



THE WORLD BANK GROUP

# Financing for Development Post-2015

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## Financing for Development Post-2015

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## Executive Summary

As we approach the 2015 deadline for the Millennium Development Goals, the international community is elaborating a new framework to promote sustainable development for all beyond 2015, which will build on achievements to date and address new challenges arising from an evolving and complex landscape. Three major trends are emerging: first, most of the poor live in middle-income countries and many live in high-income countries. Second, the Eurozone crisis and turmoil in MENA demonstrate that developed and developing countries alike are confronted with the difficult task of generating growth and creating jobs. Moreover, beyond the financing needs associated with these protracted crises, the impact on a number of traditional donors reduces the volume of available official development assistance (ODA). Third, trade, finance and other links among emerging market and developing economies are growing. This shift offers opportunities for new, mutually beneficial partnerships.

The ability to adequately finance a post-2015 development framework depends on many factors. First, we need global development cooperation that attracts aid from diverse sources, emphasizes domestic resource mobilization, and capitalizes on the potential of the private sector. Second, the success of cooperation requires good policies (and the capacity to implement them), and credible institutions to increase the impact of scarce resources and leverage additional resources from both domestic and foreign, public and private sources. The relative significance of each source, and the associated leveraging challenges, will differ between low-income countries and fragile and conflict-affected states, middle-income countries with limited market access, and middle-income countries with market access.

Aid has been essential to helping low income countries accelerate economic growth and lift people from extreme poverty over the last few decades. For many developing countries, ODA – and the reforms it supports – needs to continue to be a stable source of development financing especially for the poorest economies and fragile states with limited or no access to capital markets. It represents the biggest financial inflow to fragile states, after remittances and foreign direct investment (FDI). ODA is expected to remain a critical input to achieve the new development goals.

Financing a transformative development agenda will require that available resources be used more effectively and strategically to catalyse additional financing from official and private sectors. Developing countries will need to step up efforts to finance their own development by improving domestic resource mobilization, including by strengthening tax administration, better harnessing natural resource revenue, and curbing illicit financial flows. The public sector has a catalytic role in attracting private sector financing, such as for scaling up infrastructure investments. This paper reviews a range of existing and potential financing sources and tools: bond financing, institutional investors, diaspora bonds, pull mechanisms, advance market commitments, resources-for-infrastructure deals, climate finance, and more. Not all of these options are feasible for all countries; the challenge lies in establishing a supporting country-level policy framework and credible commitment to build domestic capacity and combat poverty in order to expand the options available.

*Domestic resource mobilization.* The ability to mobilize domestic revenues reduces aid dependency and can raise country creditworthiness. Low-income countries still struggle to increase domestic revenue mobilization in the face of high levels of capital flight and limited capacity to collect revenues from multinationals, particularly those engaged in natural resource extraction. Inefficient public expenditures and investments further compound the problem. Progress is needed in expanding tax coverage, strengthening accountability and increasing expenditure efficiency.

*Emerging donors.* A diverse group of countries has been gaining prominence in the aid landscape, particularly upper middle-income countries. These countries include the BRICS (Brazil, Russia, India, China and South Africa), which account for 25 percent of global gross domestic product (GDP) and 40 percent of the world's population, Saudi Arabia, South Korea, and Turkey. They are ramping up their development engagements through a broad range of channels and activities. Their increasing ODA is a relatively small part of a larger

trend in external financial flows to other developing economies. These new partners may help meet development needs not addressed by traditional donors.

*Private finance for development.* Achieving development goals will require the mobilization of resources from private sources, including FDI, bank loans, capital markets, and private transfers (e.g., remittances). For most developing countries, FDI is the preferred private financing modality given its potential to strengthen productivity and growth, and help diversify the economy. Although many developing economies have enjoyed increased access to international capital markets over the past decade, there is increasingly a mismatch between available financing and investment needs partly due to fragile market conditions in the wake of the global financial crisis, which constrain the availability of the type of long-term finance needed to support productivity-enhancing investment. Accessing long-term finance for infrastructure is critical and will require greater attention to investment in project preparation and policies and instruments that can lower risk and strengthen the confidence of investors over a long-term horizon.

