing Equity Technical assistance	Co-financing Grant Loan ODA
Qualifying Projects	Adaptation Mitigation Technology Energy efficiency Infrastructures Renewable energy Transport Urban Waste management Water Water efficiency	Mitigation Energy Energy efficiency Fugitive methane Low-carbon Renewable energy Transport Urban	Mitigation Carbon Capture & Storage (CCS) Energy Energy efficiency Forestry Fuel switching Renewable energy Transport Sustainable land management	Mitigation Energy Energy efficiency Fuel Switching Fugitive Methane Low-Carbon Renewable Energy Transport Waste Management	Adaptation Capacity-building Mitigation Agriculture Climate-resilient Energy Forestry Low-carbon Natural resource management Population & Human Settlements Sustainable land management Water	Mitigation Energy Energy Efficiency Infrastructures Low-carbon Renewable energy	Mitigation Energy Energy efficiency Renewable energy	Mitigation Agriculture Energy Energy Efficiency Fuel Switching Industry Infrastructure Transport

Source: Compiled from climate-finance.org

MDB Scaling-Up Renewable Energy Program for Low-Income Countries (SREP)	MDB Forest Investment Program (FIP)	Multilateral Carbon Credit Fund (MCCF)	The Global Environment Facility (GEF)	The Multilateral Investment Fund (MIF) of the IDB Group	UN-REDD Programme (Reduced Emissions from Deforestation and Forest Degradation)	UNEP Renewable Energy Enterprise Development (REED)	UNFCCC Adaptation Fund
\$318 mn	\$578 mn (Australia, Denmark, Japan, Norway, Spain, UK, USA)	€208.5 mn (Project Fund = €150 mn, Green Fund = €58.5 mn)	To date, \$3 bn has been allocated for mitigation and enabling activities and \$400 mn for adaptation.	\$600 mn (approx. \$120 mn per year)	\$97 mn	Up to \$250,000 depending on the project	\$300-500 mn by end-2012
Co-financing Equity Grant Loan	Grant ODA	Carbon finance	Co-financing Grant	Equity Grant Loan Technical assistance	Grant Technical assistance	Equity Loan	Grant
Mitigation Energy Forestry Natural Resource Management Renewable Energy Sustainable Land management	Mitigation Climate-Resilient Forestry Low-Carbon Sustainable Land Management	Mitigation Energy Energy Efficiency Forestry Fuel Switching Fugitive Methane Renewable Energy Transport	Adaptation Capacity Building Mitigation Agriculture Climate-Resilient Energy Energy Efficiency Forestry Low-Carbon Renewable Energy Sustainable Land Management Transport Water	Adaptation Mitigation Agriculture Energy Energy Efficiency Forestry Renewable Energy	Capacity building Mitigation Forestry Natural resource management Sustainable land management	Mitigation Energy efficiency Infrastructure Low-carbon Renewable energy	Adaptation Agriculture Climate-resilient Coastal Zone Management Disaster Risk Reduction Energy Efficiency Fisheries Forestry Infrastructure Low-carbon Natural Resource Management Populations & Human Settlements Renewable energy Services Sustainable land management Transport



Pilot CICs are being developed in Ethiopia, India, Kenya and Vietnam, managed by the UK Department for International Development (DFID) and the InfoDev (Information for Development) trust fund under the World Bank Climate Technology Programme (InfoDev, n.d.). Other initiatives are being pursued under the UNFCCC Technology Mechanism and implemented by 'Nationally Designated Entities' that are members of a 'Climate Technology Center and Network' in a consortium led by the United Nations Environment Programme (UNEP) (AfDB, 2012).

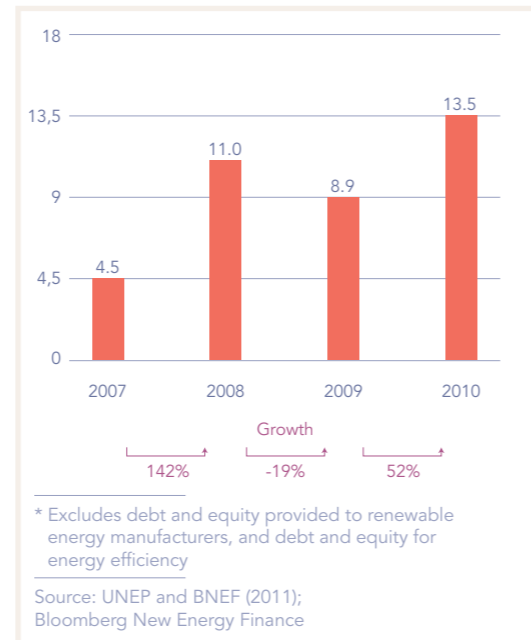
The provision of DFI and RDB finance for renewable energy and the diffusion of green energy technologies can complement domestic and international private sources. Backed by sovereign state guarantees, DFIs and RDBs can provide loans at maturities and on conditions that the private sector, subject to market conditions, cannot. The finance provided by DFIs can thus give 'additionality' to private investments (see discussion on Spratt and Ryan-Collins (2012) in the section on infrastructure). According to figures compiled by Bloomberg New Energy Finance, MDBs have kept up investments in renewable energy, even during the economic downturns following the global financial crises (see Figure 6.14).

National public finance (including support for R&D)

The Climate Policy Initiative found that 76% of climate finance originated in the same country in which it is spent, with 94% dedicated to climate mitigation or investment in green energy technology and energy efficiency. This highlights the importance of domestic public and private funding for green energy technologies, with the latter further relying on an appropriate domestic incentives and regulations to unlock private investment (CPI, 2013).

In terms of national financing, options to address the specific risks and uncertainties of GTT may

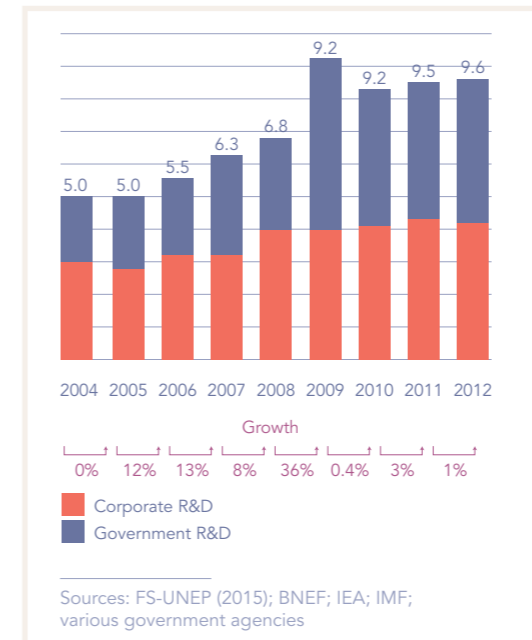
Figure 6.14 | Finance from development banks for renewable energy projects (\$ bn)



include rebates, long-term loan guarantees, R&D budgets and microfinance (see Section 6.5.2; AfDB 2012). GTT and innovation therefore rely on long-term R&D spending that fosters technological progress and innovation. The proportion of (general technology) R&D spending in relation to GDP varies considerably across different country groups and higher shares of R&D from foreign sources are associated with lower country income levels. While the share of R&D expenditure as a percentage of GDP amounts to approximately 2.3 in HICs, upper and lower middle income spend less than 1% of their GDP on general technology R&D (WDI, 2014; figures reflect data from 2011).

Innovation capacity has to be cultivated. Technological maturity varies across renewable energy technologies and includes technology venturing, commercial scale-up, and adaption as modes of innovation. Successive innovations reinforce each other over time and result in cost reductions and simultaneous deployment gains,

Figure 6.15 | R&D investment in renewable energy, 2004–2012 (\$ bn)



as has been the case for silicon PV modules. Spending on R&D is supported by domestic public and private (corporate) sources (see Figure 6.15) and supporting policies provide a key element for innovation, deployment of technologies and consequently GTT.

6.5.2 The role of policies and finance for green energy technology

Green energy technology projects usually require large-scale upfront investment and are typically characterised by higher capital intensity than fossil-fuel energy projects, but usually benefit from low and predictable operational costs. A change in the energy sector towards green-generation assets will thus increase both the capital intensity and the capital used in the sector. It is therefore imperative to take a long-term perspective on the development of the energy sector (see also commissioned background paper, FS-UNEP, 2015). Different policies, actors and sources of

capital are important for the promotion of green energy technologies (see Whitley and Tumushabe (2014) on the Ugandan energy sector).

In developing countries in particular, a key challenge in funding green energy technology stems from investment risks that affect the financing cost and the competitiveness of green technology. The aspect of risk can thus outweigh the problem of generating finance and be a major constraint on investment decisions. In response, a number of public de-risking measures have been suggested in an attempt to achieve a favourable risk/return profile that can attract private investors. These public de-risking instruments can be complemented by direct financial incentives, such as price incentives, tax breaks and carbon offsets.

All this suggests the need to examine the role of policies to mobilise and make effective use of finance for the diffusion of green energy technology.

Mobilising finance for green energy technology

Green energy technology policy

Complementary policies for mobilising and making effective use of national and international finance comprise (a) measures to stimulate demand for green innovation, i.e. demand-side policies, public procurement standards and regulations in specific markets, market-based instruments for pricing externalities and enhancing incentives; (b) regulatory reform and competition policy in order to remove barriers for new firms; (c) trade and investment policies for facilitating international (horizontal) GTT via economies of scale; (d) protection and enforcement of intellectual property rights (IPR); and (e) voluntary patent pools, innovation banks and collaborative mechanisms for GTT.

In this context, governments in developing countries have adopted many of the following regulatory policies, fiscal incentives and public



financing mechanisms to support and incentivise investment in renewable generation capacity and energy-efficiency projects (commissioned background paper, FS-UNEP, 2015):

(i) **Regulatory policies:** preferential feed-in tariffs (FITs), renewable portfolio standards, net metering, tradable renewable energy certificates, tendering procedures and heat and biofuel mandates.

(ii) **Fiscal incentives:** capital subsidies and rebates, investment and production tax credits

and reduction in sales, energy, CO₂, VAT and other taxes.

(iii) **Public financing mechanisms:** energy production payments and public investments, loans, guarantees and grants (REN21, 2014).

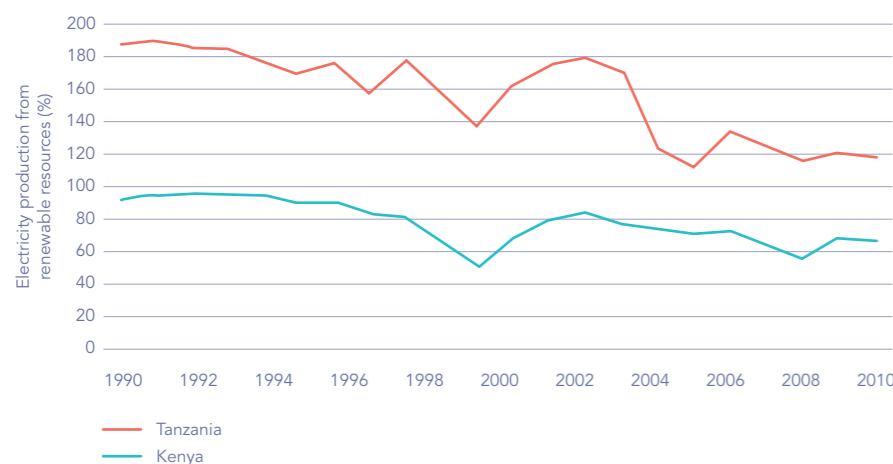
The importance of complementary regulatory policies for investment in green technology is shown in Box 6.18. Even when there is considerable interest in financing a green energy project, its implementation depends on the adoption of appropriate regulatory policies.

Box 6.18 | The role of finance and policies in the diffusion of renewable energy technology in Kenya and Tanzania

The shift to a green energy system is crucial to sustainable development. The figure below shows the proportion of energy from renewable energy sources in Kenya and Tanzania from 1990 to 2011. In 2012, Kenya's electricity-generation mix was mainly composed of hydro (761 MW) and fossil-based sources (525 MW + 120 MW of diesel-based emergency power capacity + 17MW of diesel-based isolated grid), but includes 198 MW of geothermal, 5.45 MW of wind and 26 MW from biomass in co-generation plants. To meet the 5% annual growth in electricity demand, a plant expansion will add 1,248 MW. In Tanzania, 55% of energy demand is met by the state-owned Tanzania Electric Supply Company Limited (TANESCO) and the remainder by independent power producers (IPPs) and imports from Uganda and Zambia. The absolute level of renewable energy production has been rising and making a far greater contribution to electricity generation (WDI, 2014). Despite this, the share of energy use from renewables is declining due to the more rapid development of generation assets based on fossil fuels (WDI, 2014).

Economic development in Kenya and Tanzania is hampered by the low level of access to modern energy, and a heavy reliance on traditional biomass. Frequent power outages and reliance on hydroelectricity are generating the drive to diversify energy sources (Kimuyu et al., 2011; CI by Lunogelo et al., 2015).

Figure 6.18B | Total energy use (percentage) from renewable energy sources



Source: Authors' illustration, based on data from WDI (2014)

Africa as a whole has achieved the largest percentage increase in investment in renewable energy among developing countries, excluding Brazil, China and India, except for the 2012–2013 period, when investment to the Middle East and Africa declined by 14% (Kimuyu et al., 2011; BNEF, 2014c). Financing for renewable energy technologies has come from sources including governments, donors, the private sector, PPPs and individual households. Kenya has seen sharp increases in asset finance (for utility-scale projects such as wind farms), venture capital for young firms, and equity-raising on the public markets by renewable energy companies, while the private sector invests mainly from corporate savings and loans (Kimuyu et al., 2011). Total annual investment in renewable energy has risen from \$190 mn in 2007/08 to \$740 mn in 2011/12, as well as significant increases in government-funded R&D, which reached \$1.3 bn in 2010 (Kimuyu et al., 2011). The Tanzanian government has attached high importance to the need to diversify the mobilisation of finance. Sources include private-sector debt and equity, DFIs and domestic public investment (CI, Lunogelo et al., 2015).

There are several examples of public–private finance instruments in renewable-energy projects in Tanzania and Kenya. In Kenya, the EIB recently announced an investment of €200 mn in a €620 mn wind-power project in Lake Turkana, including an additional €25 mn from grant sources (preferred equity share), €110 mn from the AfDB, and loans and equity of €288 mn from European DFIs (ERD meeting, 3 June 2014, Athens). The Olkaria III geothermal plant was developed by OrPower 4 geothermal (a subsidiary of ORMAT International) in response to a government tender, with full refinancing during the expansion phases (from 13 MW to 48 MW capacity) to include various European DFIs (Dalberg, 2012). The initial equity investment by ORMAT International of \$61.4 mn for phase I was increased by DFIs' contribution of \$121.2 mn – including almost equal contributions from the European DFIs, Deutsche Investitions-und Entwicklungsgesellschaft, KfW Banking Group, PROPARCO, FMO Dutch development bank and the Emerging Africa Infrastructure Fund (Dalberg, 2012).

Various public and private institutions have committed to financing a \$536.8 mn 100 MW geothermal project in Tanzania, including a CIF grant (\$25 mn), the Tanzanian government (\$1.5 mn), and loans from the AfDB (\$45 mn), commercial banks (\$317.5 mn), other development partners (\$5.3 mn) and private-sector commitments (\$142.5 mn) (CIF, n.d.). Private-sector investors are at an advanced stage in mobilising the financial resources required for a 100 MW Makambako wind farm in Tanzania (CI, Lunogelo et al., 2015). Initial phases were self-funded, but following feasibility demonstrations they received further finance from Chinese and Norwegian firms and the Norwegian Agency for Development Cooperation (NORAD), with further project development and financing in the pipeline (ERD meeting, 9 May 2014, Dar es Salaam). Implementation now hinges on the regulatory framework. A smaller-scale venture in Tanzania, the \$29 mn 10 MW Mapenbasi hydropower plant, also has blended public and private finance. The private company (a Special Purpose Vehicle of Njombe Resources Development Company) financed the project with a debt-equity structure including investments from British and Sri Lankan companies and the Government of Tanzania (ERD meeting, 9 May 2014, Dar es Salaam).

Kenya and Tanzania have also adopted complementary policies to promote investment in their domestic renewable-energy sectors. Incentives in Kenya include zero-tax-rated solar panels, also exempt from excise tax, and investment allowances for larger firms for entire construction periods (Kimuyu et al., 2011). A stable investment environment has also been promoted through guarantees on price and market share for the generation of renewable energy, while companies can obtain tradable certificates in markets and bid competitively for renewable-energy concessions (Kimuyu et al., 2011). Such policy support contributed to Kenya's having one of the most active renewable-energy markets in SSA, and, although far behind, the second largest investor after South Africa (commissioned background paper, FS-UNEP, 2015). Kenyan government energy agencies have been decentralised and split up into agencies for exploration, generation and distribution. According to some experts, the lack of a similar process in Tanzania to decentralise generation, transmission and distribution has added to bureaucratic delays and acted as a bottleneck for the development of renewable energy (ERD meeting, 9 May 2014, Dar es Salaam). Establishing similar incentives in Tanzania, including guarantees on market prices and shares, could help to encourage private-sector participation in its renewable-energy sector (ERD meeting, 9 May 2014, Dar es Salaam). The Tanzanian government has adopted policies to promote rural access and connection, and encourage private-sector participation, including the PPPs Policy 2009, and is also developing a renewable energy FIT programme and energy-subsidy policy (ERD meeting, 9 May 2014, Dar es Salaam). These will help to overcoming the non-financial barriers for investment and unlock private and other finance for a shift to green energy in Tanzania.

Sources: as cited



Public de-risking instruments are vital in overcoming investment risks and attracting private investment in green energy technologies. These instruments can be broadly divided into two categories (UNDP, 2013):

- a. **Policy de-risking instruments** that aim to remove the fundamental causes of risks. These instruments comprise support for policy design for renewable energy, institutional capacity-building, resource assessments, grid connection and management, and skills development for local operations and maintenance. These can act as supporting policies for mobilising and effectively using finance for green energy technology transfer.
- b. **Financial de-risking instruments** that aim to transfer investors' risk to public actors. These instruments may include loan guarantees, political risk insurance (PRI) and public equity co-investments.

Public de-risking instruments can also be complemented by direct financial incentives, for instance through price premiums, tax breaks and carbon offsets. Options to account for the specific GTT risks and uncertainties may include (AfDB 2012):

- ▶ Rebates for investments in green energy technology as part of subsidies for project development. Capital investments could be supported by using international grants to leverage finance. Involving MDBs and the SREP could be a means to overcome cost barriers, in particular for vertical GTT, as could financing schemes initiated by multilateral agencies, such as the GEF (CIF, n.d.; GEF, n.d.).

- ▶ Long-term, low-interest loan guarantees.
- ▶ R&D budgets.
- ▶ Context-specific micro-finance and hire-purchase facilities to assist farmers, households and communities to pursue green energy technology initiatives.

Many developing countries emphasise attaining the dual goals of energy access and sustainability, recognising the difficulties and costs of expanding grid connections to rural areas and focusing on support for distributed renewable energy at household and mini-grid levels. Governments have employed a variety of incentives, including capital subsidies, pre-paid metering allowances, grants to cover upfront costs, concessional loans and preferential tax treatment. Such policies have supported a proliferation of domestic solar systems in Indonesia and more than 9,000 biogas units in Kenya. While such initiatives were previously exclusively within the purview of the public sector and international development agencies, in recent years the private sector has recognised the business opportunities and many companies are participating in innovative PPPs by financing distributed assets (GEF, n.d.).

Box 6.19 presents a macroeconomic perspective on a country's energy-generation system, but household energy practices can have dramatic consequences for health, the environment and socioeconomic development. Box 6.20 discusses the findings of a systematic review of the uptake of cleaner and more efficient household energy technologies worldwide. The review stresses the importance of interactions among a range of factors, and which factors beyond finance are key for technology adoption. This offers valuable insights into complementary policies.

Box 6.19 | Policies for mobilising green energy technology finance: examples from Indonesia, Kenya and Tanzania

Indonesia, Kenya and Tanzania have adopted policies on renewable energy, with mixed degrees of success in attracting financing to new projects (commissioned background paper, FS-UNEP, 2015). Table 6.19B provides an overview of the measures these countries have applied in terms of regulatory policies, fiscal incentives and public financing.⁵¹

The government of Indonesia has set renewable energy generation targets for 2025: renewables should account for 15% of generation, with 13 GW of capacity composed of 9.5 GW of geothermal, 970 MW of wind and 870 MW of solar energy. By the end of 2013, Indonesia's overall renewable generation capacity was estimated to be 3.3 GW. Biomass and small hydro are also expected to play an important role in achieving the overall target. In order to offer more incentives for investments in energy generation from renewable sources, Indonesia has adopted a 20-year FIT of \$0.1-0.185/kilowatt hour (kWh) for geothermal projects, and FITs of \$0.14-0.18/kWh for biomass and \$0.07-0.16/kWh for other renewables, with a generation cap of 10 MW. Geothermal project developers also benefit from off-taker guarantees, an early-stage exploration/development fund, tax rebates, accelerated depreciation and exemption from VAT on imports. For energy generation from solar sources, the government established a tendering programme in 2013 in which the utility will gain \$0.25/kWh maximum, with a small top-up for projects with 40% local content. Finally, the government supports renewable projects by providing a viability guarantee for the utility (BNEF, 2014a). The consequence of this policy support has been that new investments in small hydro, biofuels and geothermal generation assets have dominated the overall mix since 2010, particularly the latter. This clearly matches the government's policy to accelerate geothermal development, as the country has 40% of the world's estimated geothermal resources (BNEF, 2014a). In 2012 and 2013, Indonesia saw \$221 mn and \$380 mn committed to its renewable generation sectors.

Much like Indonesia, Kenya has ambitious renewable energy targets, aspiring in the Least-Cost Power Development Plan 2011–31 to achieve almost 20 GW capacity by 2030, with renewables accounting for 51%.⁵² To provide incentives for developers, the country adopted a twice-revised FIT, which provides preferential revenues, differentiated by technology, for 20 years. Currently, technologies include wind, hydro, biomass, solar PV and geothermal, with differentiated rates for projects above and below 10 MW. The government has extended VAT and import-duty exemptions for renewable generation and geothermal exploration projects, and the latest draft of the country's Energy Bill proposes a net-metering system for owners of generation assets under 20 kW (BNEF, 2014b). It has also introduced standardised power purchase agreement (PPA) templates, and guaranteed priority purchase, transmission and distribution of electricity generated by renewable sources of less than 10 MW (the terms for larger generation assets are negotiated as part of the PPA) (Kenya Ministry of Energy (2012).

The country relies on renewable generation for a large portion of its capacity, approximately 65% in 2011 (REPP, 2012). While hydropower is by far the largest generation source, solar, wind and geothermal generation assets are being developed (see commissioned background paper, FS-UNEP, 2015 for detailed data). Such rapidly expanding generation capacity bodes well for Kenya's plan to greatly increase its overall electricity capacity by 2016, with 794 MW of hydro, 1,887 MW of geothermal, 635 MW of wind and 423 MW of solar PV (REN21, 2014).

Unlike Indonesia and Kenya, until recently, Tanzania had no specific targets for renewable energy generation in terms of capacity (MW) or proportion (percentage) (Heinrich Böll Foundation, 2013). In 2009, the Electricity Act opened the power sector to private-sector participation and IPPs. The government has introduced non-technology-specific FITs based on an avoided cost principle and payable over 15 years. However, in practice the standard PPA is infrequently used and IPPs negotiate rates with the utility. The government has also exempted imports of renewable energy from customs duties, which has dramatically reduced the cost of solar panels. These policies notwithstanding, few projects have materialised because the FITs are set too low – being based on the generating costs of 100 kW–10 MW small hydro plants – and the national utility is financially strained and cannot guarantee timely payment to IPPs. Payments are denominated in Tanzanian shillings, exposing international developers to currency risk. Recently the government has stated its openness to a differentiated tariff structure and the utility has undergone management changes and posted surpluses, both positive steps for attracting more activity in the country's renewable sector.

The result is that in Tanzania, renewable generation was only 30 MW in 2013, with another 60 MW commissioned. The overall annual expenditure relevant to climate change was \$383 mn from 2009 to 2012, or approximately 5.5% of the national budget (ODI, 2014).

⁵¹ Table 2 in the Renewables 2014 Global Status Report provides a comprehensive overview of the targets, policies, incentives and financing mechanisms the three countries had adopted by 2014 (REN21, 2014). The only revision among the three countries was in Indonesia, where the government recently expanded its FIT regime to include solar PV projects with a 40% local content requirement.

⁵² Of this, geothermal should account for 5.1 GW, wind for 2 GW and large and small hydro for 1 GW (the country's total renewable generation capacity was approximately 400 MW in 2013).

⁵⁰ Kenya's investment volume of \$249 mn in 2013 was only about 5% of South Africa's \$4.9 bn in the same year. Investment was up from 2012, but far below the country's peak of \$1.7 bn in 2010. ⁵⁰



Table 6.19B | Regulatory policies, fiscal incentives and public financing in Indonesia, Kenya and Tanzania

COUNTRY	RE TARGETS	FIT/PREMIUM PAYMENT	RPS	TENDERING	HEAT MANDATE	BIOFUELS MANDATE	CAPITAL SUBSIDIES	INVESTMENT/ PRODUCTION TAX CREDITS	TAX REDUCTIONS	ENERGY PRODUCTION PAYMENT	PUBLIC INVESTMENT, LOANS OR GRANTS
Indonesia	X	X	X	X		X	X	X	X		X
Kenya	X	X		X	X				X	X	X
Tanzania		X					X		X		

Source: REN21 (2014)

Box 6.20 | Factors influencing the uptake of improved solid cooking stoves and clean fuels

Worldwide, almost 3 billion people rely on biomass fuels and coal burnt inefficiently on open fires or basic cooking stoves. Ensuring access to clean and efficient household energy is consequently a challenging policy area and relies on favourable conditions across multiple domains. Reviewing the factors for policies and programmes that succeeded in improving solid fuel stoves and/or clean fuels, Puzollo et al. (2013) provide a systematic overview of the main factors for success. This provides valuable lessons for the adoption of green energy technologies.

The review distinguishes between short-term adoption and longer-term sustained use and provides a framework of seven sets of factors that influence large-scale uptake of improved cooking stoves (ICS) and clean fuels such as liquefied petroleum (LPG), biogas, solar cookers and alcohol fuels: (1) fuel and technology characteristics; (2) household and contextual characteristics; (3) knowledge and perceptions; (4) financial, tax and subsidy aspects; (5) market development; (6) regulation, legislation and standards; and (7) programme and policy mechanisms.

The paper reviews 57 qualitative and quantitative studies from a broad range of settings. It summarises the critical factors for the adoption of ICS, of which finance is only one of several:

- Meeting users' needs, particularly for cooking main dishes and being able to use large enough pots
- Providing valued savings on fuel
- Offering products of a quality that meet users' expectations and are durable
- Guaranteeing support (e.g. loans) for businesses producing and promoting ICS
- Providing financial assistance for equitable access and/or for more expensive ICS
- Having success with early adopters, in particular opinion formers
- Ensuring initial support for users, and for maintenance, repair and replacements
- Developing an efficient and reliable network of suppliers/retailers

The authors also review 44 qualitative and quantitative studies from a wide variety of settings on the adoption of cleaner fuels (e.g. solar cookers). A number of key factors are:

- **Biogas:** Production and use is constrained by a set of conditions, including adequate head of livestock and suitable farming practices, water supply, climate (the technology does not function in low temperatures without costly enhancements) and labour to manage the digester. Biogas systems are expensive to install and substantial financial support seems the norm. Maintenance and repair services are also needed, which require finance.

- **Solar:** Production and marketing of low-cost, high-quality cookers has been constrained by a piecemeal and poorly coordinated strategy.
- **LPG:** Issues of safety (and associated regulation) and production versus imports, volatile oil prices, subsidy, demand and distribution/availability are critical determinants of the use of LPG that require strong policy and management.
- **Ethanol:** Use of land for biofuels competes with agricultural production and excise (pricing) issues arising from the need to separate its use as a fuel from the legal and illegal alcohol markets present challenges, and should be priorities for strong and consistent policy.

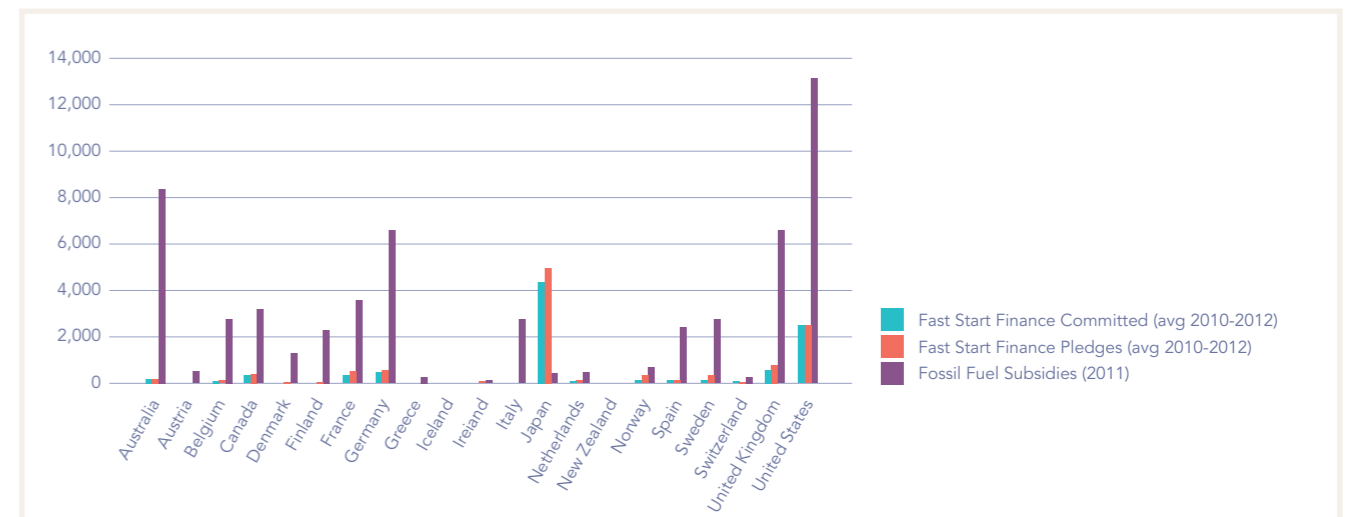
The findings suggest that these factors are mutually reinforcing. None is sufficient on its own, although in order to ensure adoption and sustained use, factors such as meeting household needs, fuel savings, higher income levels, effective financing and supporting government action seem critical.

Reform of fossil-fuel subsidies and carbon taxes

The effects of removing fossil-fuel subsidies will in general be transmitted via pricing and the public budget. In relation to the latter, Figure 6.16 illustrates the relative dominance of fossil-fuel subsidies in comparison with commitments on climate finance and pledges in UNFCCC Annex 2 countries. It highlights the potential to free up resources by removing these subsidies. The CI on Indonesia makes the point clear. The energy subsidy represented 24% of the public budget

in 2013. The CI argues that these subsidies are an inefficient use of resources, which need to be gradually removed, with the savings allocated to social assistance and the development of renewable energy (CI, Damuri et al., 2015). By the end of 2014 the Indonesian government has removed a large part of the fuel subsidies, seizing the opportunity given by low world market prices for oil. As a result, from 2015 it has gained considerable additional fiscal space for social assistance as well as for infrastructure investments, including investments in renewable energy.

Figure 6.16 | Fossil-fuel subsidies vs. Fast Start Climate Finance in (UNFCCC) Annex 2 countries (in \$ mn)



Source: Oil Change International (2013)



The removal of fossil-fuel subsidies and the introduction of a general carbon tax will send appropriate price signals (i.e. incorporating environmental damage in the price of using energy), mobilise more investment in R&D and offer greater incentives for investment in renewable energy. A price on carbon, for example, will also help to reduce the need to find additional investment in green energy, indicating investment towards green energy and away from fossil-fuel-intensive energy. Further, according to the IEA (2010) the world spends \$557 bn a year on subsidies for fossil fuels compared to \$33 bn for low-carbon sources of energy (Stern, 2006), including biofuels and nuclear power.

The economic consequences of energy subsidies in general and on fossil fuels in particular can be far-reaching. While they are often aimed at protecting consumers by providing energy security, fossil-fuel subsidies can hamper GTT. Moreover, energy subsidies can help to aggravate fiscal imbalances, depress private investment and promote capital-intensive industries and at the same time reduce incentives for renewable energy. Furthermore, since wealthier households tend to benefit most from subsidies, these might in fact reinforce inequality (IMF, 2013) and hinder social development. In most regions, energy subsidies are pervasive and ossify undesirable structures in the energy market. Removing fossil-fuel subsidies could therefore lead to greater incentives for private investment in R&D for green energy technologies and act as a policy for leveraging finance for GTT.

Establishing appropriate pricing for energy use depends upon considerable information, innovative approaches, good communication, coordination, coalition-building and leadership. It is related to social development since higher prices further disadvantage the poor, who already lack access to water, energy and land, while efficient pricing can have strong distributional consequences, which have hampered previous attempts at reform (e.g. in India and Nigeria). Thus

subsidy reform needs to be carefully managed and communicated, and be accompanied by measures to protect the poorest and address affordability issues (ERD 2011/12).

DFIs and specialised funds for mobilising finance for green energy technologies

As stated earlier, DFIs can provide loans at maturities and on conditions that the private sector (subject to market conditions) cannot, and so can finance projects that private-sector investors would deem too risky. This can leverage additional finance by reducing a project's risk profile. Furthermore, DFIs can back other private-sector investors to increase their engagement in renewable energy projects.

Given the generally higher upfront costs and perceived commercial risks that are associated with large-scale projects in developing countries, there is a major role for DFIs in the area of green energy technologies. In addition to leveraging the necessary finance, DFIs' involvement in the green energy sector leads to scaling up R&D and the application of green energy technologies and hence to reducing their cost. In the context of finance for green energy, which is segmented in terms of the type of debtor and the size of projects, DFI involvement is crucial since traditional financial instruments are not applicable and are in any case limited in the commercial financial markets of developing countries.

DFI involvement can thus be an effective means to support green energy technologies given both the supply-side characteristics and constraints for these technologies as well as demand characteristics, such as the reluctance of power grid operators in developing countries to deal with decentralised energy-provision units and the low demand from investors due to high initial costs (KfW, 2005). DFI loans if a project faces a funding gap or a commercial lender is unwilling to bear the entire project risk can therefore significantly improve project implementation (UNEP, 2009).

DFIs need to have comprehensive and clear low-carbon development strategies and to coordinate policies with the relevant national and international stakeholders. By developing technical support based on an analysis of needs and capacities in developing countries, and helping investors, commercial banks and users to absorb financing, they can play a more catalytic role.

Based on a comprehensive analysis of multilateral climate funds, and the information these funds provide on targeted volumes and proposed financial structure, it is possible to gauge the engagement of the private sector via private finance interventions (PFIs). Averaged across all PFIs mobilised by the Clean Technology Fund (CTF), the Global Environmental Facility (GEF), the Scaling Up Renewable Energy Programme for Low-Income Countries (SREP), the Global Energy Efficiency and Renewable Energy Fund (GEEREF) and the Pilot Programme for Climate Resilience (PPCR), Whitley et al. (2014) find that every dollar of public finance aims to mobilise 80 cents in private finance. PFIs that aim for significant levels of private investment take place in wealthier countries (BRICS, OECD and EU accession countries) and are primarily to support established green technologies and energy-efficiency projects. It is too early to evaluate whether the intended mobilisation has been achieved.

Financial institutions can be geared towards promoting sustainable development financing. For example, DFI finance for small-scale hydropower could have positive social and economic impacts. Scott et al. (2013) provide an example of how transforming the national energy system towards renewable sources can improve a country's general employment perspectives. Although employment growth can be achieved by suitable investments in green energy technologies, the promotion of renewable energy can lead to a substitution effect due to potential job losses in the fossil-based energy industry. The effect can be outweighed by additional jobs created in sectors concerned with energy efficiency and in the manufacturing

industry for green energy technologies. Assessing the net direct, indirect and induced employment effects of the Bugoye Hydro Power Project, a 13 MW run-of-river hydro plant in western Uganda, based on a methodology developed by the IFC, Scott et al. (2013) document a total increase of about 1,270 jobs during the construction and operation phases and between 8,434 and 10,256 permanent jobs created by investment in more and better power supply. The project thus demonstrates that investment in green energy infrastructure can have substantial linkages with social and economic dimensions and lead to positive outcomes in all three.

Policies for effective use of finance for green energy technology

Financial-sector development

Beyond the specific policy instruments to de-risk and expand investment in green energy technologies, policies aimed more generally at developing the domestic financial market will help to mobilise private investment (domestic and international), including in green energy technologies, and make finance in green technology more efficient, such as by adhering to environmental standards. The development of financial markets in ways that promote sustainable development requires a shift in financial rules and the ways in which financial institutions operate, because incentives and disincentives are not currently geared towards long-term sustainable development financing. Rather, the financial sector is characterised by short-term investment with high rates of return and investment decisions that undervalue natural capital. This is particularly the case in LICs. There is a need to change regulations in the financial sector in order to promote the financing of green technologies and biodiversity conservation. Efforts to green the financial sector would probably create synergies with economic and social development. For example, domestic policies to promote a robust domestic financial sector would improve access



ENABLER: GREEN ENERGY TECHNOLOGY

Green technology transfer

Economic development is hampered by lack of access to energy. The shift to green energy is crucial for sustainable development.

Significant upfront investment

Policies that provide financing schemes and opportunities

THE TRANSFER OF GREEN ENERGY TECHNOLOGY REQUIRES:

Risk-mitigation mechanisms

Policy initiatives that facilitate implementation

FINANCING

Reform fossil-fuel subsidies and carbon taxes

Fossil-fuel subsidies are still much larger than commitments in climate finance and pledges in UNFCCC.



In Indonesia the energy subsidy represented 24% of the public budget in 2013, but a substantial reduction in the subsidy has now created funding for social assistance and infrastructure investments including renewable energy.

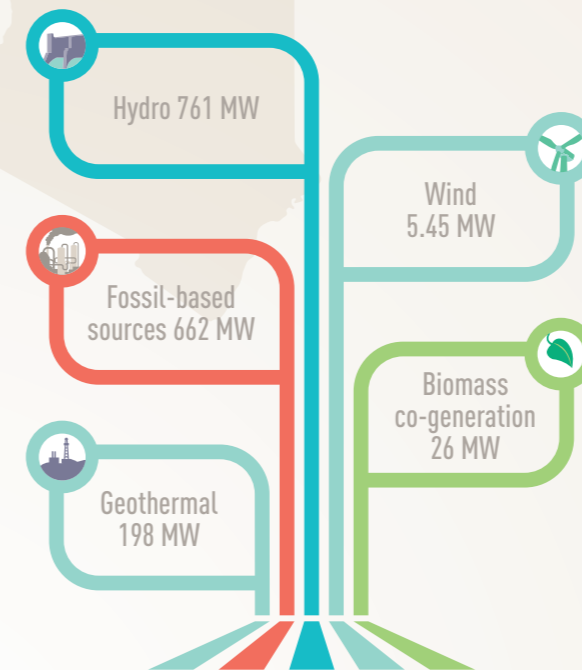
Africa has achieved the largest percentage increase in investment in renewable energy among developing countries (excluding Brazil, China and India). Total investment on the continent rose from \$750 million to \$3.6 billion.



GOVERNMENTS
PRIVATE SECTOR
DONORS
PPPs
INDIVIDUAL
HOUSEHOLDS

Kenya and Tanzania – a tale of two countries

KENYA Investment in renewable energy has risen from \$190 mn in 2007/08 to \$740 mn in 2011/12 and more than \$1.3 bn now.

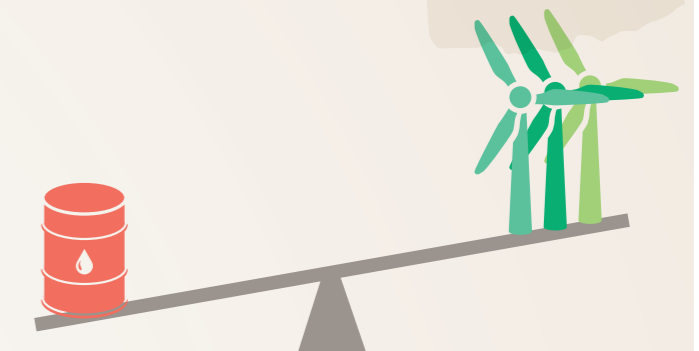


Public-private finance instruments in renewable-energy projects are important.

- ▶ A €620 mn wind-power project in Lake Turkana includes an investment of €200 mn by the **EIB**
- ▶ The Olkaria III geothermal plant includes investments from **various European DFIs**



TANZANIA: The absolute level of renewable energy production has been rising, but the share is declining due to more rapid development of fossil-fuel generation



Public-private finance instruments in renewable-energy projects are important.

- ▶ The **private-sector** is investing in the 100 MW Makambako wind farm
- ▶ Investment in a \$536.8 mn 100 MW geothermal project includes a **CIF** grant (\$25 mn), loans from the **AfDB** (\$45 mn), **commercial banks** (\$317.5 mn) and **private-sector** commitments (\$142.5 mn)



Public incentives

Both countries have adopted policies to promote renewable-energy investment. In Kenya these include:

- ▶ zero-tax-rated solar panels exempt from excise tax with investment allowances for larger firms for the entire construction period
- ▶ a stable investment environment for renewable energy with guarantees on price and market share



for smaller investors, which would in turn boost the role of SMEs in the economy and increase investment in green technologies by promoting new actors' access to the market.

A shift in incentives and disincentives in the financial sector needs to be based on domestic and international policy shifts towards promoting sustainable development. Creating an international enabling environment for such financing, as part of a global partnership for development, will be essential in order for countries to gear the domestic financial sector towards sustainable development. For example, TNCs do not necessarily comply with social and environmental regulations in their overseas operations, and need to be adequately monitored. TNCs could, however, contribute to conserving biodiversity and act as a GTT channel. In addition, Basel III rules penalise lending to riskier actors, which include poorer developing countries with undeveloped capital markets and thus reduce the funding available to them for green energy, and development more broadly.

The UNEP Finance Initiative (2011) recommendations on how to promote social and environmental responsibility in financial institutions towards sustainable development financing, include the following:

- ▶ Governments must show leadership in establishing long-term priorities, with an appropriate framework of cost-efficient regulations and economic instruments.
- ▶ Financial institutions' interactions with other economic sectors and consumers (through financing, investment and trading activities) should exercise responsibility towards sustainable development, i.e. good corporate citizenship and sound business practices.
- ▶ Sustainability management requires a precautionary approach to environmental and social issues, and impacts on the environment

and society should be appropriately accounted for in risk assessments.

- ▶ Financial institutions must comply with local, national and international regulations on environmental and social issues, and integrate such considerations into operations and business decisions in all markets.
- ▶ Financial institutions should adopt best practices in environmental management, including energy and water efficiency, and form business relations with customers, partners, suppliers and contractors that follow similarly high environmental standards. This calls for efforts to keep abreast of best practices in sustainability management.
- ▶ The financial services sector needs to adapt and develop products and services that promote the principles of sustainable development.
- ▶ Financial institutions should conduct regular internal reviews and measure progress against sustainability goals, publishing their sustainability policy and periodically reporting on the steps they have taken to incorporate environmental and social considerations into their core business.
- ▶ Financial institutions should share information with consumers, as appropriate, to strengthen their own capacity to reduce environmental and social risk and promote sustainable development.
- ▶ Openness and dialogue on sustainability issues need to be fostered with shareholders, employees, customers, regulators, policy-makers and the general public.

The UNEP Finance Initiative approach therefore encourages relationships and the sharing of information among governments, business and society at large, to ensure that they are all

committed to achieving sustainable development. A key role is highlighted for domestic and international policy-makers in providing leadership and creating an enabling environment for sustainable development financing. Measuring the impact of financial institutions in the areas of social and environmental governance will also be essential in order to promote sound practices, and social and environmental awareness would further contribute to the sustainability of financial operations (e.g. factoring in the impacts of climate change on capital assets).

6.5.3 Conclusions and implications of finance for green energy technologies

The focus of the domestic agenda on economic growth and employment creation is evident from the commissioned CIs. The environmental dimension is not yet at the centre of the political agenda in most developing countries, although environmental sustainability has been recognised as an important GPG and environmental issues are prominent in the discussions on the SDGs.

This section has focused on the diffusion of green energy technologies for sustainable energy. The transfer of green energy technology to developing countries is still at an early stage and requires a degree of upfront investments and risk-mitigation mechanisms to provide incentives for their application and commercialisation. Similar to the financing of infrastructure in general, the right mix of public financing (through ODA, special funds and RDBs) is still not properly adapted to needs, particularly in the case of LICs. Apart from the established North–South GTT flows, South–South flows of exports of solar technology from China as well as South–North exports from India and China are gaining importance.

The distinctive features of GTT require both policy initiatives and interventions that facilitate the transfer and deployment of green energy technologies and the provision of financing schemes and opportunities. A simple regulatory

issue can halt a green energy project, while support for early adopters can establish a virtuous circle. Leveraging funding to facilitate GTT is still at the pilot stage, and several new international facilities are being established. It is widely acknowledged that funding has to be complemented with support for technology transfer and adaptation, e.g. by CICs, which are being trialled in several countries. This has to be reinforced by a range of complementary policies on the demand and supply sides that are key for mobilising and effectively using finance and to creating markets of sufficient size for the commercialisation of green energy technologies. The continuation of fossil-fuel subsidies hampers investment in renewable energy, both because the subsidies provide the wrong price incentives and because their removal could free up substantial financial resources.

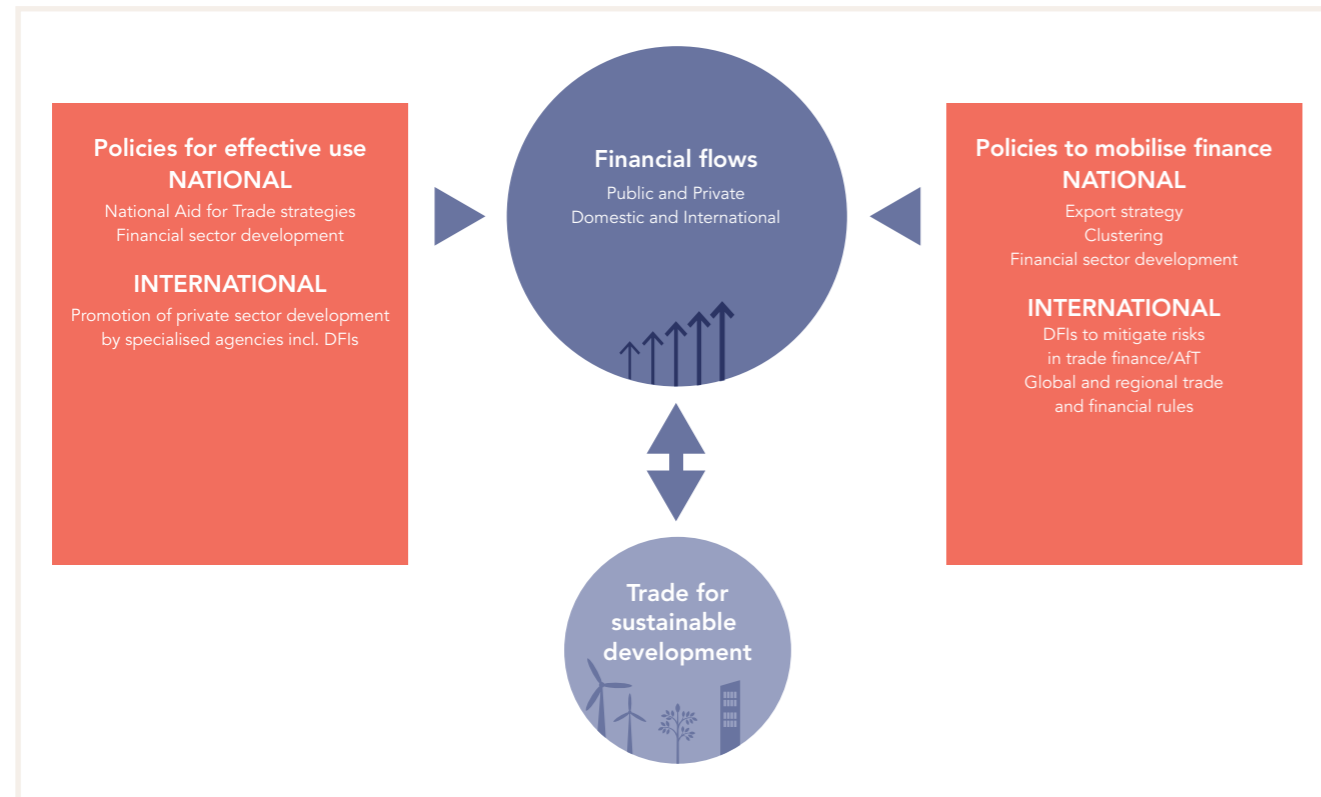
6.6 The role of finance and policies for trade

Trade is an important enabler of sustainable development. Developing backward and forward linkages between producers and consumers, and the creation of trade and value chains across firms, have reduced costs, improved productivity and increased competitiveness (AfDB, 2014). The means to promote trade depends on the country's stage of development and may include all or some of the following: investments in transport or basic energy, water and sanitation systems, telephone and ICT connectivity, incentives for horizontal and vertical linkages across local firms, the formation of business clusters, an open trade regime, regional integration schemes, integration in global supply and value chains and/or international PPPs. Box 6.21 shows how Mauritius has benefited from trade and the importance of policies and finance in this success.