*Innovative sources of finance.* Development partners are helping to develop new tools to help generate financing for development. The paper discusses a number of these:

- Pull mechanisms for development which involve ex-post economic incentives for innovation to solve a well-defined problem. By linking payments to the actual impact of an innovation, they can lay the foundations for a self-sustaining, competitive market for the relevant product.
- A number of African countries have adopted the resources-for-infrastructure (RfI) financing model to overcome limited capital market access and domestic capacity constraints. Under RfI, oil or mineral extraction rights are exchanged for turnkey infrastructure, complementing standard tax and royalty regimes.
- Diaspora resources (via diaspora bonds and remittance-backed bonds) could help finance infrastructure projects. The annual savings of developing country diasporas – \$400 billion by some estimates – represent a hitherto untapped source of financing for development.
- Linking climate finance and development finance can enhance development impact by allowing the fight against poverty to take climate effects into account and vice versa. Comprehensive carbon pricing policies, the removal of inefficient fuel subsidies, and cap-and-trade schemes are promising options to mobilize larger and higher-return investments.

*The role of the World Bank Group and regional development banks.* The World Bank Group and its regional counterparts can add value through a combination of technical expertise, prudent risk management policies, application of clear standards to project design, execution, and corporate governance, a long-term perspective, and cross-country experience. Multilateral development banks (MDB) can bring financing partners into specific deals, for example, in the form of syndications or through co-financing arrangements. Generally, the MDBs' stamp of approval and role as a "honest broker" in disputes can help to reassure investors and contribute to a project's viability, which in turn reduces the cost of engagement, including to private investors. MDBs can also contribute to extending maturities of private flows to finance productive investments.

These are just some of the ways that developing countries and their partners can respond to the evolving challenges of financing for development. Available resources are expected to continue to fall well short of development needs, implying that policy makers will need to make better use of existing resources while working to catalyze new funding. This will require greater attention to domestic resource mobilization and making countries more attractive destinations for both ODA and private sector resources by improving the underlying conditions for development and growth.

## List of acronyms

AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
BRICS	Brazil, Russia, India, China, South Africa
CDM	Clean Development Mechanism
Ci-Dev	Carbon Initiative for Development
CSO	Civil society organization
DAC	Development assistance committee
DFI	Development finance institution
DFQF	Duty-Free Quota-Free
DPL	Development Policy Lending
DRM	Domestic resource mobilization
EITI	Extractive Industries Transparency Initiative
EPFR	Emerging Portfolio Fund Research
ETS	Emission trading schemes
FCS	Fragile conflict-affected state
FDI	Foreign direct investment
FTT	Financial transactions tax
GDP	Gross domestic product
GEF	Global Environment Fund
GFI	Global Financial Integrity
GIF	Global Infrastructure Facility
GNI	Gross national income
GPEDC	Global Partnership for Effective Development Cooperation
GPFI	Global Partnership for Financial Inclusion
HIPC	Heavily Indebted Poor Country
IATI	International Aid Transparency Initiative
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IEA	International Energy Agency
IFC	International Finance Corporation
IFF	Illicit financial flows
IFFIm	International Finance Facility for Immunization
IPP	Independent power producer
LIC	Low-income country
MDB	Multilateral development bank
MDG	Millennium Development Goals
MDRI	Multilateral Debt Relief Initiative
MIC	Middle-income country
MIGA	Multilateral Investment Guarantee Agency
MSME	Micro, small, and medium enterprises
ODA	Official development assistance
ODI	Overseas Development Institute
OECD	Organisation for Economic Cooperation and Development
OOF	Other official flows
PPIAF	Public-Private Infrastructure Advisory Facility
PPP	Public-private partnership
PRG	Partial risk guarantee
RfI	Resources-for-Infrastructure
RGGI	Regional Greenhouse Gas Initiative
RPW	Remittance Prices Worldwide
SWF	Sovereign wealth fund
UNFCCC	United Nations Framework Convention on Climate Change