Limited or lack of access to finance, including trade finance, appears to hamper private-sector development and structural change in many developing countries.



Figure 6.17 | The role of policy for mobilisation and effective use of finance for trade



This section discusses the sources of trade finance, the link between finance and policies for developing trade and draws conclusions and policy implications. Figure 6.17 summarises the main policy issues discussed in this section.

6.6.1 Financing trade: different sources and effects

Traders in LICs find it very difficult to obtain affordable finance for international transactions (Auboin and Engemann, 2012). Adequate trade finance is an essential ingredient in sustaining trade flows in periods of economic volatility and downturn. It offers the liquidity required to expand trade in periods of growth, and is particularly crucial in supporting SMEs in the tradable goods and services sectors in the poorest, smallest and most vulnerable countries (Hou and te Velde, 2013).

There is a large gap in trade finance. In developing economies, there exist an estimated 360 million to 440 million formal and informal microenterprises and SMEs, about half of which have little or no access to finance. Some 24% of firms in SSA and 17% in all developing countries cite access to finance as the biggest obstacle to doing business while 43% in SSA and 31% in all developing countries cite it as a major constraint (IFC, 2014). The value of the gap in credit financing for informal and formal microenterprises and SMEs in developing economies is estimated at between \$2.1 tr and \$2.6 tr. For trade finance in particular, an ADB (2013a) survey found an unmet global demand of the order of \$1.6 tr and in developing countries across Asia of around \$425 bn.

Box 6.21 | The enabling role of trade in Mauritius

Despite being a vulnerable, small island based on a monoculture economy characterised by high unemployment, low education and the absence of natural resources, Mauritius has undergone rapid economic development since independence in 1968. By 2013, it had moved from being an economy based on sugar (which provided 90% of total exports and agriculture represented 25% of GDP) to become a diversified, service-oriented economy, with agriculture accounting for 3.5% of GDP. After breaking its dependence on sugar (1970–1979), it developed an export-oriented textile and garment sector (1980–1992), a flourishing tourism industry and dynamic financial and business services (1990–2012) that enabled it to become a regional business and financial platform. Per capita GDP in constant 2005 prices rose from \$200 in 1968 to over \$7,700 today (World Bank, 2014). By 1990, most jobs were in the manufacturing sector and the unemployment rate was less than 2%. As agriculture’s contribution to GDP declined, the share of manufacturing GDP doubled between 1970 and 1998.

The structural transformation in Mauritius can be largely attributed to its export-oriented industrialisation strategy, facilitated by (a) the strategic outward-oriented vision pursued by its political leaders; (b) inclusive institutions; (c) ethnic diversity and extensive diaspora networks; (d) a class of dynamic indigenous entrepreneurs; and (e) a well-structured private sector engaged in regular dialogue with the government.

Macroeconomic policies and regulatory policy reforms underpinned Mauritius’ trade strategy. The structural adjustment programmes of 1979 and 1982 established fiscal and exchange-rate policies that increased the economy’s competitiveness, supported fiscal consolidation and trade expansion and provided the necessary stimulus to investment and savings. Continuous public–private policy dialogue was promoted in the Joint Economic Council. The active pursuit of FDI and trade-promotion policies, including the establishment of an Export Processing Zone (EPZ), created a 50-fold increase in merchandise exports between 1971 and 1990. In response to increased competition for its textile exports as a result of the dismantling of the Multi-Fibre Arrangement (MFA) and the establishment of the WTO, the government was quick to create the Export Processing Zones Development Authority (EPZDA) to provide financial incentives for productive restructuring, and the Mauritius Offshore Business Activities Authority, established in 1992, to promote the development of offshore financial services. In the early 1990s, the Mauritius Freeport Authority was established to promote trans-shipments, and the Telecommunications Advisory Council to enhance competitiveness and bring down connection costs.

Since 2000, Mauritius has opened up its economy to foreign talents and skills, promoting ICT and financial services and pursuing a ‘blue and green growth strategy’ to take advantage of its 2 million km² maritime zone. The ICT Authority was set up in 2001 to develop Mauritius’ prospects of becoming a ‘cyber island’. The contribution of ICT to GDP grew from 4.1% in 2000 to 6.5% in 2010, creating 8,000 new jobs. This agenda, including the launch in 2008 of the ‘Maurice Ile Durable’ strategy, aims to counter the intense global competition in traditional sectors from other low-cost economies through further diversification and productivity enhancement via trade expansion and investment in technology, including renewable energy. It also aspires to tackle pressing domestic challenges, most notably rising unemployment (8.7% in 2012) and growing inequality.

Sources: Ramdoo (2014); CI by Treebhooon and Jutliah (2015)



Box 6.22 | Trade finance

Trade finance at any level involves some combination of four elements:

- Facilitation of secure and timely payment across borders
- Provision of financing to parties in a supply chain or trade transaction
- Effective mitigation of risk
- Facilitation of information flow

Table 6.22B | Elements of trade finance

PAYMENT	FINANCING	RISK MITIGATION	INFORMATION
<ul style="list-style-type: none"> • Secure • Timely and prompt • Global • Low-cost • All leading currencies 	<ul style="list-style-type: none"> • Available to importer or exporter • Several stages in the transaction • No impact in Operating Line for exporters 	<ul style="list-style-type: none"> • Risk transfer • Country, bank and commercial risk • Transport insurance • Export credit insurance 	<ul style="list-style-type: none"> • Financial flows • Shipment status • Quality of shipment • Letters of Credit systems include web- and desk-based solutions

Source: OPUS (n.d); OPUS and SWIFT (2013)

Developing financial markets to underpin trade finance supports economic development. The challenge is to develop a financial system and instruments that are compatible with the productive needs and structures of developing economies and supportive to local entrepreneurs and businesses, many of which do not meet banking criteria since they operate in conditions of high risk and without credible collateral or guarantees. Trade finance refers to innovative, custom-engineered financial products and services that can meet a country's import and export needs (see Box 6.22).

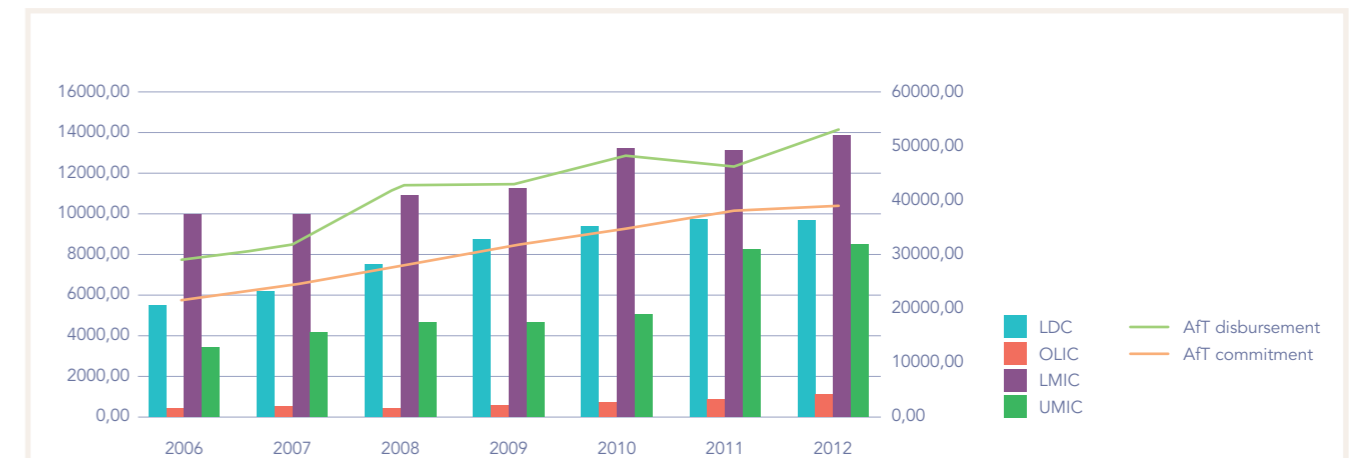
Until recently, there has been limited trade finance in LICs and LMICs. Although aimed at building trade capacity rather than trade finance as such, since 2007 the EU and its Member States have expanded AfT financing, following the example of Japan and other donors. As already highlighted, between 60% and 70% of ODA is in the form of grants and between 20% and 30% in the form of loans. Aid for Trade (including infrastructure and trade-related

assistance) is mostly directed to countries in Africa followed by Asia. According to UNCTAD (2010), most Chinese assistance to developing countries can be classified as AfT since it has elements of trade and investment cooperation.

Since its inception, AfT commitments have increased rapidly; reaching \$48 bn in 2010, falling to \$41.5 billion in 2011 but rising again in 2012 (see Figure 6.18). A growing body of evidence shows that AfT is effective in reducing the cost of trading and increasing trade capacity, income and growth in recipient countries. Its impact, however, tends to be determined by factors such as the type of AfT flow, recipient-country-specific factors (including institutional quality and income level), the sectors receiving AfT, and by geographic region.

There is growing evidence that AfT has a significant and positive correlation with exports (OECD/WTO, 2013) as it reduces trading costs (Busse et.al, 2011) as well as the time of trading (Cali and te Velde, 2011). Aid for infrastructure,

Figure 6.18 | AfT flows (constant prices, 2011, US\$ mn)



Notes: Disbursement by income group (left axis). Total AfT disbursement and commitment (right axis). OLIC = other low-income countries. The graph includes ODA but no other development flows (loans, grants and OOF).

Sources: Calculation based on OECD Creditor Reporting System (CRS) disbursement data; Keane et al. (2014)

AfT for development and AfT for policy together have been estimated to reduce global trade costs by 0.2% and to generate a total welfare gain of \$18.5 bn (Ivanic et. al, 2006).

In terms of sectoral allocation trade-related infrastructure helps recipient countries increase exports. It is estimated that a 10% increase in aid for infrastructure leads to an average increase in exports-to-GDP ratio in a developing country of 2.34% (Vijil and Wagner, 2010). Ferro et al. (2011) suggest that aid to the transport and energy sectors is the most effective in boosting exports. They find that a 10% increase in aid to these sectors is associated with a 2% and 6.8% increase in manufacturing exports. AfT channelled to institution-building also appears to be effective in fostering exports, especially if it is combined with good-quality institutions (Massa, 2013).

Effects seem to differ depending on the sector and the country income level. Thus, aid to the transport and banking services appears to have

a positive impact and is significant for LICs and LMICs, but is negative and significant in the case of UMICs (Ferro et. al, 2011). Similarly, the marginal effect of infrastructure improvements on exports decreases with country income, while the effectiveness of AfT directed to ICT, energy and business services increases with the income level of the recipient countries. (Portugal-Perez and Wilson, 2010)

In terms of AfT by geographical region, AfT facilitation appears to have a larger cost-reducing impact in SSA than in the entire sample of developing countries (Cali and te Velde, 2011). Aid to business appears to have a positive effect on exports in LAC and MENA, but a negative impact in South Asia (Ferro et. al, 2011) while aid to banking displays a negative relation with exports in LAC and MENA, but a positive impact in South Asia. These results suggest that regions with a high percentage of UMICs (e.g. LAC and MENA) benefit more from aid to business than do regions with several LICs and LMICs (e.g. South Asia).



The latter gain the most from aid to banking and the development of their financial systems. The disruption and redirection of trade flows due to the 2008 global financial crisis and the application of more stringent regulatory requirements for international banks have changed the landscape of trade finance.

Intra-regional trade flows across Asia, the Middle East and Africa have increased, as exporters have actively sought alternatives to the US and European markets. Trade among Southern partners has been dominated by exports of natural resources and raw materials from LICs to emerging economies and imports of Chinese manufactured goods along the lines of conventional comparative advantage (commissioned background paper; Uneze, 2015). China has done more than other Southern partners to develop LICs' trade capacity, especially in Africa, through AfT assistance and trade facilitation measures. For example, in 2010, it launched an Accession Programme for LDCs and created a special fund to enable them to engage in WTO programmes. It has also provided duty-free and quota-free (DFQF) access to products from LDCs but it is not as comprehensive as e.g. the EU's DFQF scheme, and has established free-trade zones in some LICs (commissioned background paper; Uneze, 2015).

Such policies have resulted in growing trade between LICs and China, especially in Africa. Thus, exports of natural resources from Africa to China have expanded fast and so have imports of cheap manufactured goods from China into African LICs. The continuation of such a pattern of trade could have negative long-term repercussions as it displaces local production and retards structural change. In Nigeria, for example, the manufacturing sector has been weakened by cheap Chinese imports. This is the reason why according to some authors Chinese-African relations present both an opportunity as well as a threat and China's assistance to Africa is a double-edged sword (commissioned background paper by Uneze, 2015; Udeala, 2013).

Several trade finance banks and others are increasingly seeking to meet the needs of dynamic and emerging commercial customers across selected 'trade corridors' in Asia and the Pacific, notably in China, India, Indonesia and Malaysia. Similarly, Africa has experienced growth driven by a combination of trade and inward (resource-focused) investment. The rise of the Chinese Renminbi (RMB) as a currency of international trade finance is expected to lower currency risks for transactions denominated in RMB and to enhance the demand for global trade banks to develop capabilities and facilities linked to RMB-denominated trade. The RMB now plays a role in transactions that represent some 10% of China's trade flows, and perhaps as much as 2–3% of global trade. Overall, LICs will be able to mobilise more resources for development if the emerging economies design programmes to build their trade capacity. Relevant trade instruments include preferential export credits, market-rate export buyers' credits, and the removal of tariffs and non-tariff barriers (commissioned background paper, Uneze, 2015).

At the same time, ever more SMEs, constrained by limited access to credit and trade finance, are bypassing the banking system by developing and directly negotiating on 'Open Account' terms with their trading counterparts. They are thus abandoning traditional instruments such as Letters of Credit – which many importers and exporters find complex and cumbersome, highly process-intensive, and prone to error, and which are therefore unpopular. Moreover, most microenterprises and SMEs in LICs and LMICs lack any access to the banking system and rely on family and social networks to finance their activities.

Figure 6.19 | General picture of trade finance

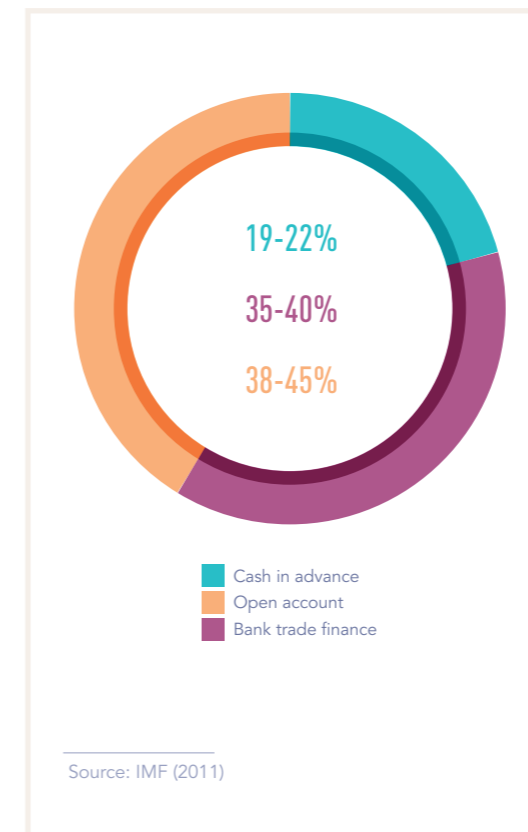
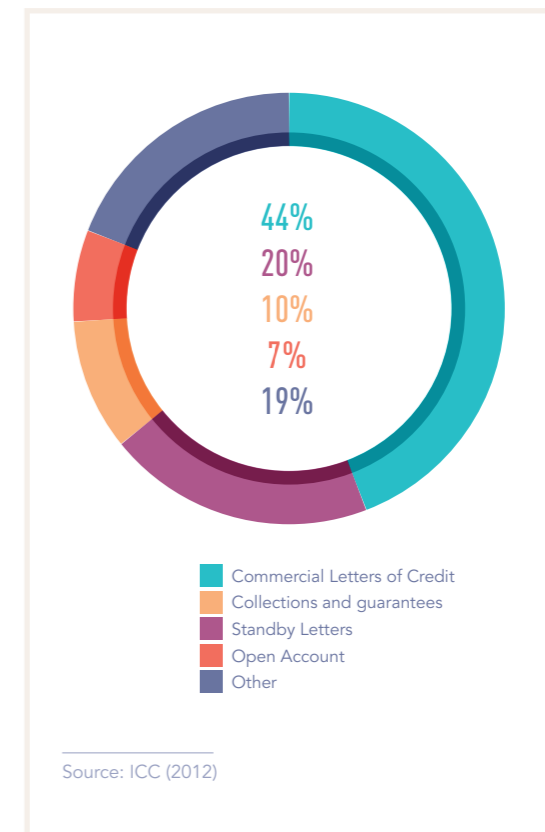


Figure 6.20 | Trade finance offered by banks



As a consequence of these developments, trade finance is engaged in an unprecedented effort to develop mechanisms and solutions better suited to the evolving needs of companies of various sizes. Trade finance was worth \$15.9 tr in 2008 (IMF, 2011), of which 19–22% was cash in advance, 35–40% was bank trade finance, and 38–45% was

Open Account (which includes guarantees by ECAs, arm's length and intra-firm) (see Figure 6.19). The product mix offered by banks differs (ICC, 2012), with 44% in the form of commercial Letters of Credit, 20% each for collections and guarantees, 10% for standby letters and 7% for Open Account (the rest is 'other') (see Figure 6.20).



6.6.2 Links between finance and policies for developing trade

In mobilising finance, five policy areas including capacity building and enhancing market access, cluster formation and integration into Regional and Global Value Chains (GVCs), risk mitigation through an enhanced role for DFIs and MDBs, transparent institutional frameworks for FDI attraction as well as financial sector development appear to be crucial. In making more effective use of finance the development of national Aft strategies, specialised institutions for trade finance and overall financial-sector development are priority areas.

Mobilisation of finance for trade

Building export capacity and enhancing market access

Despite the growing needs for trade finance and innovations in its provision, export capacity and market access remains extremely limited especially for millions of SMEs in developing countries which need to grow and obtain access to markets and trade. For example, micro and small local companies and entrepreneurs lack information and capacity to penetrate foreign markets; domestic products do not meet phytosanitary or other standards; expanding and restructuring production to meet quantity and quality requirements for exporting requires investments that are difficult to raise; delays in customs and bureaucratic procedures add to costs; inappropriate exchange-rate policies or high domestic costs damage international competitiveness; and international policies to open up trade, lift tariff barriers, remove visible and invisible barriers to entry and promote competition are crucial for enhanced access to markets. Evidence from Bangladesh and Moldova is telling in this regard (Boxes 6.23 and 6.24). Finance is not the only constraint to developing trade.

In view of these constraints, the promotion of trade requires actions on three fronts: (a) domestic capacity-building to enhance local export capacity; (b) the pursuit of coherent national trade, macroeconomic and industrial policies that are supported by governments and the private sector to foster export promotion, export diversification and overall price and structural competitiveness; and (c) the establishment of an international open-trade regime with clear and fair rules that are conducive to capacity-building and development.

According to the Swedish Board of Trade, four key elements facilitate trade: (a) strong political will; (b) a clear strategic plan; (c) close cooperation with the business community; and (d) a well-funded and long-term technical assistance programme. Trade facilitation therefore presupposes governments' political will to support private-sector development and create conditions favourable to growth and productive investment, especially for (informal) microenterprises and SMEs that characterise industrial structures in most developing countries. Sustainable macroeconomic policies, including an appropriate exchange-rate policy and an open trade regime that support the expansion of the tradable sector, are prerequisites for creating a business environment that is conducive to trade.

Last but not least industrial policies to facilitate the formation of sectoral clusters and the integration of individual firms or clusters into regional or global value chains (GVCs), coupled with appropriate supply-chain management practices, can facilitate both trade promotion and trade finance (see, for example, Kren de Backer et al., 2013).

Box 6.23 | Pro-trade policies: evidence from Bangladesh

Market-oriented reforms, the removal of trade-related quantitative restrictions, tariff liberalisation and the active pursuit of an export-oriented growth strategy helped to integrate Bangladesh's economy into the global economy. Trade openness increased from 13% in 1981 to 47% in 2013. International policies were vital to unlocking Bangladesh's trade potential. Income and employment were created by preferential access in the ready-made garments (RMG) sector and the provision of back-to-back Letters of Credit in the fabrics sector. Similar trade advantages were realised through the Everything But Arms (EBA) initiative and the Generalised System of Preferences (GSP). Open-trade policies were thus conducive to a policy environment and global linkages that boosted human capital and capital investment in the tradable sectors. Despite this progress, poor infrastructure, weak productive capacity and technological readiness, low competitiveness and the lack of trade-related expertise still hamper the country's trading potential.

Source: CI, Khatun (2015)

Box 6.24 | Surmounting barriers to trade promotion: evidence from Moldova

With the exception of a few in the agro-food and textile export sectors, most firms in Moldova are either micro or small-scale companies that cater to local markets. They face substantial difficulties in upgrading export capacities due to lack of information, know-how, appropriate financing and backward and forward networks. According to the preliminary results of a survey of approximately 40 firms conducted by the Ministry of Economy (Katseli, 2014), even firms with solid export experience face serious obstacles to entering foreign markets. The five most serious obstacles include exchange-rate volatility, excessive costs of obtaining finance, bureaucratic export procedures, lack of appropriate contacts with potential importers and the entrenched presence of competitors in foreign markets. To address these constraints they rank as their highest priority support for investments in new machinery and equipment, and assistance in locating partners in export markets; they also seek support in finding skilled labour, securing lower costs of energy and identifying strategic investors.

Representatives of firms with little or no export experience include among the five most important inhibiting factors exchange-rate volatility, the high costs of finance, high costs of entry into foreign markets, lack of information about the export potential in these markets and lack of appropriate contacts and networking. Their highest priorities are to locate suitable partners in export markets, and to meet quality standards; support for investment in new machinery and equipment; improvements in infrastructure; and help in finding strategic investors.

These responses reveal bottlenecks in both domestic cost and supply conditions (most notably the high cost of financing, exchange-rate risk, high energy prices, inadequate infrastructure, and limited investment capacity) and to demand conditions (inadequate information about export potential, lack of access to potential importers, greater competition in foreign markets, and high costs of entry into foreign markets). Thus, to enable firms to expand their productive capabilities and promote exports, supply and demand constraints need to be jointly addressed and progressively relaxed.

Source: Katseli (2014)



Cluster formation, integration into GVCs and supply-chain management

Export promotion and market access is highly dependent on market conditions. Unlike trade in the nineteenth century, which was largely in primary products and finished manufactured goods, the late twentieth century saw a dramatic growth in the share of semi-processed intermediate products in global trade. Trade is increasingly in semi-finished components and sub-assemblies rather than in final products. Production is fragmented as lead firms outsource their non-core competences to suppliers in different countries. Global trade is thus increasingly conducted by GVCs led by TNCs, which spread different parts of a production chain (e.g. materials, parts, components) across countries and markets. A major European importer of furniture or a car-manufacturing company is today buying materials and components from across the world.