## Introduction

This paper is a contribution to UN-led efforts to articulate a Post-2015 Development Framework, building on the *Millennium Declaration* and Millennium Development Goals (MDGs). It focuses on the challenge of financing development goals and complements the extensive work conducted by the United Nations<sup>1</sup> and other institutions, including the World Bank Group.<sup>2</sup>

This exercise was prompted by the report of the *High-Level Panel (HLP) of Eminent Persons on the Post-2015 Development Agenda*,<sup>3</sup> which provides sound and concrete recommendations for International Financial Institutions (IFI) to enable global investment in long-term prosperity for all. The HLP report acknowledges the connection between the MDGs and the international community's ability to support them, given market failures in mobilizing financing for development in low- and middle-income countries and the consequent importance of leveraging official-sector resources and expertise to attract and scale up private financing.

For many developing economies (particularly fragile states), ODA and the reforms it supports continue to be critical to mobilize and catalyze resources from other sources. When the MDGs were adopted, ODA was already falling short of the level required for success. Today, ODA budgets are under even greater pressure due to the tepid global economy and heavy fiscal burdens on many major donors. Even if the UN's 0.7 percent ODA-to-GNI target and the 2008 *G8 Gleneagles pledges* were achieved, and non-DAC (Development Assistance Committee) donors contributed additional resources, ODA alone would still fall short of the resources needed to achieve the next set of development goals.

In addition to financing, progress toward each MDGs also requires supporting policy and institutional reforms that boost growth and improve service delivery. In its Post-2015 Agenda report, *Realizing the Future We Want for All*, the UN System Task Team acknowledged that “in the global debate, the MDGs led to overemphasizing financial resource gaps to the detriment of attention for institutional building and structural transformations”. The Post-2015 HLP's report emphasizes the importance of “creating a global enabling environment and catalyzing long-term finance”.

No quantity of financing - grant, concessional, or non-concessional - is sufficient to achieve ambitious development goals without a supporting country-level policy framework and credible commitment to build domestic capacity and combat poverty. In the absence of these factors, the question of resource mobilization is moot. A supporting policy and institutional environment can not only enhance the effectiveness of development spending, but also catalyze additional resources from the official and private sectors. Indeed, when it comes to policies, donor assistance, and private-sector resources, the whole is greater than the sum of the parts. Reflecting this, any feasible approach to financing post-2015 development goals requires a two-pronged strategy—first, to significantly enhance the impact of available resources, and second, to increase those resources. This paper highlights the importance of domestic policies and capacity building to enhance the impact of available resources on development and poverty reduction, including with support from the donor community and IFIs. It is in supporting policy reform and capacity building—rather than through

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<sup>1</sup> Including the series of annual *MDG Gap Task Force Reports*, *World Economic and Social Survey, 2012: In Search of New Development Finance* and more recently the Post-2015 UNTT Thematic Think Piece on *Financing for sustainable development in the global partnership beyond 2015*; documents prepared on Financing for Development for the fourth HLP meeting in Bali, Indonesia, 24-27 March 2013.

<sup>2</sup> See, for example, the *2013 European Report on Development. Innovation with Impact: Financing 21<sup>st</sup> Century Development*, and *Bill Gates' Report to G20 Leaders for the Cannes Summit*, in November 2011, as well as the *Global Monitoring Report 2013*, the *2013 Global Development Horizons (Capital for the Future: Saving and Investment in an Interdependent World)*, and the *Long-Term Investment Financing for Growth and Development: Umbrella Paper*, presented to the Meeting of the G20 Ministers of Finance and Central Governors in Moscow (February 2013).

<sup>3</sup> *A New Global Partnership: Eradicate Poverty and Transform Economies through Sustainable Development*. United Nations, May 2013.

direct financing—that donors and development institutions like the World Bank Group can often have the biggest impact.

The paper is structured as follows. Section 1 outlines elements of what it will take to achieve development outcomes -- the importance of a global development cooperation framework, the role of targeted, evidence-based policies and sound institutions; and the mobilization of resources for global public goods. Section 2 focuses on how best to support developing countries in mobilizing domestic resources for development, by boosting taxation capacity, harnessing natural resource revenue, improving expenditure efficiency, and curbing illicit financial flows. Section 3 examines issues of aid effectiveness and considers ways for development actors to provide better and smarter aid. Section 4 discusses trends in private financial flows to developing countries and the growing mismatch between available financing and investment needs. It then turns to strategies for mobilizing financing for long-term infrastructure. Finally, section 5 explores a range of emerging and innovative sources of finance, and the role an inclusive financial system can play to promote development.



## Section 1: What will it take to achieve development outcomes?

### 1.1 A global development cooperation framework

The United Nations' development agenda beyond 2015 calls for a renewed global partnership to foster a number of transformative and mutually reinforcing actions that apply to all countries, including: poverty eradication, tackling exclusion and inequality, women and girls' empowerment, the provision of quality education and lifelong learning, better health, climate change mitigation and adaptation, managing environmental challenges, inclusive and sustainable growth and decent employment, the end of hunger and malnutrition, addressing demographic challenges, enhancing the positive contribution of migrants, meeting the challenges of urbanization, peace building and effective governance.<sup>4</sup> Given concerns with the availability of financing from many of the traditional providers of ODA, what is needed is an integrated discussion of development goals and the associated financing framework. Will there be enough resources for safety nets, infrastructure, health, and education? Are the resources available sufficient to address current problems of food security, water scarcity, water pollution, land degradation, access to energy? To what extent will climate adaptation increase the cost of achieving new goals and maintaining progress on existing goals? The new framework for development cooperation should also provide means to improve the mobilization and allocation of resources for sustainable development.

#### **Box 1.1: Innovation with impact: financing 21<sup>st</sup> century development, *The Gates Report to G20 Leaders***

In a report prepared at the request of the French Government during its 2011 G20 Presidency, Bill Gates discusses many of the topics relevant to the financing of a post-2015 development framework. The report emphasizes the significant potential to achieve greater impact with money that is already being spent, calling on countries to use public-private partnerships to enhance their capacity to evaluate their own development spending.

The report highlights the importance of ODA and the need for traditional donors to meet their commitments. ODA will generate an estimated an additional \$80 billion annually starting in 2015. Gates points out that countries outside of the OECD donate an estimated \$18 billion annually, and urges them to maintain their support as a share of their rapidly growing GNI, while aiming to increase that percentage over time. Written in the midst of the global financial crisis, Gates acknowledges the pressure on aid budgets but maintains that ODA represents a very small part of government expenditures and that cutbacks would do irreparable damage to global stability, the growth potential of the global economy, and the livelihoods of millions of the poorest people.

At the same time, Gates argues that developing countries' domestic resources will be the largest source of funds for development. Therefore, to maximize impact, it is essential that domestic resources be mobilized on a larger scale and spent more effectively on key priorities, particularly in agriculture and health. Improving natural resource information and management is key to improving domestic resource mobilization.

However, to point to domestic resources as the largest source of financing for development does not free major economies of their responsibilities. Rather, it implies that they also have a duty to help poor countries raise more revenue by passing legally binding transparency requirements for mining and oil companies listed on their stock exchanges to ensure that natural resources in developing countries are better managed, among other things. Gates also calls for a "natural resource charter" to increase transparency in land, timber, and other natural resource related deals.

The report highlights the importance of bolstering investment in infrastructure, drawing on the potential of the private sector, sovereign wealth funds, and diaspora communities, and supports explicit taxing of carbon, including through shipping and aviation fuels as proposed by the World Bank and IMF. Gates also notes the revenue-generating potential of financial transactions taxes at a low rate and on a large base, and of tobacco taxes, with countries allocating a portion of revenues to global health initiatives (on a sliding scale according to per capita income).

In his report to G20 Leaders in 2011,<sup>5</sup> Bill Gates addresses the mismatch between needs and government and donor resources by arguing that all stakeholders--governments, civil society, and the private sector--need to cooperate and take action to activate new, reliable sources of financing (Box 1.1.). A similar conclusion can

<sup>4</sup> UN, *A life of dignity for all*. Report to the Secretary-General, A/68/202, 26 July 2013.