It is estimated that 80% of global trade takes place within TNC-coordinated GVCs, which makes it increasingly difficult for businesses from developing countries to integrate if they are small and in the lower part of the value chain (UNCTAD, 2013). Based on international experience over the past decade and in particular on the insights gained from the AfT initiative, ‘those economies that are better integrated into global value chains have been best positioned to gain from trade’ (ADB, 2013b). Conversely, countries that remain outside GVCs face serious market-access problems and difficulty in penetrating foreign markets.

Especially in the presence of many micro, small and largely informal firms, trade promotion can be facilitated if policy-makers, in collaboration with producers’ associations, support the formation of *sectoral productive clusters* that help to create positive spillovers from joint action, i.e. generate ‘external economies’ that develop skills or infrastructure, training activities, logistics, warehouse management or marketing. Cluster formation can be based on criteria such as

proximity of suppliers or of customers or inter-firm specialisation, and should aim to build on what already exists, thus taking advantage of existing cooperatives, regional associations, presence in an EPZ or industrial parks (IP), etc.

Cluster formation tends to create incentives for GVC participation as it enhances productive capacity and lowers the transaction and operating costs of participation. It could also mobilise supply-chain financing, as evidenced by recent initiatives of the EIB and EIF in Moldova in relation to the wine and horticulture industries.

Aid could support clustering and supply-chain management. A commissioned background paper (Cadot et al, 2015) suggests that aid could be focused on weak links, i.e. sectors that hold back productivity improvements downstream in the value chain. This requires better targeting rather than a fundamental overhaul.

Transparent, regulatory and institutional frameworks for FDI attraction

There are diverse approaches to preparing an economy to integrate into value chains, but a positive business environment and an open economy are considered to be key to developing comparative advantages (ECDPM, 2014). The Asian experience, in particular, suggests that attracting FDI and building regional trade – investment interlinkages have been instrumental in fostering regional and subsequently global value chains and in so doing mobilising additional finance. The so-called “flying-geese” paradigm that has been characteristic of integration and development patterns in South East Asia (Katseli, 1993) has been spearheaded by such trade–investment interlinkages while the formation of inter-country value chains has been one of the principal drivers of structural change and economic transformation of the region.

According to The World Investment Report countries with a greater presence of FDI relative

to the size of their economies tend to have a higher level of participation in GVCs and to generate relatively more domestic value added from trade (UNCTAD, 2013). Thus, the provision of appropriate regulatory, institutional and infrastructural frameworks to attract green-field FDI and to facilitate participation in TNC-managed GVCs promotes linkages that enable economic development. Policies to promote export diversification and to develop capacity and skills through FDI attraction are vital components of a pro-trade agenda that can mobilise additional financial resources. Pursuing such an agenda requires a shared vision, concerted efforts and substantial investment. Access to finance to spur the adoption of such an agenda, especially in LICs, is critical to the successful participation in GVCs (Nadeau, 2014).

Risk mitigation through an enhanced role for DFIs and MDBs

Given the high risks associated with expanding trade and attracting FDI in LICs and LMICs, the development and provision of risk mitigation

instruments needs to be an integral component of a pro-trade and pro-investment strategy. Such provision is also essential in mobilising additional trade finance, the need to mitigate risks in trade finance, especially for SMEs, originating in importers’ or exporters’ failure to meet their obligations, has given rise to Export Credit Guarantee Schemes. Since these have sovereign backing they expand the opportunities available to exporting companies. This has led to the evolution of Special Purpose Vehicles, or Export Credit Agencies (ECA), which provide finance for exporters and assume the associated risks. Examples of such ECAs are the US Exim Bank, the UK Export Credits Guarantee Department, Nexim of Nigeria and Koexim of South Korea. During the 2008 global financial crisis, trade financing needs had to be addressed by public or quasi-public ECAs as well as DFIs, MDBs and RDBs (e.g. the EBRD, EIB, the ADB and the Inter-American Development Bank (IADB)), the World Bank’s IFC and others. As with infrastructure, DFIs and MDBs have been major providers of finance for the trade and supply chains. Some illustrative examples are given in Table 6.6 below.

Table 6.6 | International Finance Institution (IFI) trade finance programmes

	EBRD	IFC	IADB	ADB
Programme	Trade Facilitation Programme	Global Trade Finance Programme	Trade Finance Facilitation Programme	Trade Finance Programme
Number of countries	20	91	20	16
Date of commencement	1999	2005	2005	2004
Number of transactions (by 31 December 2011)	11,600	11,255	1,066	4,236
Value of transactions since commencement	€7.2 bn equivalent to \$9.5 bn	\$15.8 bn	\$1.96 bn	\$8.8 bn (\$3.5 bn of which in 2011)
Number of banks	800	800	264	112
Claims to date	2 claims, zero losses	zero	zero	Zero

Source: OPUS and SWIFT (2013)



Increasingly DFIs are using supply-chain financing to cover the 'integrated trade finance needs' of participating companies, especially in agriculture, ranging from providing affordable working capital to suppliers to commodity-backed lending against warehouse receipts or other collateral agreements, to structured finance. In Moldova, for example, the EIB made a €75 mn loan to the wine sector, combining a €2 mn grant from the Neighbourhood Investment Facility Trust Fund, which provided vital technical assistance. The wine industry accounts for about 30% of Moldova's exports and employs 15% of the labour force.

As with finance for infrastructure, DFIs and MDBs can play a catalytic role in trade finance and financial-sector development. Engaging them further in the provision of trade finance and risk mitigation instruments appears to be an effective strategy for private sector development and trade promotion that helps overcome constraints in credit provision from underdeveloped domestic financial markets.

It should be noted however that, in the absence of sustainable clusters or supply-chain financing, it is usually larger firms that would have access to such financing. More can be done to lower the cost of financing and enhance SMEs' access to blended trade-finance instruments and risk-mitigation mechanisms. The extension of such instruments to SMEs, supported by appropriate technical assistance and trade-facilitation policies (custom and tax policies, upgrading standards, market surveillance etc.), can enhance trade activities at least in leading sectors; public resources and remittances could also be mobilised further to enhance supply capacities especially in local and rural markets. Moldova's PARES programme, for example, whereby the government matches remittances channelled to local investment projects, is a good example (CI, Ghedrovici, 2015).

AfT has similarly been instrumental in promoting SME trade capacity in many LICs and LMICs. Technical assistance and grants provided by

the IFIs have helped SMEs to grow in many parts of the world. A commitment to private-sector development and the adoption of economic and regulatory reforms are probably the most important preconditions for mobilising international public funds for linkages and trade promotion.

Financial-sector development

In most LICs, it is the provision of microcredit, simple guarantee schemes and development finance, often supported by ODA or remittances, which has enabled trade through the promotion of private-sector development, and the creation of linkages (AfDB and OECD, 2006).

As with broader economic development, trade tends to be accompanied by the development of the financial and private sectors. Private-sector development, facilitated and supported by economic and regulatory reforms (e.g. more transparent property rights, tax incentives, appropriate exchange-rate policy, and capacity-building programmes) involves a progressive shift from informal to formal economic activities, growth of company size and capabilities, trade promotion and linkages across firms and consumers. Development of the financial sector tends to follow. In most countries, however, even in some HICs, the availability of credit to the SME sector remains limited and costly. Creating financial mechanisms and instruments suited to SME development, especially in the risky environment of LICs and LMICs, remains a major challenge. It requires government initiatives to set up specialised institutions, mechanisms or blended instruments and to promote supporting policies so that resources are channelled directly to viable exporting companies and SMEs at affordable rates. Mauritius' strategy (CI, Treebhooon and Jutliah, 2015) in securing financial resources to promote its economic development through trade is a good example (Box 6.25).

Box 6.25 | Mauritius' policies to mobilise trade finance

As the economy of Mauritius diversified, the sources of financing shifted from an exclusive reliance on import and export duties on sugar (1972–1980), to domestic taxation and private flows. In the 1980s, the private sector invested sugar profits in the garment and tourism industries. Grants and ODA were used to compensate those who lost out in the process of change. As the garment and tourism sectors developed, domestic and foreign loans were extended by a rapidly expanding financial sector to a thriving private sector and a growing market economy. Development of the financial sector was supported by liberalising interest rates and the creation of a Stock Exchange in 1989. Tax incentives, including a 25% corporate tax (down from 35%), were used to encourage companies to be listed. The Development Bank of Mauritius, the State Bank of Mauritius, the State Insurance Corporation of Mauritius, the State Investment Corporation and the Mauritius Leasing Corporation were created to mobilise financial resources. Mauritius has since become a regional financial centre.

FDI as a proportion of GDP remained at below 2% over the period 1990–2005. Since 2006 it has risen, mainly due to investments in real estate promoted by the government's Integrated Resort Scheme, which offers foreign nationals a residence permit if they invest in a property worth at least \$500,000. Net FDI inflows have increased by 96% to \$361 mn in 2012 compared to 2004 levels (World Bank, 2014). Despite a growing financial sector, trade financing is still a critical binding constraint and there is a need for government policies to increase the level of equity, debt and mezzanine finance channelled to the real economy. The government is thus seeking to internationalise the Stock Exchange of Mauritius to make it a regional centre for raising capital, to develop PPPs and long-term bonds for developing infrastructure, to improve skills in the financial-service sector, and to attract FDI from global companies, which are not currently allowed to conduct business in Mauritius.

Source: CI, Treebhooon and Jutliah (2015)

Effective use of finance for trade

The use of trade finance can become more effective if it is supported by policies that enhance effective and efficient responses to enhanced market access on the part of private-sector participants as well as greater transparency and accountability on the part of governments, financial institutions and intermediaries. Improved standards, policies on competition and market surveillance, regulatory reforms to lower the costs of doing business and transaction costs, appropriate incentives to combat informality, and judicial and legal reforms can all support private-sector development and make the use of finance more effective. Governance reforms and modernisation of tax-administration, customs and legal systems can facilitate trade, including better use of public funding. The following sections focus on three complementary policies for effective use: (a) design of national AfT strategies; (b)

development of specialised institutions for trade finance; and (c) effective oversight of the financial sector.

National AfT strategies

A number of factors specific to donors and/or recipient countries influence the effectiveness of AfT (OECD/WTO, 2013; Basnett et al., 2012; OECD/WTO, 2011; Keane et al., 2014). These include (a) determining AfT priorities, including the identification of binding trade-related constraints to growth, needs assessment, the integration of needs into national development plans; and how donors respond to trade-related needs through their country or regional programmes; sound Diagnostic Trade Integration Studies; (b) structuring AfT on the basis of different delivery instruments, the benefits and drawbacks of bilateral and multilateral programmes as well as pooled funds and regional approaches

ENABLER: TRADE

Investing in Trade

COUNTRIES CAN USE A RANGE OF POLICIES TO MOBILISE FINANCE FOR TRADE



The creation of an **OPEN, TRANSPARENT, RULE-BASED MULTILATERAL TRADING AND FINANCIAL SYSTEM** is a Global Public Good of paramount importance for development.

Increased trade volumes, better market access and lower costs associated with trade and finance can boost growth, create employment and reduce poverty.



Three important, complementary policies for effective use of trade finance are:

- ▶ The design of national AfT strategies
- ▶ Development of specialised institutions for trade finance
- ▶ Oversight of the financial sector



Policy for mobilisation and effective use of finance for trade

1 National policies for effective use

- ▶ National Aid for Trade strategies
- ▶ Financial sector development

2 International policies for effective use

- ▶ Promotion of private sector development by specialised agencies incl. DFIs



3 National policies to mobilise finance

- ▶ Export strategy
- ▶ Clustering
- ▶ Financial sector development

3 International policies for effective use

- ▶ DFIs to mitigate risks in trade finance / AfT
- ▶ Global and regional trade and financial rules

Pro-trade policies: Bangladesh

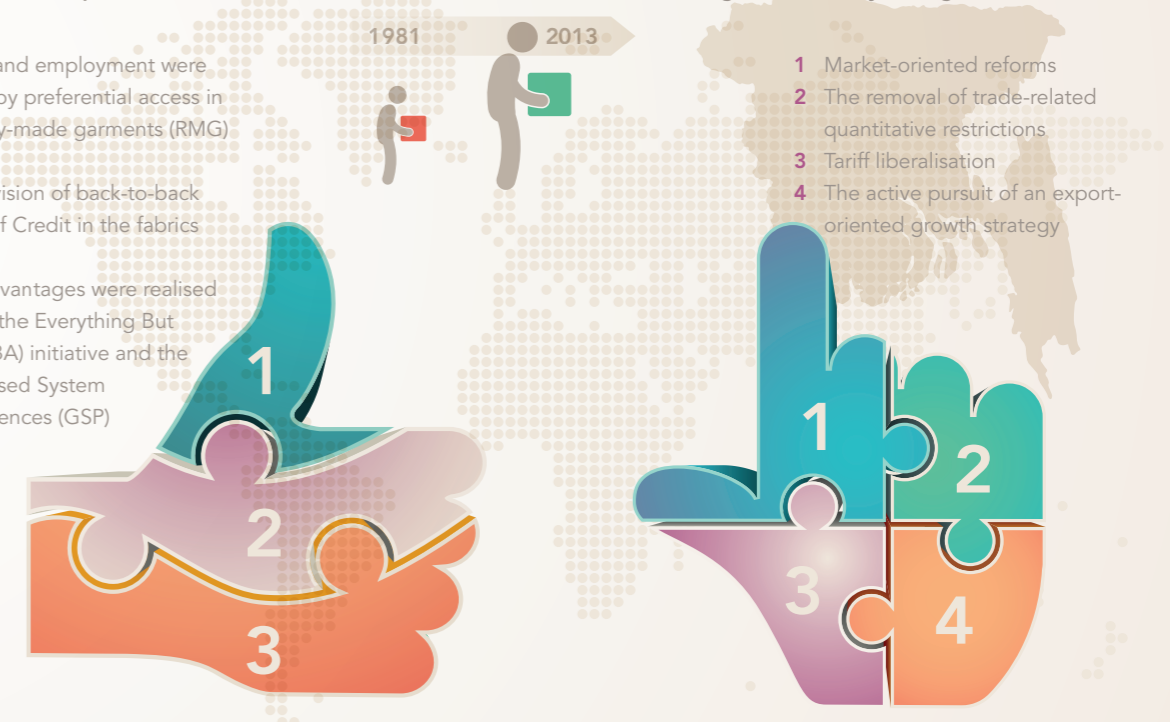
Imports and exports increased from **13% of GDP in 1981** to **47% in 2013**.

International policies were vital to unlocking Bangladesh's trade potential:

- 1 Income and employment were created by preferential access in the ready-made garments (RMG) sector
- 2 The provision of back-to-back Letters of Credit in the fabrics sector
- 3 Trade advantages were realised through the Everything But Arms (EBA) initiative and the Generalised System of Preferences (GSP)

Bangladesh's economy integrated the global economy through:

- 1 Market-oriented reforms
- 2 The removal of trade-related quantitative restrictions
- 3 Tariff liberalisation
- 4 The active pursuit of an export-oriented growth strategy



These initiatives boosted human capital and capital investment in these sectors.



entailing multiple recipients (including AfT to RECs and transport corridors); (c) the design and implementation of projects and programmes, focused on national and regional AfT programmes, donor coordination, integration of country systems, inter-ministerial coordination on the recipient side and the linkages of programmes to the transnational and regional level; and (d) M&E, including different methodologies, and how this informs existing and future programmes at the global, regional, national and project levels. Countries that have designed AfT strategies that combine these issues, such as Cambodia, have made good use of AfT.

Specialised institutions for effective trade finance

Collaboration with regional DFIs and MDBs to develop specialised facilities to support enterprise development has had positive effects not only on trade promotion but also on effective management of resources. The EU/EBRD SME Finance Facility, for example, has provided considerable financing to SMEs in EU Accession and new Member States in central and eastern Europe through local banks, leasing companies and equity funds. By the end of 2012, the EBRD had provided €1.2 bn in credit lines to 44 banks and 40 leasing companies supported by an EU grant of €139 mn for incentive payments and technical assistance (EBRD, 2013). Similarly, the Western Balkans Enterprise Development and Innovation Facility, launched in December 2012 by the European Commission, EIB, European Investment Fund, EBRD and a number of bilateral donors to support SME financing and investments in infrastructure, private-sector development and energy efficiency as well as to provide technical assistance to the public and private sector in the Western Balkans, is a promising and ambitious initiative that could be studied and introduced in other settings.

Effective oversight of the financial sector

Finally, there is a need for effective supervision of the banking sector to prevent oligopolistic practices by domestic banks, high lending rates or selective credit-extension policies, all of which can limit access to credit and prevent the most effective use of financial resources.

Financing trade can help small entrepreneurs and small-scale farmers in LICs and LMICs to participate in activities and value chains that raise incomes and so help to reduce poverty. Women's empowerment can also be promoted through policies on financial inclusion connected to SME development (Box 6.26).

6.6.3 Conclusions and implications regarding investment in trade

Trade depends on the availability of and access to finance for trade promotion and private-sector development, especially for SMEs with limited or no access to credit and finance, the so-called 'missing middle'. Initiatives such as AfT can be effective, but their impact depends on factors such as purpose, country and provider. Countries can use a range of policies to mobilise finance for trade. Capacity-building activities need to be complemented by the development of special supporting financial institutions, mechanisms and instruments to mitigate risks by providing trade finance, and insurance and guarantee schemes. The disruption and redirection of trade flows due to the 2007–2008 global financial crisis and the application of more stringent regulatory requirements for international banks have changed the landscape of trade finance. For LICs and LMICs in particular, the introduction of Specialised Facilities managed by DFIs could be important in supporting private-sector development and trade financing. Cluster formation and integration into supply chains could be decisive steps towards the mobilisation of additional financial resources.

Box 6.26 | Women's empowerment through financial inclusion

Women's access to finance can support their empowerment and economic and social development. Panellists at a recent Chatham House event (June 2014) highlighted that:

- Women face far more financial exclusion than men. In SSA, only about 20% of women have bank accounts. The proportion is much lower in LICs but over 50% in MICs.
- Women tend to be more risk-averse than men, and less willing to borrow from financial institutions. In any case, women also face a male bias in the provision of formal financial services (according to customary law or legal status, related to land and assets). Women therefore make greater use of community savings, for instance in table banking, where charges are near zero and returns are higher.
- A survey of 200 microfinance institutions and larger banks in emerging economies found that women outperformed men in portfolio quality and return on assets.
- The criteria for women's use of financial services emerged as: (a) security (e.g. not having to carry a lot of cash); (b) confidentiality (whether they control their own savings, or must share them with male relatives); and (c) convenience. Kenya is leading the way in mobile banking, which addresses these three criteria.
- Increasing women's share in financial services leads to more investment in children's health and education; allows women to make savings; provides opportunities to network (important for business development); improves women's credit scores, which makes it easier for them to obtain future loans; increases women's voice in economic, business and policy decisions; leads to women's economic empowerment, which can increase the level of respect they command and hence reduce their vulnerability.
- There remain many challenges to unlocking women's financial potential. Simply increasing women's participation is not enough, as women already make up the majority of the labour force in many settings. It is important to examine the underlying factors that hinder economic opportunity, e.g. level of education, legal barriers, and social or cultural factors including early marriage and high fertility rates.

The creation of an open, transparent and rules-based multilateral trading and financial system is of paramount importance for development. Increased trade volumes, better market access and lower costs associated with trade and finance can significantly boost growth, create employment and reduce poverty. The abolition of prohibitive tariffs, quotas and trade-distorting subsidies in developed countries would be a major impetus for growth and employment creation.

This section also provided evidence on the importance of three complementary policies for effective use of trade finance: design of national AfT strategies, development of specialised institutions for trade finance and oversight of the financial sector.

CHAPTER 7.

Synthesis & Conclusions: Enabling a post-2015 development agenda

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07

This concluding chapter synthesises the main issues discussed in this Report and draws out the principal policy conclusions. The approach and main policy conclusions are compatible with other recent approaches to FFD (notably ICESDF, 2014; and OECD DAC CDR, 2014). This Report's special contribution lies in offering concrete examples of **how finance and policies combine to enable sustainable transformations, based on existing evidence and specific country experiences**. In particular it (a) encourages a discussion of finance and policies together rather than in an artificially disconnected fashion; (b) brings new evidence (ERD commissioned papers and CIs) to support key policy messages; and (c) examines concrete areas (or enablers) in which policy and finance together can support sustainable development.

The structure of this chapter is as follows. Section 7.1 sets the scene by recalling the main messages of the preceding Chapters. Sections 7.2 and 7.3 discuss issues related to the evolution of finance (Section 7.2) and the link between finance and policy (Section 7.3). Section 7.4 examines the steps needed to move towards a new FPDF for the post-2015 agenda, and Section 7.5 presents some concluding remarks.



7.1 Setting the scene

This Report has discussed the lessons to be drawn from the MDGs. The debate on financing the attainment of the MDGs following the 2002 Monterrey Consensus had a number of positive outcomes, such as an increased level of ODA commitments, but despite its broad scope, its interpretation and implementation also led to an excessive focus on financial resource gaps to the detriment of addressing the longer-term challenges of building institutions, improving policy and achieving structural transformation.

Chapter 2 draws three major conclusions from a review of the studies on MDG finance needs:

A range of studies on finance needs supported the implementation of the MDGs. They emphasised financial gaps to be filled with aid, but this represented only a partial vision of how needs could best be met. Furthermore, the context has since changed so that we need to move **from aid as a 'silver bullet' to considering all available sources of finance**.

- ▶ The focus on finance needs associated with the MDGs often ignored the role of policy, which is crucial. There is thus a need to think beyond only policies or only finance and **promote discussions that can foster joint thinking on appropriate policies and finance**.
- ▶ The MDGs successfully attracted ODA for specific social sectors, but in a post-2015 context with proposed goals that seek to be more comprehensive and transformative, it is important to consider long-term *enablers* for such a development agenda. This requires a new way of thinking about the role of different finance sources and a **better understanding of structural transformation and poverty eradication**.

This Report stresses that the post-2015 finance and policy framework should strengthen the shift in focus from mobilising more finance to effective mobilisation of finance to the right areas and ensuring the quality of investment and effective use of existing finance.

This conclusion is supported by the report of the **UN Intergovernmental Committee of Experts on Sustainable Development Financing** (UN ICESDF, 2014), which argues that while global public and private savings would be sufficient to meet needs, the current financing and investment patterns will not achieve sustainable development in the absence of public policies that are more effective in social and economic terms. Taking into account that all financing takes place in the context of national and international policy environments, the report suggests '...a basket of policy measures [...] encompassing a toolkit of policy options, regulations, institutions, programs and instruments, from which governments can choose appropriate policy combinations', and it recommends '...a cohesive approach, with national financing strategies as an integral part of national sustainable development strategies' (UN ICESDF, 2014: 7).

The report also points to the fact that financing must be understood as one component of a strategy that includes improving private-sector productivity and public-sector efficiency. The pursuit of the MDGs focused on public finance on the assumption that private investment would follow. The successors to the MDGs are likely to focus more on public-private interaction, and on domestic and global policies required to stimulate private investment, institutions and capacity as well as a broad range of sources of finance.

This Report further shows that **FFD options have changed** in real (volume) terms, by country income grouping, and over time. Chapter 3 shows that:

- ▶ Domestic public revenues (tax and non-tax revenues) rose by 272%, from \$1,484 bn in 2002 to \$5,523 bn in 2011

- ▶ International public finance (net ODA and OOF) rose by 114%, from \$75 bn in 2002 to \$161 bn in 2011
- ▶ Domestic private finance (measured as Gross Fixed Capital Formation, less FDI) rose by 415%, from \$725 bn in 2002 to \$3,734 bn in 2011
- ▶ International private finance (net FDI inflows, portfolio equity and bonds, commercial loans and remittances) inflows rose by 297%, from \$320 bn in 2002 to \$1,269 bn in 2011

Since the 2002 Monterrey Consensus, in real terms (2011 dollars) developing countries have had access to an *additional* \$0.9 tr in international private finance, \$3 tr in domestic private finance and \$4 tr in domestic public revenues. International public finance increased by just under \$0.1 tr (and is now less than 1.5% of the total resources available).