<sup>5</sup> Gates, Bill. *Financing 21<sup>st</sup> Century Development*, November, 2011. See <http://www.thegatesnotes.com/G20>

be found in the report<sup>6</sup> prepared by the Secretariat of the Post-2015 High Level Panel, which highlights “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 productivity improvements”.

## 1.2 Good policies and sound institutions

**Targeted, evidence-based policies and sound institutions help determine progress on each of the MDGs.** A decade of *Global Monitoring Reports*<sup>7</sup> by the IMF and World Bank, provides compelling evidence that with the right policy and institutional reforms, ODA can be used more effectively to make progress towards MDGs.

**The cost of achieving any development goal depends on the efficiency with which the objective is pursued, taking into account the quality of underlying policies and practices.** For instance, the undersupply of infrastructure in developing economies has been estimated at around US\$1 trillion per year through 2020, with an additional US\$200 to US\$300 billion per year to ensure that infrastructure investments are low emitting and climate resilient<sup>8</sup> (Figure 1.1). But these costs can be reduced by making more efficient use of existing infrastructure and improving project quality and management. The McKinsey Global Institute and McKinsey’s infrastructure practice have outlined practical steps to boost productivity in the infrastructure sector by as much as 60 percent, thereby lowering spending by 40 percent for an annual saving of US\$1 trillion. Over the next 18 years, this would be the equivalent of paying US\$30 trillion for US\$48 trillion worth of infrastructure.<sup>9</sup>

**Similar lessons on cost efficiency emerge from other sectors.** In human development, for instance, recent World Bank research<sup>10</sup> notes that there is considerable scope to improve social protection outcomes without increasing the overall fiscal deficit. This can be achieved by reallocating untargeted and inefficient energy subsidies to social safety net programs. Box 1.2 provides another illustration, in the case of education, of how learning outcomes can be improved with the right institutions without increasing spending.

**Simply increasing public spending is unlikely to lead to better outcomes in countries suffering from poor governance.** Improved fiscal transparency, for example, can have a positive impact on government budgets in several ways. Transparency can facilitate taxpayer compliance and willingness to pay and contribute to a better investment climate. It also has a significant and positive impact on FDI flows, sovereign spreads and credit ratings, thereby having a multiplier effect on the volume of resources available for development.

<sup>6</sup> Background Paper for the Post-2015 HLP meeting in Bali, *Summary of Financing for Development*, March 2013.

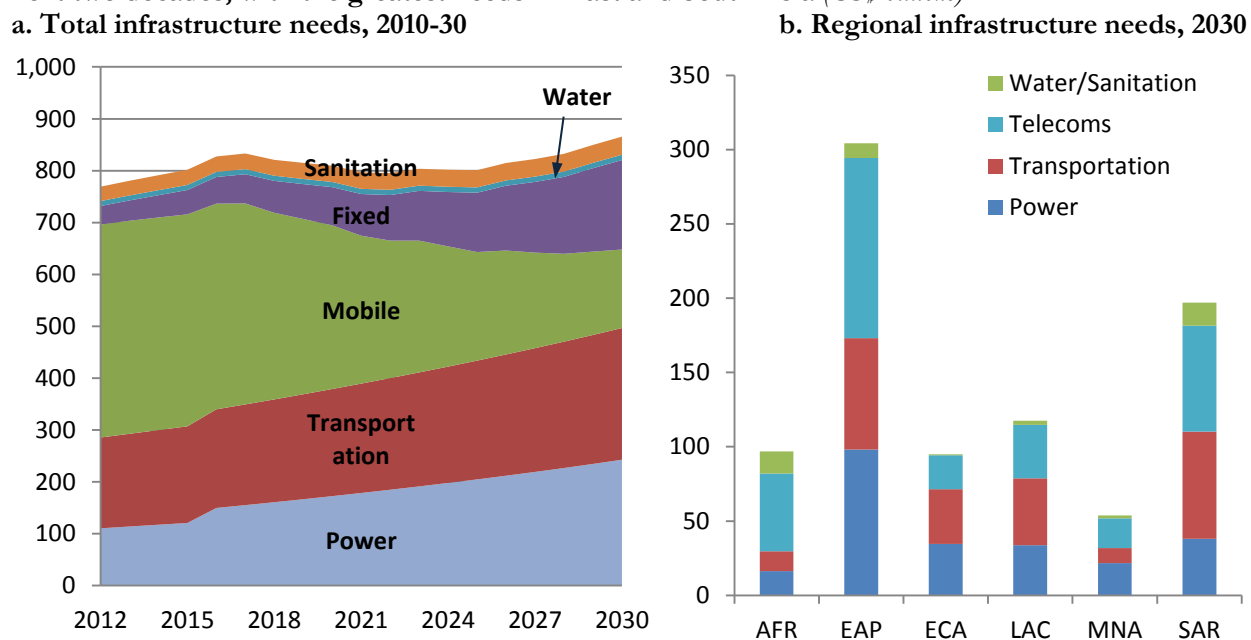
<sup>7</sup> Go, Delfin S. and José Alejandro Quijada. *Assessing the Odds of Achieving the MDGs*. WPS5825. World Bank, October, 2011.