The data therefore show that domestic public resources have grown rapidly and are the largest source of finance for all country income groupings. International public finance has also increased but is declining in relative importance. Domestic private finance has shown the fastest growth, but is still much lower (as a percentage of GDP) in LICs than in LMICs and UMICs, with rapid transformations continuing. International private finance has been highly volatile compared to the other flows. These trends set the context and also present a number of key challenges that need to be addressed in the post-2015 development agenda and FPDF. For example, it is clear that there is a need to think more about public resources 'beyond aid' and to consider new approaches to ODA.

Chapter 4 examines **the role of policies in mobilising financial flows and in making finance more effective** and provides initial empirical evidence for a framework within which to consider the links between financial flows and

policies. The review of the role of policies in the mobilisation of financial flows shows that finance seldom reaches the intended objectives unless it is accompanied by complementary policies. The chapter illustrates several policies that can help to mobilise domestic public revenues and domestic private finance. International private finance can be mobilised through a range of policies including trade and investment policies, new tax rules, and a domestic climate policy that will attract public and private climate finance. Chapter 4 also shows that the effective use of domestic and international, public and private finance is fostered by a range of complementary policies, taking into account that what often appears to be a financial constraint could in fact be the outcome of a general or specific regulatory distortion, or of a policy or market failure. It shows, too, that global policies – trade and investment regimes, a global climate regime, and the international financial architecture – have a significant impact on the mobilisation and effective use of finance (see Table 4.3).

In Chapter 5 the Report proposes a **framework for thinking about finance and policies for sustainable development**. It has four elements: (a) a transformative post-2015 development vision; (b) a focus on long-term enablers; (c) recognition of the role of complementary policies; and (d) consideration of all types of finance. This framework contrasts sharply with the view that it is possible to achieve sustainable development with finance, and ODA in particular, alone. These contributions set the scene for an analysis of the role of finance and policies for sustainable development.

Finally, in Chapter 6 the report applies the framework to the six selected enablers of sustainable development (infrastructure, trade, green energy technology, biodiversity, human capital and local governance) to illustrate the link between finance and policies for each of them. This chapter addresses domestic public, international public, domestic private, and international private



financial flows for the selected enablers. These are easily identifiable sources that finance specific enablers (e.g. public spending on social protection or vertical public transfers to local government). In practice, however, different types of finance are often combined in multidimensional packages in order to make the financing of enablers both feasible and sustainable (e.g. when grants, loans and private finance are combined to finance a renewable energy project).

7.2 Composition of finance flows: What has been learned?

Three key messages emerge from the empirical evidence on the evolution of finance: (I) that the composition of finance differs across the selected enablers for sustainable development; (II) that the finance mix differs by level of income and (III) that financial sector development is vital for unlocking transformative potential.

7.2.1 The finance mix varies by enabler

The first key finding is that the composition of finance differs markedly by enabler. Finance for **institutions and governance** seems to be largely public, mainly provided through tax revenues, and international public finance can play a part, particularly in LICs, as shown in the commissioned CIs. Patterns of finance for **human capital** vary across education, health and social protection, although all depend heavily on domestic public finance. In the education sector, finance varies by level of education although most comes from public sources, including ODA, for primary and secondary schooling. Private spending by richer households and migrants' remittances is also important. Formal training, such as TVET schemes, is financed mainly from private sources, although this approach can be regressive. There is also evidence of PPPs (as in Malaysia) or tax levies for training being allocated and used according to

private-sector interests (as in Mauritius). Funding for health systems comes mainly from public sources, although private OOP expenses can also be critical. While the reliance on OOP expenses tends to make it harder for poorer people to obtain access to health care, this could also create opportunities for private-sector insurance and micro-insurance schemes to complement public funding. Well-designed, publicly funded social-protection systems are essential to safeguard investment in human capital, especially in times of turbulence.

Finance for **infrastructure** and **green technology** tends to come from a mixture of public and private sources, although national government expenditure is the principal source for infrastructure. There is a clear progression in the use of private finance, including bond financing, as country income levels rise. Due to the large upfront requirements, large infrastructure or renewable energy projects usually depend on the blending of private finance, ODA grants, technical assistance and OOF. Such blending has increased since the 2007–2008 global financial crisis in the context of the rising presence of DFIs and MDBs. Public funding has been used primarily to alleviate risks and attract private investment. MDBs from emerging economies also increasingly use blended instruments (see Chapter 6). Although significant ODA-backed concessional and non-concessional loans are common in LICs, public grants remain the main source of finance.

While private expenditure on R&D for green technology is rare in LICs, there is often private investment in renewable energy (generally supported by some form of public finance). **Trade** finance is largely provided by private banks through the extension of Commercial Letters of Credit, although this is changing rapidly in the wake of the global financial crisis. This was seen in the Bangladesh CI in relation to trade finance for exports of ready-made garments. In this case, exporting firms, especially SMEs, are starting to

bypass the banking system by developing and negotiating trade directly on 'Open Account' terms with their trading counterparts, and DFIs and MDBs are creating Special Purpose Vehicles to support private-sector development by pooling private and public funds. LICs continue to have very limited access to trade finance and rely on AfT finance for trade-related capacity-building (Chapter 6).

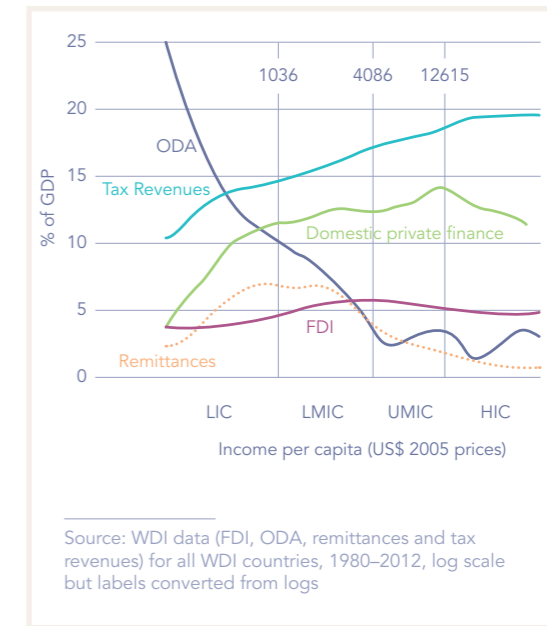
7.2.2 The finance mix differs by level of income

The second key finding is that the appropriate composition of finance and the role for private finance is likely to vary by level of country income (as illustrated in Figure 7.1).

As their income levels rise, countries typically experience sharply declining aid-to-GDP ratios and modestly rising FDI inflows. At the same time tax-GDP ratios rise, stabilising as they approach LMIC levels, and the composition of tax revenue changes, shifting from tax on trade to tax on goods and services, and there is a modest shift in lower public investment-to-GDP and rising private investment-to-GDP. There are also generally increasing private flows relative to GDP and whereas public flows decline they remain greater than private flows for all LICs and MICs. Other changes occur as well: banking credit increases, there is more private finance for infrastructure, spending on R&D (both public and private) rises, and there are more effective PPPs and better developed financial markets.

The evidence presented in the CIs also suggests the pattern of financing evolves as a country develops, as shown in the stylised pattern depicted in Figure 7.2. At the lowest level the dominant form of finance may be international public, but as the country develops domestic public finance becomes more important and then also domestic and international private finance. As a result, international public finance becomes less dominant and ultimately fades away. Eventually, domestic and international private finance assumes dominance, and domestic public sources decline.

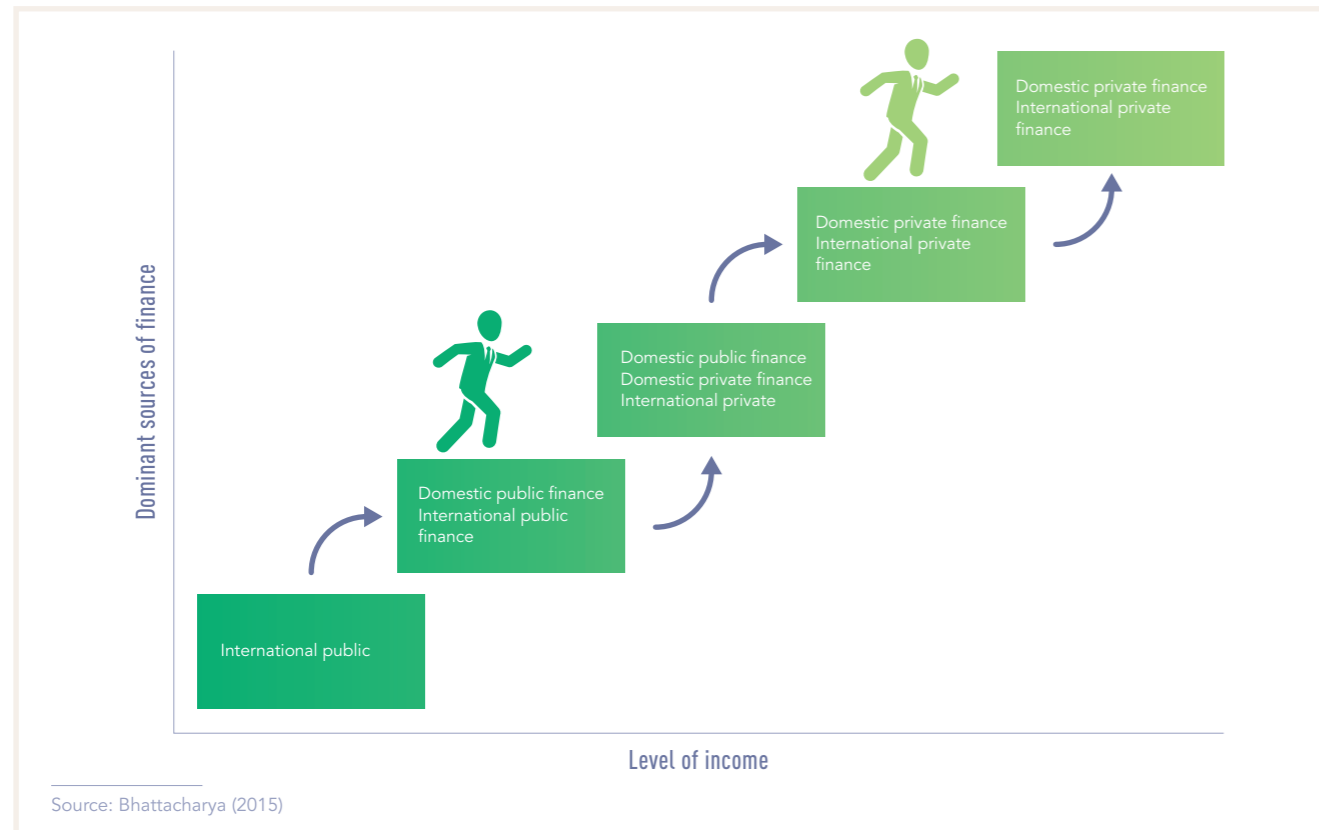
Figure 7.1 | Financial flows (percentage of GDP) by income



As any particular form of finance assumes dominance, it is likely to be more pervasive; conversely, as it becomes less dominant it should be more carefully focused on areas in which its specific characteristics can be used to best effect.



Figure 7.2 | The evolution in financing for development changes as country income levels rise



7.2.3 Financial-sector development is key to unlocking transformative potential

A third key finding relates to the importance and maturity of financial-sector development and the impact of the quality of governance and financial services during a country's transformation to higher levels of income. The CIs suggest that weak financial intermediation can hinder domestic private investment, the flow of FDI or listing in capital markets. It also affects the implementation and effectiveness of PPPs. In fragile states, where financial markets are underdeveloped and the private sector consists of very small and mostly informal enterprises, often co-existing with a few large companies in the extraction industries, formal

finance to the private sector (e.g. bank lending) is practically non-existent. In LICs and LMICs the level of SME activity depends on the business environment. Countries such as Kenya or Senegal, which have introduced incentives to promote access to financial services, such as mobile banking and support of microfinance institutions, have experienced much more rapid SME-sector development than countries such as Nigeria, which have relatively poor business environments characterised by insecurity, rent-seeking and obsolete infrastructure. For UMICs this is usually accompanied by a fast-developing financial system, active stock markets and the provision of a wide range of financial services (e.g. Mauritius, South Africa and several North African countries).

Box 7.1 | Development Finance Institutions: a new way to mobilise finance for transformation

Meeting the large finance gaps for the infrastructure needed for green economic and social development calls for a comprehensive response. The financing of such projects usually requires a combination of domestic public commitments, official loans, and commercial debt and guarantees from by private investors. ODA may also be provided. Bilateral and multilateral DFIs (e.g. IFC, EIB, DEG, PROPARCO) are government-backed institutions that provide loans, equity and guarantees to the private sector – they provide around \$40 bn each year to infrastructure projects (a third of the total) and to the financial sector (also a third), both of which address impediments to structural transformation.

DFIs can address failures in the capital market and leverage other financial flows by reducing the risks for investors. These include both financial and governance risks. They often help to reach financial closure by offering a stamp of approval. One unit of DFI finance supports other finance, with static 'leverage ratios' of sometimes more than 1:10, although this varies across the economic cycle, DFI, instrument etc. In addition, preliminary econometric evidence suggests that the increased financial exposure of the IFC, EBRD and EIB has led to higher investment rates in the recipient countries. Unlike ODA grants, DFIs tend to focus on areas that are likely to support productivity indirectly, e.g. better infrastructure or financial services (commissioned background paper, Cadot et al., 2015). DFIs provide a new means through which to channel ODA for a transformative post-2015 development agenda, although there is to date only limited evidence of their contribution to achieving identifiable development outcomes.

DFIs appear to be quite selective in their investment strategies and are less likely to invest in countries with very low GDP per capita. This may be in part because they face several constraints to closing deals in the poorest countries. They operate under strict investment rules, setting out finance on market-like terms and abiding by social and environmental rules. Investment plans in such countries are seldom well thought out and projects are not routinely assessed for potentially adverse impacts, leading to a poor project pipeline. The challenge is to develop a solid and credible project pipeline, using public support to mobilise DFIs and associated finance. An additional challenge is to channel resources primarily to companies based in recipient countries and to monitor and evaluate development outcomes transparently.

Evidence of the impact of DFIs on growth, innovation and jobs is very limited. Most is at the micro-level, such as the number of jobs directly supported (e.g. 1.2 million in the case of CDC). A few studies suggest that DFIs lead to higher labour productivity (12% in one case) and indirectly to job creation, with significant transformative effects. Donors should consider pooling resources by providing more ODA via DFIs (finance) while at the same time developing infrastructure project pipelines (policy environment) and capacity.

Sources: commissioned background paper by Cadot et al. (2015); Frankfurt School-UNEP (2015); IFC (2013); Jouanjean and te Velde (2013); Kapstein et al. (2012); Kingombe et al. (2011); Massa (2011); te Velde (2011)

DFIs and MDBs are playing an increasing role in leading transformations in key areas (see also Box 7.1), including infrastructure and trade, by leveraging private finance, supporting the selection of appropriate projects and policies, and providing technical assistance, credit and risk-mitigation instruments. Infrastructure facilities managed by DFIs are likely to scale up and draw commercial lenders into co-financing schemes. They can do this because of their more

transparent and inclusive governance structure. DFIs are also increasingly financing private-sector development initiatives, including the provision of trade finance (Chapter 6). Depending on the state of a country's financial sector and the mobilisation of DFIs, the composition of flows to enable structural transformation is likely to change from grants to other forms of finance, including loans, guarantees, technical assistance and blended instruments.



In view of these findings I – III and the specific evidence on enablers in Chapter 6, it is clear that any approach to financing development needs to take into account the following messages on the composition of finance:

- ▶ Domestic public resources are vital for governments to achieve sustainable development, especially at low income levels (issue I). But the impact might be greater if they are focused on alleviating binding constraints (or the weakest links in a chain).
- ▶ International public financial resources, play an important transformative role in the finance mix for some enablers, most notably institutions and human capital in the poorest countries where domestic public spending levels are low, particularly in LICs. International public finance is especially important in fragile states and in SSA.
- ▶ For enablers where private finance could potentially be significant, most notably large-scale infrastructure, trade and green technology, international public resources can play a catalytic role by financing start-up schemes, capacity-building, reforms of tax, customs or legal systems, providing guarantees and technical assistance, and complementary funding in blended instruments extended by DFIs and MDBs, etc. (see Box 7.1 for a transformative way of using international public finance).
- ▶ Mechanisms such as PPPs, bond financing and user fees work at higher-income levels but have equity implications that needs to be addressed. (Issue III).

7.3 The interaction between policies and finance: What has been learned?

A key innovation in this Report is to consider finance and policies together in enabling a transformative development agenda. In this section we first discuss policies in the context of mobilising finance (I) and then for its effective use (II). There is a need for special coordination among various forms of finance and policies in order to achieve triple-win outcomes in the economic, social and environmental spheres. We discuss this briefly (III). We conclude by discussing the ways in which policies and finance interact (IV).

7.3.1 Policies are crucial for the mobilisation of finance

Chapter 6 demonstrates that **policies matter in financing for development**. Although there is considerable finance available for development at the global level, it does not follow that it is used appropriately. FDI does not reach the most vulnerable and poorer segments of society, tax-to-GDP ratios have changed very little in many LICs; SMEs and infrastructure are starved of capital; and much international public finance does not go to the poorest countries. Indeed, there is a need to overcome a number of market, governance and coordination problems in order to mobilise and channel financial resources to their most effective use. The good news illustrated in this Report is that appropriate actions can to a considerable degree address these challenges. Chapter 6 discusses a range of factors and specific policies that can help to mobilise finance, making the case for going 'beyond finance' and paying serious attention to policy coherence.

A range of **policies can help to mobilise finance**. Of course, there are one-off factors – for example, the presence of oil (or natural capital) attracted FDI to Ecuador (ERD commissioned CI, Borja

and Ordóñez, 2015). But in other cases there are clear policy implications. For example, the evidence suggests that infrastructure, human capital and governance can also mobilise finance. In Mauritius, better governance (e.g. good state–business relationships) drew financial flows into the country. In Moldova, the signing of the Moldova–EU Association Agreement and the DCFTA has mobilised public and international private financial flows. A good and appropriately trained labour force attracts more finance, particularly from private sources. Sound infrastructure might also act as a catalyst for further financing.

Our framework further allows for discussions on a range of specific policies that help to mobilise finance. For instance, regulatory reforms (e.g. clear property rights, land titles or cutting bureaucratic red tape for licensing) help to mobilise resources for the private sector and market development as well as for investment in infrastructure, human capital, networks or technology (Chapter 6). The point here is not to discuss each and every potential policy, but to show that individual countries have the principal opportunity and responsibility to attract finance and make it work for sustainable development. The Report presents evidence on policies that help to mobilise different types of FFD by helping to address market, coordination and governance failures (or constraints) (see discussion in Chapter 2).

The CIs show that **some countries have successfully mobilised more tax revenues (as a percentage of GDP)** by reforming the tax authorities and adopting better tax policies. The evidence on this is from Bangladesh, Mauritius and Tanzania (Chapter 4), all of which have raised tax-to-GDP ratios by building administrations that limit rent-seeking and curtailing the use of tax exemptions, enhancing compliance, renegotiating contracts with companies, computerising the customs-clearing process, and adopting a broad-based VAT with a reasonable threshold (although more can be done). In such ways, countries can use policy frameworks to raise domestic finance

and address otherwise low and stagnant tax-to-GDP ratios. Low levels of domestic public finance are neither predetermined nor insurmountable and are to a large extent a question of public policy.

Countries can also use policy to attract FDI and use it for development objectives. Indonesia is one example of a country where changes in investment policy helped to attract FDI. When it was hit by the Asian financial crisis, there were large outflows and foreign investment became more volatile; when countries adopt better macro-financial policies, the volatility in foreign investment flows is markedly reduced (e.g. CIs for Indonesia and Mauritius). Sometimes, very small regulatory changes make the difference in attracting foreign investment. For instance, Mauritius allowed the local use of foreign equity funds and Norway changed the rules of its pension funds to allow investment in illiquid investment (similar to what the ABP pension fund did for Dutch civil servants through FMO).

We summarise the broad policy principles that guide the effective mobilisation of finance, as follows:

- ▶ Finance can promote enablers (**local governance, human capital, infrastructure, green energy technology and trade**), which in turn can also attract more private finance. This creates a virtuous circle between the enablers and finance – examples include mobile phone technology for mobile banking services, and human capital for FDI.
- ▶ An **appropriate regulatory framework is of critical importance in order to attract private finance**. For example, clear property rights or land titles help to mobilise domestic private finance by providing collateral, and an improved and more transparent and efficient investment climate can unleash more finance. Enhanced competition in transport services and benchmarks in contract provision



promote finance for and investment in infrastructure. Rules that create incentives for institutional investors to finance infrastructure in developing countries or green technology, rather than in liquid assets, help to channel international private finance to sustainable development purposes.

- ▶ Development of **financial-sector instruments** and the capacity to apply them can mobilise private resources. Blending instruments or public-sector guarantees can enhance credit availability, which in turn leverages more private-sector finance.
- ▶ A **conducive international policy environment** can be critical in setting the right conditions, e.g. transparent global financial rules and standards for global finance, appropriate trade policies for investment in agriculture in developing countries (abolishing harmful subsidies), tax regulations for tax havens, or appropriate climate-mitigation deals to set a carbon price that will mobilise climate finance.

A post-2015 development agenda needs to consider policies to mobilise domestic and international finance and to look at these policies in terms not only of the types of finance involved but also in terms of the enablers of structural transformation that they are intended to encourage. The further challenge is then to reach agreement on these policies and identify ways to encourage and monitor their implementation.

7.3.2 Policies are crucial for effective use of finance

We can deepen our understanding of the role of policy by analysing the supporting policies needed to make finance more effective and thereby reduce how much finance is required. Some financial flows are managed directly by the public sector (e.g. tax revenues, sovereign bond flows, ODA) while others are regulated at arm's length (e.g. FDI, domestic private finance), but both are influenced by policies and capacities.

While the effective use of finance differs by enabler, the evidence so far suggests **five general policy areas (or principles)**:

(i) The ability to implement, manage or facilitate finance effectively requires the presence of **sufficient national and local public capacities**. In domestic public finance, this relates to identifying and implementing sound investment projects (including those with co-benefits across the economic, social and environmental dimensions of sustainable development) and for ensuring that there are good social systems (e.g. health and education) supported by significant expenditure on them. For instance, as reported in the Ecuador CI, increased government investment in social programmes successfully increased the coverage of its Conditional Cash Transfer programme. Education up to 10th grade is now universal and both urban and rural poverty have decreased markedly in the same five-year period. Equally important is the capacity to manage debt given that much finance is non-concessional in nature. There is also a need to invest in supporting local-level capacities to ensure that decentralised spending works in practice.

(ii) The **design and implementation of public and private standards** facilitates the effective use of finance. While standards need to be defined nationally, global coordination and benchmarking can help. Standards can relate to public procurement, accountability in public revenues from natural resources, public financial management, and standards for green technologies or resilience to climate change. Global standards can help in raising standards at the country level. The private sector has an important role in observing international standards such as the ILO definition of Decent Work. A lack of public coordination could lead to a plethora of incoherent standards that would be harmful for development. International trade and investment standards can help, provided that they do not restrict trade.

(iii) An appropriate and **clear regulatory framework** allows competition and provides better incentives for the diffusion of technology in addition to directed finance. Financial and prudential regulation is required to avoid financial crises at the global level, and especially in developed countries. There is also a need for better regulatory frameworks and supervision of banks, more innovation and competition in the banking sector and better regulation of the non-banking sector – such as corporate bonds, stock markets and pension funds – in order to improve the terms on which finance is made available. As argued in Chapter 4, the financial sector in SSA needs to be reformed, including more competition to drive down interest rate spreads. It is estimated that private investors across Africa face additional costs of around \$15 bn (2% of credit extended) compared to the average interest rate spread, simply to obtain finance. More competition and innovation aimed at lowering the interest rate spread in SSA to the average of LICs and MICs would increase the availability of finance by more than 1.2% of GDP and increase investment by 6%.

(iv) Improving **transparency, information and accountability** contributes to the effective use of finance. For instance, a lack of transparency regarding government taxes paid by investors hampers the quality of public investment. Transparency concerning the large-scale acquisition of land by foreign interests could improve the governance of natural capital.

(v) Finally, **policy coherence** towards specific development objectives is vital to ensure the effective use of finance. It is important to ensure that policies in different sectors do not undermine policies to promote sustainable development and to take an integrated approach. Lack of policy coherence will lead to wasted finance. Investing in 'white-elephant' projects or inefficient productive capacities behind closed borders will not promote transformation in the long run. Financing the development of technologies without building the human capital required to employ them will

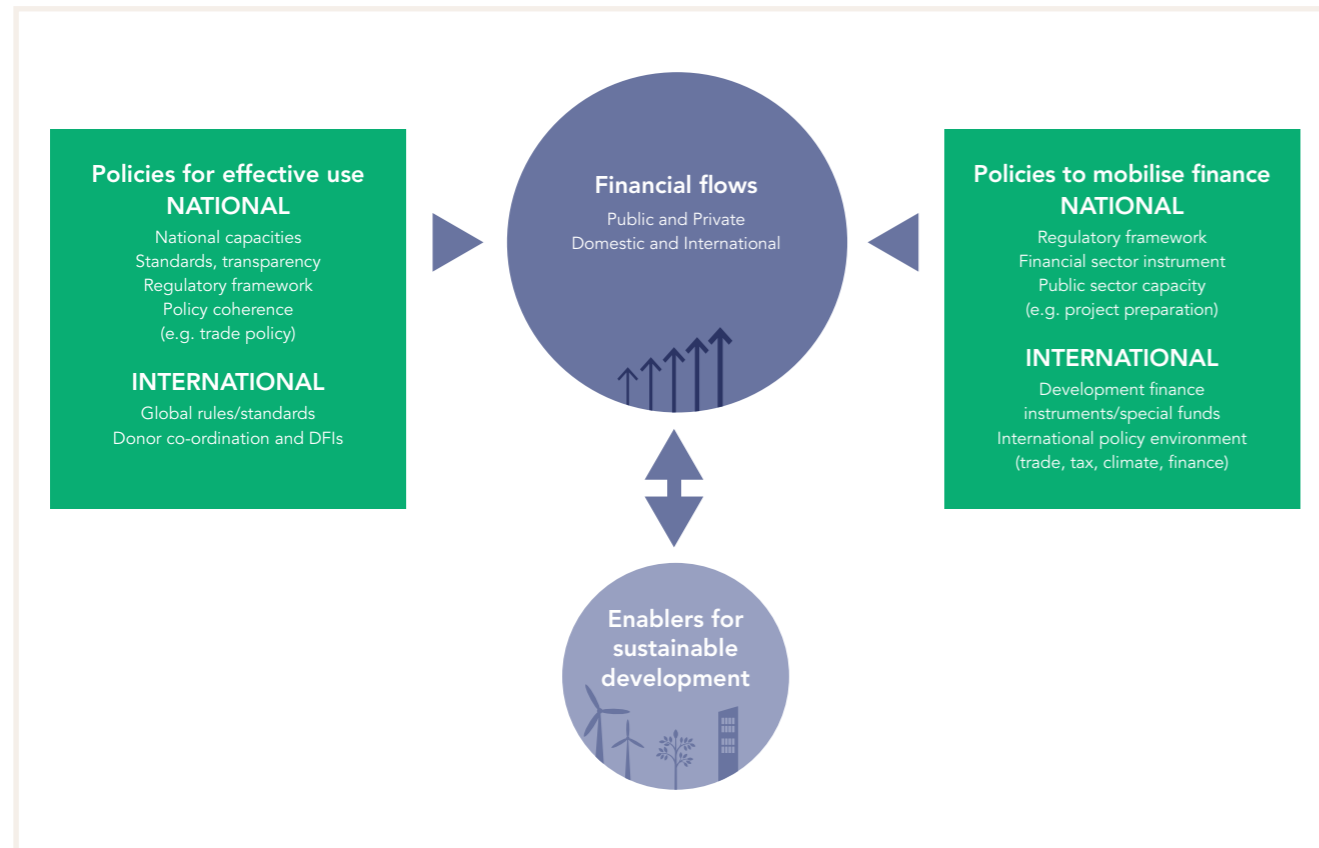
be a half measure. Providing more capital to DFIs or raising credit without the prospect of projects in which to invest can lead to excessive 'financialisation' and indebtedness. Improving access to credit without improving the terms on which it is available can still be prohibitive for firms. This also applies to global rules on trade, finance, climate, migration and technology.

The Report discusses a number of examples of how finance can be more effective or where less additional finance may be needed in the context of appropriate policies. Prominent examples include:

- ▶ **Efficient management of public finance.** Measures that boost the productivity of infrastructure by scaling up good practice and making better use of existing infrastructure could help countries to improve infrastructure productivity by 60%, estimated to be worth annual savings of \$1 tr (McKinsey, 2013).
- ▶ **Reforming resource subsidies.** The finance gap for renewable energy is estimated to be between \$400 bn and \$900 bn. This is similar to the current level of fossil-fuel subsidies (more than \$500 bn in 2010), which means that reducing such subsidies could free up finance for other purposes. Lower subsidies are also likely to reduce the need for additional green investment since there would be fewer incentives to use fossil fuels.
- ▶ **Policies that increase remittances, FDI and export revenues** (see MAMS commissioned papers) can reduce the need for additional finance.
- ▶ **Reforming trade policies.** Duty-Free Quota-Free (DFQF) access to the markets of the G20 countries (beyond the EU, which already provides such access) could increase LDCs' national incomes on average by 0.5% of GDP (World Bank, 2013). This is similar to the \$30–40 bn provided in AFT each year.



Figure 7.3 | Summary of policies for effective mobilisation and use of finance



The benefits of full implementation of a WTO agreement on trade facilitation (changing border procedures, better infrastructure etc.) are far greater (Chapter 6). The international community could also accelerate the liberalisation of environmental goods and services in order to disseminate energy-efficient technologies. The presence of agricultural subsidies in developed and emerging economies has a net negative effect on developing countries overall.

► **Curbing illicit flows** (Chapter 6). Illicit capital outflows undermine financial capacity, economic development and revenue collection (GFI, 2014). For example, between 2002 and 2011, \$60.8 bn was illegally moved into or out

of Ghana, Kenya, Mozambique, Tanzania and Uganda using trade mis-invoicing, with losses in tax revenue worth between 7% and 12% of total government revenue. A more appropriate and realistic approach to transfer pricing could free up \$3.5 bn in African countries (commissioned modelling paper, Fic, 2015).

Annex 1 provides a comparative analysis of the approach taken in this Report, the recent ICESDF report (2014) and OECD Development Co-operation Report (OECD DAC DCR, 2014). This Report pays particular attention to the split between domestic and international finance. Figure 7.3 summarises the main policy areas.

7.3.3 Coordinating policies and finance is crucial in achieving triple-win sustainable development outcomes

Selected enablers can help to achieve economic, social and environmental outcomes. In practice, finance may flow to enablers with trade-offs among the outcomes. Policies clearly make a difference to these trade-offs. For example, investment in **infrastructure** creates jobs, but limited access or high tariff rates could lead to social exclusion and inequality. It is possible to overcome this and include targeted subsidies and transfers to compensate those who lose out and facilitate access by people living in poverty or in remote areas, as can the promotion of small public-investment projects in underprivileged areas in order to enhance local employment, introduce green or social standards in project design and implementation, or safeguard competition in service provision.

Finance for infrastructure can help growth and poverty reduction, but it can also be associated with greater inequality when factor incomes increase and transfers to households do not grow at the same pace. More generally, adequate capacity and public funding are required in order to mobilise finance for green infrastructure.

Although the promotion of **trade** through participation in GVCs can make it even harder for small-scale entrepreneurs and farmers to obtain access to markets, women's empowerment can be promoted through financial-inclusion policies linked to SME development.

With respect to investment in **green energy technology**, the greater (energy) efficiency achieved can worsen income distribution depending on the skill bias, although at the same time DFI finance for more investment in (small-scale) hydropower reduces CO2 emissions, transforms economies and creates jobs. Moreover, developing and greening the financial sectors by extending affordable credit for SME green projects combines job creation with environmental sustainability.

Financing **biodiversity** can hinder economic and social development if local people can no longer exploit natural resources, but this can be addressed by complementary policies to support them through other means, e.g. the restoration of agricultural land can support agricultural production or the preservation of coral reefs can support tourism.

In relation to **human capital**, an inadequately skilled labour force can hinder investment and economic development. Skills can be good for economic growth and the adoption of green technology. A triple-win activity could be financing Sustainable Energy for All (SE4ALL) and thus freeing up time for women and young adults to engage in economic activities while also improving the environment.

Finally, **local governance** aimed at promoting social development can support local economic development and the adoption of green energy technology and is crucial for the effective implementation of new green financing mechanisms. Triple-win finance brings together stakeholders that could support sustainable development strategies such as enhancing natural resource management (NRM) and/or new financing schemes such as PES (ERD, 2012).

Based on this evidence **a key finding is that achieving triple-win finance for enablers of sustainable development requires actions in four areas**. First, **targeting finance** to prioritise sustainable development projects and direct subsidies to the most vulnerable, e.g. through enhanced DFI support for hydropower projects that create jobs and transform economies. Second, **designing standards** that encourage adherence to principles of sustainable development finance (e.g. infrastructure procurement standards that require sustainable development impact assessments) could unlock triple-win finance. Third, **supporting public-sector capacities** to mobilise and implement sustainable development strategies helps to unlock sustainable development finance.

Finally, **coordinating and networking** in the design and implementation of sustainable development strategies at appropriate levels can unleash sustainable development finance.

Synergies and complementarities across enablers point to the need to consider not only how much finance is mobilised for them, but also whether it is the right type of finance. While public finance for infrastructure can have multiple benefits and create additional capacities, greater involvement of DFIs and MDBs is needed to channel finance towards green infrastructure. National climate change adaptation and mitigation plans can help to mobilise finance for infrastructure that benefits the environment. Similarly, PES can be used to mobilise finance for natural capital and, when it is well targeted, can achieve social benefits. Moreover, the removal of fossil-fuel subsidies will mobilise more finance and the co-benefits could include more spending on renewable energy (which can have triple-win effects) and a less regressive tax and subsidy system (in cases where fossil-fuel subsidies go mainly to prosperous firms and consumers).

7.3.4 Finance cannot be treated independently from policy

In summary, it is crucial to link policy alongside finance in order to implement a transformative post-2015 development agenda. Poor or adverse policy can stop the potential of finance, but **appropriate policy can:**

- ▶ **Generate, attract and guide finance** (clear policy frameworks for transformation, e.g. Mauritius CI)
- ▶ **Unleash more public and private finance** (e.g. reductions in tax exemptions and public finance (Tanzania CI), or weaknesses in energy regulatory framework limit private finance for renewables energy (Tanzania CI))

- ▶ **Increase the stability of international private finance** (e.g. global banking (Basel III) rules lead to benefits for countries in SSA that are ten times greater than the costs)
- ▶ **Pull finance from less productive to more productive uses** (e.g. better tax policies such as reducing bad transfer-pricing or tax-avoidance practices can lead to large benefits, or relaxing SWF investment restrictions can lead to more finance for developing country infrastructure)
- ▶ **Lead to more results with the same amount of finance** (better project management can improve infrastructure productivity by 60%)
- ▶ **Reduce the need for finance** (cutting fossil-fuel subsidies reduces the amount of climate finance required to keep climate change within safe levels)

POLICY MATTERS

The virtuous circle of policies and finance



POLICIES TO MOBILISE FINANCE

- ▶ Regulatory framework
- ▶ Financial sector instruments
- ▶ Public sector capacity
- ▶ Development finance institution / Special funds
- ▶ International policy environment

POLICIES FOR EFFECTIVE USE OF FINANCE

- ▶ Sufficient national and local public capacities
- ▶ Design and implementation of adequate public and private standards
- ▶ Appropriate and clear regulatory frameworks
- ▶ Improved transparency, information and accountability
- ▶ Policy coherence (also for sustainable development)

ENABLERS FOR SUSTAINABLE DEVELOPMENT

- ▶ Local governance
- ▶ Human capital
- ▶ Infrastructure
- ▶ Green energy technology
- ▶ Trade



7.4 Steps towards a Global Partnership for the post-2015 development agenda

The UN Secretary-General's Synthesis Report (2014) discusses establishing a new Global Partnership for the post-2015 development agenda at the Third International Conference on Financing for Development (para. 24 ff) in Addis Ababa. The value of this renewed Global Partnership is that it would establish a common foundation and contribute to new ways of thinking about collective action in much the same manner as previous non-binding agreements have done, including the MDGs or G20 communiqués. Such agreements help to coordinate collective actions, such as establishing rescue plans following the 2007–2008 global financial crisis, or put the spotlight on specific global challenges, such as green growth or tax avoidance and evasion. The Conference outcome could therefore provide a set of common principles on the nature and value of different types and combinations of finance and policy, and how these are best used.

7.4.1 Financing for development as an on-going process

A finance and policy framework under such a Global Partnership would be expected to steer global collective action up to 2030 by stimulating domestic and international efforts by all countries, commensurate with their capacities. There is compelling evidence that the MDGs had persuasive value at the global and to some extent national levels, and that over time they prompted increasing acceptance and collective action towards poverty reduction; but they were perhaps insufficiently exploited as a basis for on-going accountability and dialogue among stakeholders. The wide-ranging nature of the SDGs being considered for a post-2015 development agenda will make it still more challenging to reach broad international consensus on a strong framework. Moreover, as implementation progresses, there

will be a need for flexibility and realignments. A strong agreement at the 2015 Addis Ababa conference should therefore include agreements on monitoring and accountability and be followed by continuing dialogue, to monitor progress and refine approaches.

Moreover, as our analysis of finance shows, private sources of finance that lie beyond the direct control of national governments are gaining in importance, especially at higher levels of country income level. This is another important aspect of the concept of Global Partnership. Although other stakeholders in development finance, such as the private sector, philanthropists and NGOs, may not be formal parties to the agreement at the Addis Ababa conference, it is important to seek a formula that encourages their participation in the financing and implementation of the post-2015 development agenda – all the more important given the widespread consultative and participative process that has gone into formulating the agenda.

7.4.2 Keeping core principles in mind

The post-2015 development agenda is expected to be 'universally applicable' while 'taking into account different national realities, capacities and levels of development', building on the two principles of universality and differentiation (UN Secretary-General Synthesis Report, 2014). Both principles would make the new framework very different from the MDGs and would help to move the debate away from the donor–recipient model, which most stakeholders seek to put behind them.

Universality

Universality implies that the new framework will apply to all countries and governments and not only to developing countries. On this basis, each government will be expected to pursue the agreed goals in a manner that is appropriate for their country, and to contribute resources (finance and other MOI) to the global effort commensurate with their means.

The underlying theme of the UN Secretary-General's Synthesis Report (2014) is the need for a universal set of goals that apply to all countries and for countries and individuals to take shared responsibility for achieving them.

First and foremost, the finance and policy framework needs to recognise governments' domestic efforts in raising resources. This is a universal responsibility. Domestic resource mobilisation (of both public and private finance) needs to be properly recognised and valued as the real foundation of the financing framework in all countries, and is the most important source of FFD in most countries. It also enables countries, as they get richer, to provide international public finance.

Equally, our analysis suggests it is not simply the mobilisation of finance that matters, but that government efforts to adopt and pursue policies for its effective use are of equal importance. The principle of universality should apply equally to this aspect of the framework. In other words, if governments adhere to the new framework and expect it to be based on the principle of universality, by extension they are expected to make effective use of the finance raised.

The same argument applies to both domestic and international finance. Just as it is important for governments to adopt policies to ensure the prudent use of domestic resources, so appropriate policies also need to be in place to make effective use of international resources, whether public, private, or extended at different levels of concessionality.

To be consistent, the principle of universality means that all governments should both pursue the new post-2015 development agenda at the national level, and also all seek to contribute at the international level. The universality principle would thus apply both to the resources they contribute to the global system and to their efforts to establish effective global policies in order to secure the 'conducive international environment'

that the post-2015 development agenda is expected to include as part of the proposed Global Partnership. Moreover, it is important to take into account the international impact of national policies and apply the PCD principle. As suggested by the UN OWG's (2014) use of the term PCSD (para. 17.4), or 'policy coherence for sustainable development', this principle would apply to all governments at the national and international level. It would thus have a universal application and also cover, for instance, the impact in developing countries of climate policies in emerging economies.

Differentiation

The concept of differentiation is an important complement to the notion of universality (UN, 2014, para. 84) in that it clarifies that while the new framework should apply to all countries, given the differences in capacities and needs, not all can or should be expected to contribute to its achievement in the same way. This implies first, that, although contributions may differ, each is important. All contributions are valued. Second, these responsibilities do not apply only to governments, but call for all stakeholders to contribute according to their capacity.

Our analysis suggests that financing mix vary not only from one enabler to another, but also across different country income groupings. As we have seen, countries' capacities are dynamic and the spectrum of income groupings is evolving and increasingly diversified. As countries develop, public finance constitutes a progressively declining proportion of total FFD as the relative share of private finance grows. Many poor countries tend not to be attractive to international private finance, which can be a very important source for richer countries. Equally, as countries develop they tend to be able to raise more domestic public finance. The role of international public finance is thus expected to fall, although this also depends on the policies adopted.



THE ROUTE TO A GLOBAL PARTNERSHIP

A financing for development (FFD) framework for the post-2015 development agenda can establish a common foundation and contribute a new way of thinking about international development action. It can provide a common understanding of the nature and value of different finance resources as well as how these are best used.

Core principles

The post-2015 development agenda will build on the principles of universality and differentiation.

Universality implies:

- ▶ the new framework will apply to all countries and governments
- ▶ all countries will take shared responsibility for achieving the SDGs

Differentiation highlights:

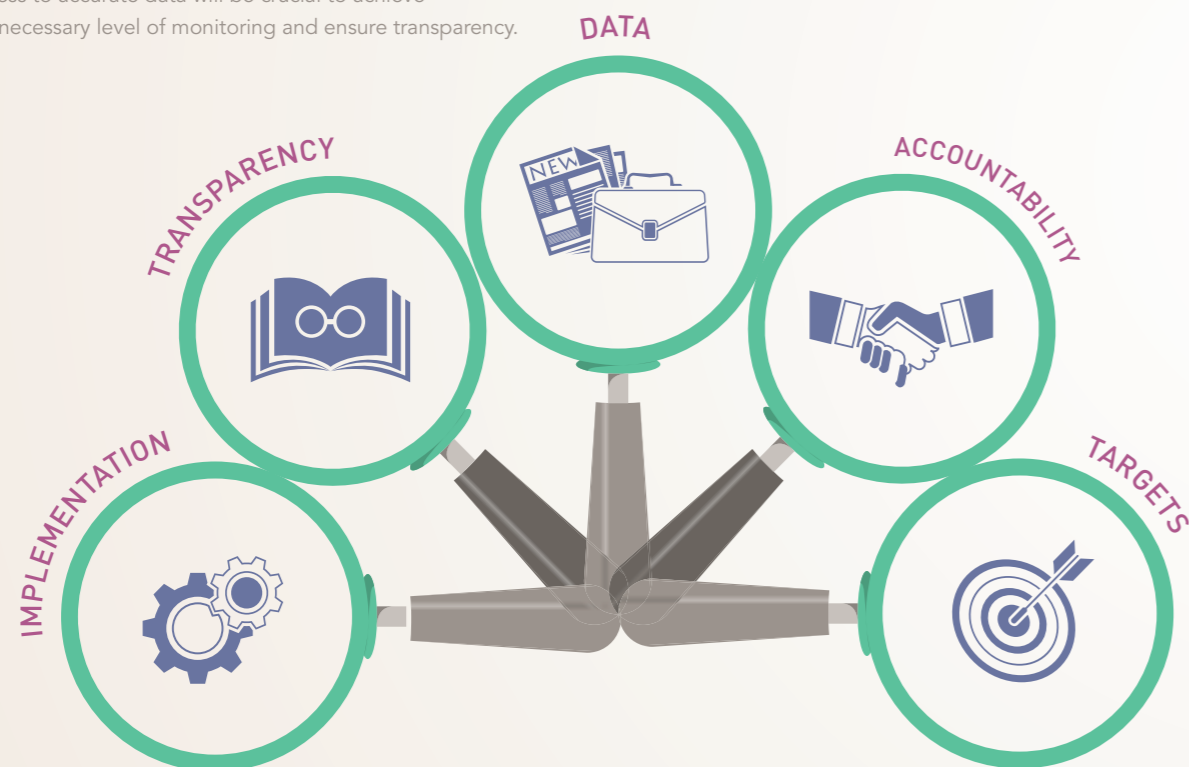
- ▶ the differences in capacities and needs of individual countries
- ▶ the different expectations of what each country can contribute



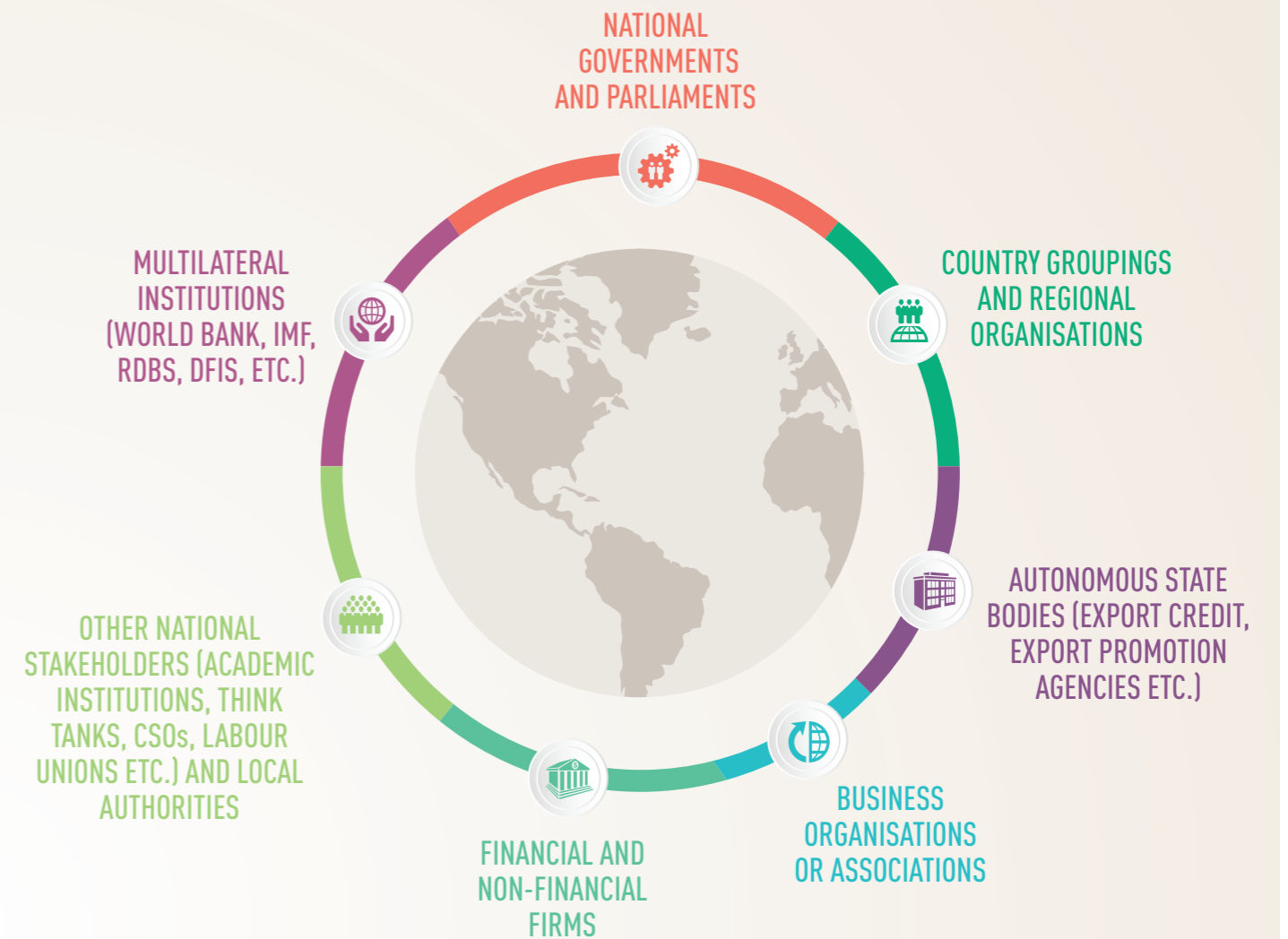
Monitoring and accountability

A major challenge for the new FFD framework is to establish targets and measures that can incentivise finance and implementation.