<sup>8</sup> World Bank, IFC, and World Economic Forum. *Tackling the Infrastructure Finance Deficit*, January 2013.

<sup>9</sup> McKinsey Global Institute, *Infrastructure productivity: How to save \$1 trillion a year*, January 2013.

<sup>10</sup> Fiszbein, Ariel, Ravi Kanbur and Ruslan Yemtsov, *Protection, Poverty and the Post 2015 Agenda*, WPS6469, World Bank, May, 2013.

**Figure 1.1: Annual infrastructure investment needs in developing countries will be substantial for the next two decades, with the greatest needs in East and South Asia (US\$ billions)**



Source: World Bank, *Global Development Horizons*, 2013.

**Box 1.2: Spending more is not enough to improve students' learning outcomes.**

**Invest in inputs and institutions.** Beyond getting children and youth into school, education systems should promote learning and skills acquisition for all. Evidence shows that additional expenditures have not often been sufficient to improve learning for all. There is no question that providing adequate levels of schooling inputs—whether school buildings, trained teachers, or textbooks—is crucial to educational progress. The increase in inputs in recent years has made it possible to enroll millions more children in school, and this effort should continue wherever inputs remain inadequate. But improving systems also requires ensuring that inputs are used more effectively. Merely spending more, without changing the way education systems work, does not automatically translate into more learning.

**Think systemically.** Strengthening education systems means aligning their governance, management of schools and teachers, financing rules, and incentive mechanisms, with the goal of learning for all. Policymakers need to recognize that they have tools to reform the system beyond providing more resources (or, where appropriate, in conjunction with providing more resources). Thinking systemically means looking at all the determinants of learning beyond the formal K-12 system—early childhood development (ECD), non-formal learning, private schools—and adopting policies and programs to align them.

**Increase accountability for performance and focus on results.** Support accountability structures that are clear, measured, and monitored, with a feedback loop between inputs and results.

**Invest in and use information and knowledge.** Too often, policymakers and education professionals lack key information about how and how well the system is operating—especially in terms of learning outcomes and the quality of policies and service delivery. Information allows them to "turn on the lights" and determine how to improve learning outcomes. Data-gathering, analytical work, and practical evidence can help answer questions like: Are children and youth acquiring the knowledge and skills that they need? What are the strengths and weakness of the system, relative to its own goals and international benchmarks? Which interventions have proved most effective in achieving outcomes?

### 1.3 Financing global public goods

Global public goods (GPGs) are at the intersection of national development priorities and global interests, where common opportunities and shared risks increase mutual interdependence. **While the development community should work cooperatively to produce GPGs, it must also identify how financing can be mobilized to ensure adequate supply of GPGs.** Many donor countries have increased the portion of their ODA dedicated to global public goods. There have been recent discussions about a transition of ODA to “global public investments”, particularly to address climate change and fight infectious diseases, and recent innovations in financing GPGs (section 5). However, funding remains short of needs. Under provision of GPGs - preserving the environment, controlling communicable diseases, enhancing developing country participation in the global trading system - disproportionately impacts the poor. They must be considered in national and regional development strategies.