Access to accurate data will be crucial to achieve the necessary level of monitoring and ensure transparency.



A Global Partnership



A Global Partnership for the post-2015 development agenda will include multiple actors. Each actor will have distinct roles and responsibilities.



A useful and relatively simple way to distinguish between roles and responsibilities with respect to finance for development is to look at three main groups of countries by income levels: (a) LDCs/LICs and fragile states; (b) MICs; and (c) HICs or developed countries. It also needs to be recognised that small and vulnerable economies face special challenges, which implies that they cannot be easily categorised as LICs or MICs

(e.g. some small MICs have very large debts). The broad distinctions between what each of these groupings would be able to do in terms of mobilising and making effective use of finance are identified in Box 7.2, but further differentiation is possible.

Box 7.2 | Differentiation: illustrative stylised roles and responsibilities of country income groupings

For LICs/LDCs, fragile and small and vulnerable states:

- **Mobilisation** requires an essential, often tough, domestic effort to improve the regulatory environment and administrative capacities, to build up the tax revenue system, combat tax evasion and to start to mobilise private capital flows, including remittances. Ensuring effective regulation and supervision of the financial markets encourages private capital. Well-managed domestic public finance will tend to attract international public finance (including ODA and SSC) to fill development finance gaps. These may also be a catalytic role in helping to reform the domestic revenue system.
- **Effective use** involves focusing on domestic budget allocations on transformative priorities and associated enablers, as well as channelling international public resources to invest in human capital, capacity-building and strengthening institutions as well as creating specialised facilities or funds to direct public and private resources to specific enablers, most notably infrastructure and networks.

For MICs:

- **Mobilisation** at this level entails greater emphasis on DRM as the major source of FFD. Strengthening the tax effort and extending the tax base are important priorities. MICs can be expected to have a well-developed domestic private finance sector and should also be able to attract higher levels of international private finance (although small and vulnerable MICs face challenges in this area that are similar to those facing LICs). Small amounts of ODA may still be used in a catalytic fashion to stimulate other finance (including tax revenues). Development of stock exchanges and bond markets can mobilise additional private resources, as can PPPs, which might save resources over a project's lifetime. At the same time, as countries move to MIC status they also move into the league of potential SSC providers contributing external financing (international public and private finance) or concessional lending to other countries and to GPGs. This effort needs to be acknowledged and encouraged. The UN Secretary-General Synthesis Report (2014) suggests that 'more countries will need to commit to increasing their contribution to international public finance, and set targets and timelines to do so' (para. 111).
- **Effective use** involves, among other things, allocating the domestic budget to transformative priorities and associated enablers, encouraging private investment to support public investment in key enablers such as infrastructure, reducing ODA to a minimum and using it mainly to pursue social or environmental goals and/or enhance leverage of other resources. At the national level, PCSD and a serious commitment to establish and maintain a supportive international policy framework need to be major policy priorities. MICs can also be expected to play a growing role in global governance in helping to establish such a policy environment and through their willingness to accept and adhere to global standards, as is increasingly the case for the G20 and the UN.

For HICs/developed countries

- **Mobilisation** involves sufficient DRM to finance national efforts towards achieving the goals as well as providing the basis for sizeable ODA contributions and major concessional lending to the countries most in need. Given their developed domestic private finance markets, HICs should be able to attract large volumes of international private finance, although it is important to prevent illicit transfers, which among other things may undermine poorer countries' ability to mobilise finance.
- **Effective use** involves in particular ensuring that resources intended to achieve domestic and international goals are allocated most effectively and making serious efforts to adjust other internal and external policies to ensure greater policy coherence to support development objectives. In their role as major contributors to establishing a conducive international policy framework, they need to ensure by means of proper incentives, rules, regulations and oversight that GPGs – including an open trade regime, environmental sustainability, and financial stability etc. – are provided in a consistent and inclusive manner. Further, domestic policies in areas such as climate resilience and economic development also have important spillovers on other countries.



7.4.3 Involving multiple actors

The Global Partnership that is expected to be part of the universal post-2015 development agenda implies that all governments should make an explicit commitment to it. Relevant actors, each with a distinct role and responsibility, include national governments and their various departments, country income groupings, autonomous state bodies (e.g. export credit or export promotion agencies), and non-state actors such as business organisations or associations, financial and non-financial firms, and other national stakeholders such as academic institutions, think tanks, CSOs and labour unions. Multilateral institutions such as the World Bank, IMF, RDBs and other DFIs are also key stakeholders.

Country income groupings and regional organisations could, in accordance with their respective competencies, contribute to finance and policy-setting by adopting appropriate standards, consensus-seeking and spotlighting. The EU and the AU, for instance, play valuable roles in consensus-seeking. The EU is the first contributor to global ODA, and although it has still not met its commitment to the 0.7% GNP target (COM, Accountability Report 2014), it provides half of total ODA, is a strong advocate of aid effectiveness (Paris Declaration, etc.) and actively seeks to promote PCD. The EU-based DFIs are also major global players. Other country groupings such as the G7 mobilise the efforts of the largest economies and the G20 plays a valuable role in establishing global rules given its widely recognised status as the world's premier economic forum.

Developed countries such as the USA, Japan and others can contribute to international agreements on trade, investment, climate change and other areas, which in turn can help to contribute to financial flows and appropriate policies. The BRICS and other providers of SSC will be particularly important in the implementation of the post-2015 development agenda. Already SSC is providing an increasing amount of FFD both in the form of international public finance and as international

private finance to support trade and investment, as well as sharing technology and technical assistance – areas in which assistance can be provided quickly, flexibly and efficiently. The international community should welcome SSC efforts to help mobilise finance of all types. At the same time, as Uneze (commissioned background paper, 2015) suggests, ways in which to improve the effectiveness of SSC include better coordination among providers, stronger governance, institution-building and greater transparency.

Development finance institutions are also key players. While national governments will be making decisions at the 2015 Addis Ababa Conference, e.g. on sustainable development finance, these would apply to and be implemented by a range of financial actors such as export credit agencies, SWFs and development banks or development agencies. This means that it is not only civil servants who would need to adapt to the new financing for development framework, but also these other semi-autonomous agencies.

Private-sector actors and social partners, including labour unions, CSOs, business associations and representatives of the financial sector, also have specific roles and responsibilities as critical partners in development in addition to being public actors in their own right. Their participation in policy dialogue and in the design, implementation and monitoring of policies for the mobilisation of finance and its effective use can go a long way towards enhancing and supporting transformative processes and outcomes and mitigating negative ones. A transformative agenda would need to be supported by social contracts that spell out the rights and responsibilities of each party.

Leadership and partnership: While governments will play the leading role in implementing the agenda, they will need to assume, at both the national and global levels, an explicit responsibility to promote open dialogue and partnership among all relevant parties.

At the national level they will need to reach political settlements that favour and support transformative agendas while maintaining social cohesion. In the same way, at the global level governments need to demonstrate a willingness to share responsibility for implementation and become involved in *collective leadership*.

7.4.4 Introduce a monitoring and accountability framework

Part of the success of the MDGs was that they allowed for specific monitoring and follow-up. Yet in terms of the finance and policy in the Monterrey Consensus it was really only international public finance that was assigned a target that could be monitored. A major challenge for a new finance and policy framework is to establish targets and other measures that can incentivise finance as well as other aspects of financing and implementation in the years ahead. This is not an easy task but it is vital in order to make genuine progress. Equally, it is important in terms of promoting transparency and the full participation of all those whose support will be required to make the framework a reality. A strong effort in this direction is ultimately what will give substance to the term 'global partnership'.

Data will be crucial in order to achieve the necessary monitoring and ensure transparency. In the past it was possible to monitor ODA because the OECD provided data supplied by its members, according to their own agreed definitions and systems. Other data systems to cover different aspects of finance and MOI can be established (e.g. on disclosure for private entities, including banks) alongside the existing system. An approach that encourages different actors to create the data systems concerning the financial flows for which they are responsible is likely to foster ownership and support – but these need to be compatible or to work easily alongside each other in order to create an overall picture of progress.

A common effort implies the need for a common system for mutual accountability or at least one that brings together various complementary systems in a transparent manner. In other words, imposing a top-down system is unlikely to improve on the accountability framework of Monterrey.

Given the fundamental role of the finance and policy framework in the post-2015 development agenda, it will be important to ensure that this monitoring and accountability process is part of a broader system which monitors progress against the goals and targets as well as their means of implementation.

Table 7.1 identifies selected finance and policy areas that can be taken as part of such an integrated monitoring and accountability framework. The selection covers many of the key areas of action for governments and other stakeholders that have emerged in the course of our research. They therefore constitute a useful starting point from which to identify which actions to pursue. These actions will vary from one country and set of circumstances to another, but taken together these work in a common direction and illustrate what kinds of things governments could usefully do to pursue these three main priorities. They also cover all type of flows.



Table 7.1 | Illustrative examples of a Finance and Policy monitoring and accountability framework (rationale, actors and indicators)

KEY ELEMENTS OF THE FINANCE & POLICY FRAMEWORK	DETAILS	REASONS FOR INCLUSION	PRINCIPAL ACTORS	INDICATORS FOR ACCOUNTABILITY (EXAMPLES)
Domestic public finance and policies				
Domestic tax revenue systems	Institutional capacity development; extend tax base; less exemptions; 'smart' use of investment incentives	To provide a strong basis for increasing tax revenue and extending the tax base (incl. into the informal sector)	Tax authorities; Ministries of finance; Social consensus on tax and distribution policy	Capacity of tax authority, extent of tax base, Tax effort, tax-GDP ratio towards at least a minimum %
Public financial management	Use of PFM standards; Medium-term expenditure plans;	To increase efficient allocation and use of finance	Government departments such as the finance ministry	Benchmarks for budgeting procedures, Clear agreed standards in contracts (e.g. publish as you pay)
Government procurement	Procurement standards that encourage adherence to principles of sustainable development finance.	Increased transparency and accountability in procurement can incentivise private sector and improve impact of e.g. green infrastructure finance	Government procurement agencies	Government procurement agencies adhering by standard operating procedures and e-tendering
Debt sustainability and debt-restructuring	Design and incorporate new methods of debt sustainability	To check debt increases seen in many country groupings	Governments, donor international development partners and source funds of debt	Levels of sovereign debt, debt sustainability analysis
Domestic private finance and policies				
Financial sector development	Transparency and oversight of sector; stock and bond markets; specialised funds	To ensure vibrant stable financial sector allocates savings to profitable and needed purposes	Regulator, central banks, development banks, institutional investors	Credit to private sector (minimum of 30-50%), stock market capitalisation, financial inclusion reduce 2.5 billion unbanked, better oversight of credit, non-performing loans
Encourage competition and innovation in financial sector	Apply competition policy to financial sector	To remove uncompetitive practices and improve market access	Regulators, banks, competition authorities	Benchmark the interest rate spread (between central bank base rate and lending rates of commercial banks), bank cost to income ratio, and overhead cost to assets ratio to the developing country average
Business environment	Regulatory environment, skills, infrastructure, corporate governance	To provide an attractive business environment with efficient rules and regulations (incl. on firm operations and corporate governance)	Sectoral ministries, semi-autonomous public agencies, private sector, competition authorities	Indicators of public-private dialogue Selected doing business indicators
International private finance and policies				
International rules on taxation	Transparency on transfer pricing and illicit flows, country by country reporting	Difficulties to ascertain what profits levels can be taxed in country	Governments, private firms, tax and trade authorities	Number of appropriate tax agreements, number of private entities reporting payments; Measures of illicit flows

International trade rules	All G20 countries to implement DFQF to LDCs and introduce services preferences, all countries to implement Trade Facilitation agreement, reduce all trade distortionary subsidies	To ensure liberalisation relevant to current trading realities	Governments, G20	Trade logistics index, trade distortionary subsidies, share of G20 imports from LDCs/LICs covered by preferences
International finance rules and finance networks	Adopt global financial regulation and foster network of financial and non-financial actors on stability & sustainable development finance	To create a more stable financial environment, discussed by public and private players	G20, developed countries, financial institutions	Implement Basel III Number of financial institutions part of a sustainable development financial network
Rules for TNCs	To improve government ability to regulate TNCs and their contribution	To create level playing field, balance distribution of economic power	Governments, Investment agencies, TNCs	Number of firms complying with new standards, e.g. disclosure of terms of engagement
Improve international investment by institutional investors	Institutional investors & SWFs to invest in long-term assets in developing countries;	To increase institutional investment and help developing countries deal with foreign investors	SWFs, governments, institutional investors	Levels of SWF investment in poor countries.
Remittance transfers	Set standard rates for transfers; establish reporting systems by banks and transfer services	To increase remittances and flows through formal banking improve safety and monitoring	Financial intermediaries	Costs of remittances Volume of remittances going through formal banking system
Agreement on carbon dioxide emissions reduction	Under the auspices of UNFCCC, agree a binding reduction for emission reduction	To promote a transparent framework that incentivises joint action by public and private sector conducive to sustainable development	Governments, private sector, civil society	CO2 emission levels Carbon price Climate finance incentivised
International public finance and policies				
Target ODA on LDCs and Fragile States	Differentiation policies	To use ODA in the poorest countries for enablers such as governance, infrastructure and human capital	Governments and international development partners	Aid statistics - share of ODA to LICs, LDCs and Fragile States not less than current
In MICs use ODA for catalytic purposes	Use ODA in a transformative way so it can enhance the development of other sources of finance	To optimise use ODA (a minor source of finance in MICs)	Governments and international development partners	Aid statistics and impact assessments
Statistics on international finance	Expand statistics; Introduce grant, officially supported and GPG categories	To incentivise different providers of international public finance	International development partners	International finance statistics
Recognise the valuable role SSC	Establish system to define different components of SSC and allow data collection	To create greater transparency on role of SSC and maximise value	Providers of SSC and partner governments	Create definition and collect data on SSC contributions
Recognise the transformational role of DFIs & RDBs	Pool resources of DFIs, improve additionality and prioritise enablers of transformation	To enhance catalytic role and improve transparency and allocative efficiency	DFIs and RDBs	Exposure of DFIs and RDBs in sustainable development finance areas; Leverage ratios (short and long run, direct and indirect)
Recognise export credit & promotion agencies as international development players	Incorporate export promotion agencies in development debates	To promote coherence between export and development objectives	Export credit and promotion agencies	Number of cases of ECAs assessing their development impact and making decisions based on it



7.5 Concluding remarks

In conclusion, this Report has identified three broad findings that should inform a new finance and policy framework.

- ▶ **The pattern of finance for development evolves at different levels of income.** A key government objective should be to move the financing pattern to the next level and as each form of finance declines to ensure it is put to best use. This has implications for the mobilisation and use of all types of flow, including, for example, ensuring a more transformative role for international public finance in the evolving pattern of finance.
- ▶ **Policy matters:** finance is not enough on its own and it is essential to adopt appropriate domestic and international policies for its effective mobilisation and use:

Domestic policy and financial frameworks that promote mobilising domestic resources and facilitating their effective use for sustainable development. This includes an effective regulatory framework to govern private sources and adequate capacity to raise public revenues, and applies to developing and developed countries.

A conducive global system and policy environment that supports the mobilisation of finance and includes supportive agreements on climate change, an improved global trade regime, better global tax rules and the management of the global financial system.

- ▶ **Accountability and participation:** Given the new financing context, and within it the importance of using several different types of finance in synergy (domestic, international, public, private), it is essential to create a

framework for on-going dialogue between the various stakeholders involved in each type of finance during the implementation of the post-2015 agenda. Participation in such a dialogue will allow stakeholders to monitor progress, hold each other accountable, jointly manage the evolving pattern of finance and make adjustments as required. The dialogue will need to be informed by data from appropriate monitoring and evaluation (M&E) systems.

7.5.1 The pattern of finance for development evolves at different levels of income

Since the 2002 Monterrey Consensus, in real terms (2011 dollars) developing countries have had access to an *additional* \$0.9 tr in international private finance, \$3 tr in domestic private finance and \$4 tr in domestic public revenues. International public finance increased by just under \$0.1 tr. Total public revenues increased by 272% from 2002 to 2011, international public finance (net ODA and OOF) increased by 114%, domestic private finance by 415%, and international private finance inflows increased by 297%.

Private finance generally becomes more significant as incomes rise. Domestic private finance (measured by gross fixed capital formation by the private sector minus FDI) increases as incomes rise, and becomes larger than ODA at income per capita of \$1,000–\$2,000. Remittances and FDI also exceed ODA at income per capita of \$2,000–\$3,000, albeit at more modest levels as a share of GDP than domestic private investment.

There are many implications for different types of flow. Given the emergence of domestic public and private flows, much attention has focused on these flows. One further implication is to design **international public finance** so that it becomes more transformative depending on the financing context and helps leveraging other types of finance. The evidence suggests it needs to be less fragmented, more inclusive of new actors, more catalytic, more sustainable, and more focused

on addressing bottlenecks, for example through channelling: (a) more aid to tax authorities for the purpose of institution-building; (b) more support for DFIs, subject to monitoring their additionality; and (c) more ODA focused on addressing blockages to sustainable development and vulnerable sectors of the population. Serious application of the principles of debt sustainability, aid effectiveness (including donor coordination) and agreement on a sovereign debt-restructuring mechanism are all essential measures to improve the use of international public finance.

This Report has provided quantitative evidence underpinning the transformative potential of development cooperation. One dollar of support on African tax administrations leverages \$6 in revenues. Development finance institutions can create jobs at a cost of \$5–10,000 each, with significant repercussions for indirect job creation and productivity. Providers should therefore be concentrating not only on the direct impact of their support but also on the long-term incentives for a transformative development agenda.

7.5.2 Policy matters

Extending and reforming domestic finance and policy frameworks

Domestic finance and policy is crucial for mobilising and using finance effectively. This applies to public and private finance and to developed and developing countries.

The finance and policy framework needs an approach to monitoring that can follow up efforts to enhance tax-to-GDP ratios. This Report highlights, for example, that when countries take supportive policy action, they have been able to **raise tax-to-GDP ratios by five percentage points in the scope of a few years**, which in the case of LICs would raise around \$20–25 bn, or more than half of their current ODA inflows. **Monitoring tax-to-GDP ratios and understanding the determinants of tax is thus a crucial first step.**

Many countries in all income groupings lack the capacities, resources or political incentives to address shortcomings that limit the tax base and/or prevent tax and other government revenues from supporting institutions and the other critical enablers of sustainable development transformation. More technical and political support for tax authorities to implement and design tax policy that can mobilise **public finance** for sustainable development, especially via the enablers, can therefore be important.

Evidence also suggests that governments can do more to guide and facilitate the **private sector** (including banks, SMEs and TNCs) to channel finance to productive uses and promote the expansion of trade and investment so that it can support development and contribute to rather than hamper sustainable development transformation. As an example, the Report highlights ways in which inefficient regulation can prevent private investment and that its absence can exacerbate risks and inequalities. Similarly, the financial sector needs more competition to drive down costs and interest rate spreads. The finance and policy framework needs to signal that complementary policies are just as important as the finance itself, including in the case of the private sector. Monitoring interest rate spreads would be a first step and could be applied to other economic areas.

Designing a global system and policy environment that is fit for purpose

Designing a **global system** that is fit for purpose entails significant reforms alongside finance. The evidence suggests that the lack of effective and inclusive financial governance, the lack of progress on trade and climate rule-setting and the continued presence and abuse of outdated international tax systems harm the growth prospects particularly of the poorest people and countries. The current guidelines, frameworks and networks fail to offer sufficient incentives to financial institutions to contribute to sustainable



development and fail to direct finance away from wasteful uses (e.g. fossil-fuel subsidies, or financial instruments that ignore social development) and towards sustainable development transformation.

For example, the **removal of fossil-fuel subsidies (more than \$500 bn)** would be sufficient to address green finance gaps; and the **cost of better global banking rules to SSA would be ten times lower than the benefits achieved by averting crises**. Ultimately a stronger real economy is in the long-term interest of most if not all countries and actors.

7.5.3 Accountability and participation

One of the lessons from the experience with the Monterrey Consensus was that follow-up concentrated almost exclusively on ODA since it was really the only type of finance for which a target was set and a monitoring system (i.e. DAC aid statistics) existed. In future other types of finance should also be monitored in order to arrive at a more extensive accountability framework. Equally, given the new financing context, the recognition of the importance of other types of finance and the different stakeholders (public and private) involved in each of them, it is important to establish a mechanism that allows for their participation in the on-going dialogue and accountability framework.

Having in place a framework for multi-stakeholder dialogue, which can monitor progress over time, will allow the FFD system to be properly managed and adjusted as required. Such a framework will depend on having appropriate data and information, which in turn depends on establishing an appropriate M&E system adapted to each form of finance. We have provided examples in Table 7.1.

Final remarks

This Report has analysed the **considerable changes in the FFD landscape since the 2002 Monterrey Consensus**. It has also noted that the implementation of the Consensus came to focus largely on the role of ODA and paid insufficient attention to the importance of increasing domestic tax revenue. Yet in some of the countries that were achieving the greatest progress in reducing poverty, domestic tax revenue carried the main burden. This calls for adopting **a more comprehensive view of FFD that takes fully into account the crucial role of domestic public finance and private finance, both domestic and international**. This will set the scene for international public finance to be a valuable complement to other flows of FFD.

The Report's main message is that **finance alone will not be sufficient to promote and achieve the post-2015 development agenda. Policies also matter. Indeed, they are fundamental**. Appropriate policies will ensure that finance is used effectively to achieve results and that it is not wasted or underused. Good policies will also help to ensure that more finance is mobilised as success breeds further success. The Report has identified many examples of governments that are making effective policy choices in mobilising and using finance for major **enablers of development transformation**, including local governance, infrastructure, green energy technology, biodiversity, human capital and trade.

Given the challenges encountered in the follow-up of the Monterrey conference, it is crucial to develop an **appropriate system of monitoring and accountability** that covers as many flows of finance as possible and that stimulates the right actions in the finance and policy framework, nationally and internationally. This accountability system must cover both the SDGs and their targets and the finance and policies required to achieve them. It can then guide implementation of the post-2015 agenda in a way that covers finance, policies and partnerships.

Overall our analysis suggests that it is not an overall shortage of funds that will be the constraining factor in achieving a transformative post-2015 development agenda. Rather, it is the way finance is mobilised and used that will determine success in achieving the goals the agenda enshrines. This in turn will require efforts both to improve the effectiveness of each category of financing by drawing on its unique characteristics in support of the enablers of poverty eradication and sustainable development, and also to explore how different flows can work together more effectively. This will call for reform of national finance and policy frameworks, as well as concerted effort at the international level.

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CHAPTER 6.

6.1 Local Governance

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Finance alone will not be sufficient to promote and achieve the post-2015 development agenda. Policies also matter. Indeed, they are fundamental.

Annex 1.

The approach taken in the current European Report on Development compared with other reports

The Report has demonstrated the importance of policies in financing sustainable development transformation through enablers. Table 1 below compares these policies with those highlighted by other reports on financing for development (the ICESDF report, 2014, and OECD Development Co-operation Report, 2014). There are many similarities and this Report extends the policies, and distinguishes between domestic and international policies.

This table highlights that the follow-up agreement on Financing for Development (to support the post-2015 development agenda) must systematically address the role of policies in mobilising finance and making more effective use of finance for development. Though there are many policies that will be important in creating a coherent implementation agenda (under the follow-up finance for development agreement), Chapter 7 highlights those that will be vital in creating an enabling environment for further policies and finance.

Table 1 | Mobilising financial flows - specific domestic and international policies by type of flow

	ICESDF	OECD/DAC	POLICIES FOR MOBILISATION OF FINANCE (ERD)	
			Domestic	International
Domestic public (e.g. tax revenues)	<p>Improve capacity of tax and custom authorities</p> <p>Enhance the tax base by bringing more and a wider range of contributors into the system; incentives and regulatory changes to combat informality</p> <p>Ensure good financial governance and public financial management</p> <p>Internalise externalities and mainstream environmental sustainability</p> <p>Address inequity and social protection imperatives</p> <p>Manage public debt effectively</p> <p>Explore the potential contributions of national development banks</p>	<p>International support in taxation (e.g. Tax Inspectors Without Borders)</p> <p>Platform for learning, capacity-development and dialogue on tax (e.g. African Tax Administration Forum)</p> <p>Build capacity of tax systems and administrations, and strengthen the effectiveness and efficiency of existing systems (structures and processes)</p> <p>Build capacity on international policy, transfer pricing and exchange of information</p> <p>Remove tax exemptions.</p> <p>Policies to promote more transparent, accountable and fairer tax systems</p>	<p>A conducive domestic policy environment</p> <p>Promote the capacity of tax authorities (and government more generally)</p> <p>Enhance the tax base by bringing more and a wider range of contributors into the system, or through expansion of the economy</p> <p>Increase tax collection efficiency, and introduce new taxes, e.g. real-estate taxes</p> <p>Increase coherence of taxation regimes, e.g. for SMEs</p> <p>Increase technical and political support for tax authorities</p>	<p>A conducive international policy environment, including financial stability and transparency in international flows</p> <p>Make international efforts (e.g. global tax rules) to address tax avoidance and evasion (e.g. OECD Base Erosion and Profit Sharing) to increase public resources, including measures to stop illicit flows enforce and more disclosures in tax havens</p> <p>Negotiate (or re-negotiate) and disclose contracts with details on tax and royalties between state and natural resource or infrastructure companies</p>

		<p>Improve the capacity to investigate and prosecute financial criminals, recover illicit assets and tackle international bribery payments</p> <p>Sustained political commitment and strong leadership in revenue administration and reform</p> <p>Increased training and pay for tax-administration officials.</p> <p>Transparent fiscal regimes for natural and mineral resource extraction</p> <p>New and innovative DRM instruments</p> <p>Confront tax base erosion</p> <p>Involve civil society and business associations in effective tax bargaining to tax increase compliance</p> <p>Make consistent data sets on domestic revenue collection publicly available</p> <p>Single global standard for automatic exchange of information</p>	<p>Adopt effective laws and regulations to protect taxpayers</p> <p>Promote fiscal sustainability, and a predictable and stable tax system</p> <p>Improve tax administrative infrastructure, e.g. introduction of e-governance</p> <p>Combat corruption</p> <p>Improve public-sector budgeting</p> <p>Reduce inefficient subsidies to increase fiscal space.</p> <p>Develop domestic bond markets</p> <p>Expend political capital on reaching pro-poor political settlements</p> <p>Innovative DRM, e.g. currency exchange taxes or increased taxes on alcohol and tobacco, diaspora bonds or GDP-linked bonds</p> <p>Suspend tax exemptions for e.g. officials and NGOs</p> <p>Domestic policies with detailed requirements for TNCs on transfer pricing, and adequate monitoring</p> <p>Decentralise tax collection to promote accountability</p>	<p>Cancel debt in order to raise expenditure for human development, green technology and infrastructure</p> <p>Ensure ODA is untied</p> <p>Promote sustained donor commitment, debt relief and conducive incentives for middle class/elites</p> <p>Global policies on appropriate pricing strategies to prevent transfer mispricing</p> <p>International co-operation to promote liquidity on bond markets</p>
International public finance	<p>Meet existing commitments</p> <p>Make use of all international public financing sources and instruments</p> <p>Use international public resources efficiently and effectively</p>	<p>Innovative policies to finance GPGs</p> <p>Agree on an international target for international cooperation, e.g. 2% GDP to fund GPGs</p> <p>Develop a global co-ordination mechanism for new and emerging sources of development finance</p> <p>Global fiscal tools to finance global goals (e.g. carbon taxation or arms trade)</p> <p>Recommitment to 0.7% GNI target for ODA</p>	<p>Elaborate a national transformative strategy, supporting policies to finance enablers</p> <p>Create National Facilities or Funds to pool resources and implement specific sectorial programmes</p> <p>Tackle corruption</p> <p>Blending schemes for ODA grants to leverage OOF</p> <p>Shock facilities to address shocks and crises</p>	<p>Agree regional and global additional resource targets (e.g.. SDGs, climate finance)</p> <p>Improve donor co-ordination and management and pool resources to improve aid effectiveness</p> <p>Create blending schemes, trust funds, facilities (in DFIs)</p> <p>Develop South-South partnerships</p> <p>Introduce international taxes (e.g. carbon or financial transaction tax) and market mechanisms (e.g. carbon trading)</p> <p>Increase political commitment to ODA</p> <p>Reform fossil-fuel subsidies</p>

Note: Although policies for domestic private finance and international private finance are presented separately, many of these policies may attract both domestic and international private finance.

	ICESDF	OECD/DAC	POLICIES FOR MOBILISATION OF FINANCE (ERD)	
			Domestic	International
Domestic private finance	<p>Provide access to financial services for households and micro-enterprises</p> <p>Promote lending to SMEs</p> <p>Develop financial markets for long-term investment and enhancing regulations to balance access and stability</p> <p>Strengthen the enabling environment</p> <p>Strengthen economic, environmental, social and governance (EESG) and sustainability issues in the financial system</p>	<p>Instruments to mitigate risks or augment returns</p> <p>Policy reform in the areas of tax, finance, investment and trade</p> <p>A stable macroeconomic environment conducive to growth with consistent policies</p> <p>Remittance schemes to encourage receiving households to invest in the formal financial sector or productive capital</p> <p>Private sector development, an enabling environment for sustainable development e.g. guarantee schemes</p> <p>Whole-of-government approach to improving policy frameworks for investment</p> <p>Promotion of PPPs e.g. through public sector investment in risk capital (e.g. equity stakes in domestic companies)</p> <p>Clear and transparent laws and regulations for investment, including for SMEs</p> <p>Effective and transparent regulations on investment restrictions, access to land, investor protection and tax incentives</p> <p>Improving the efficiency and governance of state-owned infrastructure providers (to attract private investors)</p>	<p>Develop and supervise development of the financial market sector: banking sector, equity, bond and stock markets (managed adequately for volatility), including appropriate regulation</p> <p>Develop and increase the capacity of savings institutions, pension funds and banks</p> <p>Tackle financial illiteracy</p> <p>Bind political settlements and consensus-building to reduce expected risks/delays</p> <p>Create Free Economic Zones, growth corridors, industrial parks and clusters to reduce expected costs and enhance profitability</p> <p>Create specialised facilities or funds for infrastructure or private-sector development and use blended instruments</p> <p>Promote a collaborative attitude towards the private sector, e.g. PPPs</p> <p>Risk mitigation instruments</p> <p>Regulatory reforms: standards, competition policy, improve property rights</p> <p>Adopt user fees or incentives to enhance expected profitability of investments.</p> <p>Policy incentives for sustainable development investments</p> <p>Incentives for domestic saving</p> <p>Design of bankable projects</p> <p>Promote private sector awareness in export promotion</p>	<p>Reform international finance architecture (e.g. Basel III)</p> <p>Reform investment strategies of institutional investors that allow them to invest in illiquid assets in developing countries</p> <p>Mobilise DFIs in leveraging resources through blended and risk-mitigation instruments, including the issuance of development bonds that could attract domestic private capital</p> <p>Improve M&E of DFI and multilateral development bank (MDB) activities to support national stakeholders and development outcomes</p> <p>Adopt trade policies conducive to development (e.g. duty free quota free for LDCs, application of services waiver for LDCs)</p> <p>Form regional Free Trade Areas</p> <p>Form regional stock markets</p> <p>Use ODA to support institutional reforms and private-sector development</p> <p>Develop procurement policies that enable the domestic private sector</p>
International private finance	<p>Channel international funds towards long-term investment in sustainable development</p> <p>Manage volatility of risk associated with short-term cross-border capital flows</p> <p>Facilitate the flow of remittances and private development assistance (PDA)</p>	<p>Instruments to mitigate risks</p> <p>Reduce transaction taxes and transfer costs for remittances</p> <p>Introduce schemes on subsidising or matching remittances</p> <p>Channelling remittances through national commercial banks for greater leverage</p> <p>Use remittances as collateral or to securitise sovereign external loans and improve countries' credit ratings</p> <p>Create policies/environment required to attract investment</p>	<p>Financial market development through appropriate domestic policies and institutions</p> <p>Promote a collaborative attitude towards the private sector e.g. PPPs</p>	<p>Reform international trade policy; participation in regional trade agreements</p> <p>Apply international climate policies and associated mechanisms (e.g. GEF)</p>

International private finance	<p>A stable and integrated policy environment for clear and long-term investment incentives (e.g. for infrastructure)</p> <p>A national, long-term strategy for the infrastructure sector; with predictable pricing and competitive infrastructure markets (sound regulation)</p> <p>Regional infrastructure projects</p> <p>Policy reform in tax, finance, investment and trade</p> <p>Domestic action on bureaucracy, controls and weak financial infrastructure</p> <p>Policies to tackle inflation and currency risk, restrictive investment requirements, and lack of local capacity/expertise</p> <p>Investigate regulatory barriers</p> <p>Foster collaborative mechanisms between investors</p> <p>Market transparency and improved data gathering</p> <p>Collect international, official, accurate and comparable data on alternative investments, pension fund asset allocations, and their returns</p> <p>Include philanthropic organisations in international development processes</p> <p>Correction of market failures</p> <p>Transparent bidding processes, property protection and non-discrimination</p> <p>Reform of legal investment frameworks, improvements in transparency and predictability of procedures, phasing out of capital transfer restrictions on businesses and improve capacity of ministries in PPPs</p> <p>Adequate capacity to negotiate and implement international investment agreements</p> <p>Effective rules and enforcement for IPR</p> <p>Proactive policies to pre-empt market failures</p> <p>Well-coordinated business registration and land-allocation processes</p>	<p>Promote macroeconomic stability, institutional quality, infrastructure development and supply of skilled labour</p> <p>Industrial policy for trade promotion and to attract FDI</p> <p>Political stability and improved governance</p> <p>Regulatory reforms (standards, competition policy, market surveillance, property rights, timely dispute settlements, etc.)</p> <p>Implement Basel III rules</p> <p>Mechanisms to attract finance from institutional investors and philanthropic groups.</p> <p>Risk-mitigation instruments (guarantees, insurance, equity)</p> <p>Introduce shock facilities</p> <p>Innovative instruments e.g. loan and insurance mechanisms, crowd funding</p> <p>Transparent tariff rates and taxation schemes</p> <p>Monetary policy</p> <p>Monitoring of exchange rates, interest rates and inflation</p> <p>Natural resource and clean energy incentives and regulation</p> <p>Design of bankable projects</p> <p>Blending DFI and private sector investment, to reduce risk, short-term investment and volatility in private finance</p>	<p>Mobilise DFIs and Regional Development Banks; create of facilities, funds and use of blended instruments to address risks</p> <p>Mobilise sovereign wealth funds (SWFs) and pension funds to developing countries</p> <p>Develop bond financing including diaspora bonds preferably issued by DFIs or MDBs</p> <p>Design global banking supervision rules</p> <p>Devise a coherent international financial network (with a more effective voice for developing countries)</p> <p>Establish rules of conduct for TNCs and lead firms in GVCs</p> <p>Stabilise global monetary conditions</p> <p>Rules on migration</p> <p>Global environmental policies</p> <p>Reduce costs of remittance transfers</p> <p>International anti-money laundering regulation</p>
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Annex 2.

Variation in flows across countries

There is a significant variation in the experiences of countries across country groupings and for a range of individual countries including (1) outliers (i.e. those at either end of the range of country groupings); (2) selected countries that are the focus of country illustrations discussed throughout this Report⁵³; and (3) selected countries where the largest numbers of people in extreme poverty will be living in the coming years.⁵⁴

We first examine in Figure 1 the variation in tax revenues across countries by identifying for each group the countries with the highest and lowest levels of this source of finance in 2011, as well as the group average and data for select high poverty countries. It illustrates that the range of PR/GDP within each group increases as you progress through the income groups. In terms of poverty focus countries, Tanzania mobilised higher than average levels of PR/GDP compared to other countries in its group, and Bangladesh, Pakistan, India and China received lower than average levels of PR/GDP compared to other countries in their groupings.

Figure 2 also illustrates the variation of levels of net ODA/GNI within the country income groupings by identifying for each group the countries with the highest and lowest levels of this source of finance in 2011, as well as the group average and data for select high poverty countries.⁵⁵ It illustrates that by far the largest range in net ODA/GNI was experienced by LICs, with a notable range also apparent for LMICs. In terms of poverty focus countries, Ethiopia and Pakistan received higher than average levels of net ODA/GNI compared to other countries in their groupings, and Bangladesh and India received lower than average levels of net ODA/GNI compared to other countries in their groupings.

Figure 3 presents an overview of the variation in levels of REM/GDP within the country income groupings, by identifying for each group the countries with the highest and lowest levels of this source of finance in 2011, as well as the group average and data for select high poverty countries. The largest diversity of REM/GDP levels has been experienced by LICs, although each group has a wide range of levels for this resource. In terms of poverty focus countries, Bangladesh and Nigeria received higher than average levels of REM/GDP during 2010-12 compared to their groups, with DRC, Ethiopia and Pakistan receiving lower than average levels of REM/GDP.

Figure 1 | PR/GDP selected LICs, LMICs and UMICs, 2011

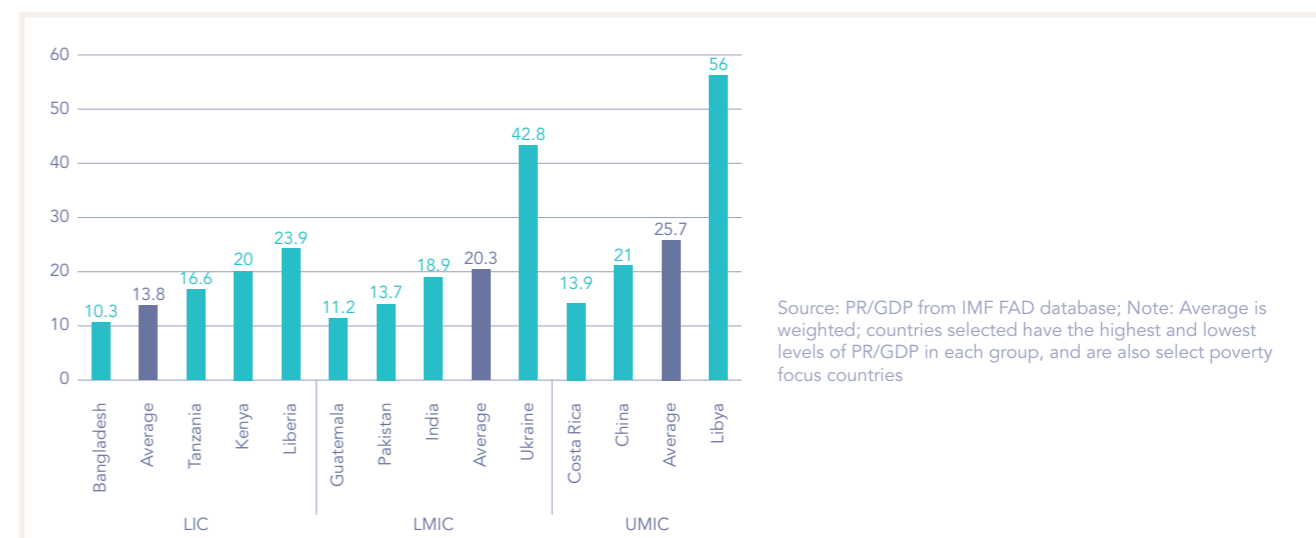
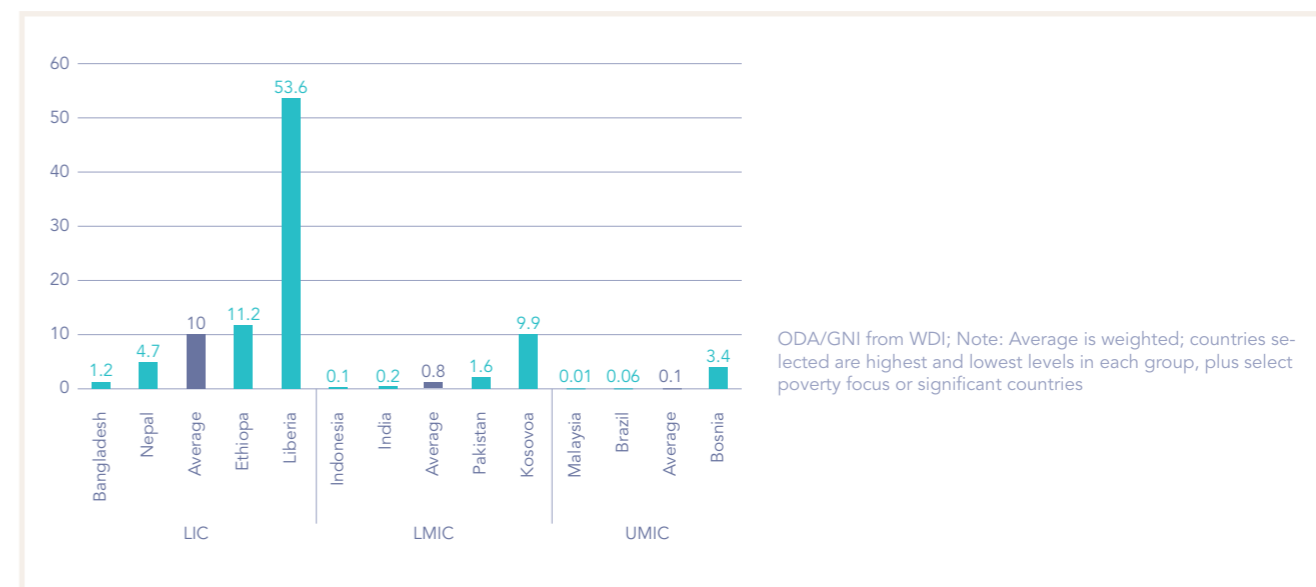


Figure 2 | ODA/GNI selected LICs, LMICs and UMICs, 2011



53 Bangladesh, Ecuador, Indonesia, Moldova, Mauritius and Tanzania.

54 The 2014 Chronic Poverty Report identifies the following countries as the projected location for the largest numbers of people living on under US\$2 a day by 2030 (in order of significance) – India, Pakistan, Bangladesh, Ethiopia, Democratic Republic of Congo, Nigeria, China, Tanzania, Madagascar and the Philippines (CPR, 2014).

55 The 2014 Chronic Poverty Report identifies the following countries as the location for the largest numbers of people living on under \$2 a day by 2030 (in order of significance) – India, Pakistan, Bangladesh, Ethiopia, Democratic Republic of Congo, Nigeria, China, Tanzania, Madagascar and the Philippines; these countries are the focus of our presentation of country experiences (CPR, 2014).

Figure 3 | REM/ GDP, select LICs, LMICs and UMICs, average 2010-12



Annex 3.

Further details of IFD

A significant number of all types of instruments have been implemented during the last two decades. The UNDP (2012) categorised IFD instruments based on their “sourcing” mechanisms, as follows:

- Taxes, dues and other obligatory charges on globalised activities (initiatives levied at the national level but within a framework of international co-ordination. The revenues raised are allocated to international development)
- Voluntary solidarity contributions (initiatives that give consumers the option to donate a small sum to international development at the point of product purchase. Although private in nature, public authorities facilitate such contributions through tax incentives and technical facilitation in the distribution of resources)
- Front-loading and debt-based instruments (initiatives that ‘frontload’ resources, make public funds available earlier for development, via the issuance of bonds on international capital markets)
- State guarantees, Public–Private Partnerships (PPPs), Insurance and other Market-based Instruments (initiatives which leverage private funds to create investment incentives for the private sector, e.g. through subsidies or commitments to purchase a particular product at a set price (e.g. a vaccine). In doing so these initiatives aim to correct market failures. Other mechanisms aim to reduce sovereign risk and/or macroeconomic vulnerabilities (e.g. weather-based insurance or counter-cyclical loans). These mechanisms aim to improve the effectiveness of finance rather than create new revenue streams for development)

The main characteristics of IFD mechanisms could be summarised as follows:

- ▶ New sources of development finance expand countries’ choices, whether from innovative sources, emerging donors, private philanthropists or other stakeholders. They all bring with them **more resources** to help developing countries achieve the MDGs. According to the UN (2012), there are a number of IFD proposals that are technically feasible and have significant potential to raise revenues, even though co-ordinated international implementation is likely to face substantial political difficulties. Examples of these include international taxes, such as financial and currency transaction taxes, carbon tax, and non-tax revenues such as the use of IMF’s SDRs for development finance.
- ▶ According to Herman (2012), IFD proposals have usually shared two common objectives – to raise significant additional resources for development and to do so in a stable and predictable manner. **Predictability** can be an advantage to most IFDs over ODA, albeit with variation across initiatives e.g. taxation-based incentives are more predictable than voluntary solidarity contributions. IFDs are characterised by great **transparency and accountability** regarding criteria for accessing resources. However, LICs often lack the necessary capacity to handle the complex procedures.
- ▶ The general principle of IFD is to **‘ earmark ’** resources in order to motivate participation and represents ex-ante conditionality. Performance-based approaches to IFDs also represents ex-ante conditionality, therefore these IFDs have a double conditionality burden. Performance-based approaches are suitable for short-time relatively simple

interventions rather than for more complex, expensive and/or longer-term interventions (e.g. women's empowerment).

- ▶ IFD amounts are generally small compared to official ODA and spread over a wide range of different initiatives, involving a large number of mechanisms, participants and beneficiaries. Many small un-coordinated priorities and programmes are associated with **fragmented aid** delivery and can create heavy costs, thus reducing their effectiveness.

There is potential for scaling up and replicating IFD mechanisms, UNTT (2013d):

- ▶ IFFIMs frontloading aid using a securitisation mechanism could be replicated in programmes where there are benefits to be gained by large upfront investments such as (green) infrastructure investment.
- ▶ Advanced market commitments mitigate risks and change incentives with the purpose of spurring innovation. These could be replicated in other areas of innovation, in particular with regard to clean energy and low carbon products (e.g. mini-grids in remote areas with limited access to central electricity grid, large-scale grid-connected renewable-energy projects, development of new technologies to address problems of land and water scarcity, climate change and declining crop yields, medium-scale deployment of biogas for schools and hospitals, etc.) and to social sectors as well (e.g. similar structures to promote education and health services such as ICT or web-based applications adapted for isolated and poor communities in Africa for example.)
- ▶ The Caribbean Catastrophe Risk Insurance Facility mechanism could be replicated covering more risks and/or groups of countries. In addition, well-structured insurance pools could be sold to the private sector as "catastrophe bonds".

There are also important considerations about the effectiveness of IFDs:

- ▶ The **importance of an adequate delivery mechanism** is particularly evident with some suggesting that a 'capable institution' is a key requirement (UNDP, 2009). Most IFDs are supported officially, a few IFDs are classified as public (front-loading and debt-based instruments). Private IFDs concerned with crowd-funding increased in 2012 by 81% (Massolution, 2013).
- ▶ IFD instruments **focusing on improving the effectiveness** of development finance (e.g. countercyclical loans, sovereign issuance pools, performance-based aid) are increasingly added to those creating new revenue streams. Major development banks and regional banks are becoming involved in this process thus connecting the advantage of holistic project assessment from both the banking and the development perspective.
- ▶ Concrete results are most evident in the **health sector**, owing to the economies of scale achieved by the implementation of thematic single-use vertical programmes. In the **environment/climate sector**, the initiatives supported are more diverse and the results more difficult to measure (UNDP, 2012).
- ▶ **Long-term sustainability**, a key-importance factor in the post-2015 development agenda as indicated in UNTT (2013d). Long-term sustainability varies significantly across different IFD initiatives, e.g. tax-based initiatives are sustainable as long as countries wish to endorse the specific policy and voluntary solidarity contributions are sustainable as long as the donors' commitment continues. For front-loading and debt-based instruments (e.g. diaspora bonds, green bonds) medium and long-term debt sustainability of the beneficiary countries is crucial.

Although currently limited to HIPCs, countercyclical loans that reduce debt/service payments when major shocks occur could be viewed from a different angle in view of the current economic situation. (Mustapha et al., 2014)

- ▶ IFD **PPP (Public-Private-Partnerships) initiatives** in the form of venture capital and mutual funds for strengthening SME development are gaining ground (ADB and OECD, 2014). In addition to tax-based initiatives, solidarity contributions and diaspora bonds, using PPP initiatives for IFD are important in the agricultural sector to facilitate modern banking instruments and guarantees in order to assist SME development.



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