**Infectious disease is an excellent example of a case where the social benefits of addressing challenges of a global nature exceed their cost.** Neglected vaccines (e.g. against malaria), limited access to affordable essential medicines, overuse of antibiotics, the disincentives of drug companies to develop new more resistant antibiotics, all threaten the global fight against poverty.<sup>11</sup> Innovative mechanisms can be introduced to finance purchases and expand local production of medicines.<sup>12</sup>

**An open, transparent, and rules-based multilateral trading system is a GPG, and most countries will benefit from liberalization.** With supporting capacity building efforts, increasing developing country access to markets for agricultural goods and other products of importance and removing non-tariff measures with discriminatory restrictive impact have significant developmental and poverty reduction potential, particularly for low-income countries (LIC). In particular, Full Duty-Free Quota-Free (DFQF) access to the markets of G20 countries could increase national incomes in LICs on average by 0.5% of GDP. These income gains could rise to 1% of GDP if a DFQF initiative were complemented by transparent and simple rules of origin.<sup>13</sup> A DFQF access initiative could lift three million people in least developed countries (LDC) above the poverty line.

Implementation costs would be minimal, and removal of tariffs on LDCs could be achieved through “stroke of the pen” policy changes. Although there would be costs associated with implementing the proposed liberal rules of origin, the impact on G20 imports would be limited. If complemented by simple, transparent, and liberal rules of origin and measures to reduce trade costs for firms and farmers in LDCs, a broad trade initiative by the G20 could boost national incomes of LDCs by 1.3 to 1.5 percent on average. This is substantial, even with a conservative estimate that ignores the impact that a reduction in trade costs could have in generating new trade flows (penetration of new markets, development of new exports).

Climate change will affect all developing countries, and the poorest and most vulnerable ones will be hit the hardest. Climate variability and change can have severe implications for countries’ economic prospects and poverty reduction efforts, posing high risks to ecosystems, eroding agricultural productivity and food security, and threatening fragile human settlements and vulnerable groups.<sup>14</sup> Without ambitious action we could experience a 2°C (3.6°F) world in our lifetime and significant climate and development impacts are already being felt, notably with extreme weather events resulting in widespread human suffering and increasing economic damage across all regions. Against this backdrop, **financing to address climate change is not growing fast enough.** Global climate finance flows were estimated to be at US\$364 billion per year in 2011, with developing countries accounting for some US\$171 billion, while much larger amounts are needed to

<sup>11</sup> World Economic Forum. *Global Risk 2013* (Section 2 in particular).

<sup>12</sup> For example, through the creation of patent pools and the use of flexibilities and public health safeguards in the World Trade Organization agreement on Trade-related Aspects of Intellectual Property Rights.

<sup>13</sup> World Bank. *Opening Markets for the Poorest Countries: Assessing the Effects of Duty-free Quota-free Access to the G20*, 2011.

<sup>14</sup> World Bank, *Turn Down the Heat: Climate Extremes, Regional Impacts, and the Case for Resilience*, 2013.

engage and maintain countries on a sustainable and inclusive development pathway.<sup>15</sup> Significant efforts, ingenuity and capacity are required to achieve this transformation and cover additional costs and risks of climate action, shift investments to greener alternatives, and mobilize additional resources -- mostly private -- to fill the financing gap (see Box 1.3). Beyond climate change, attention should be given to global biodiversity and other environmental issues, such as the preservation of marine stocks.

### Box 1.3: Climate finance

The World Bank and other development partners have argued that Climate Finance and Development Finance are strongly interrelated and must not be separated. The fight against poverty must take climate effects into account and vice versa, while leveraging respective financial flows.

In 2011, the World Bank coordinated a joint paper with the IMF, the OECD, and RDBs, *Mobilizing Climate Finance*, which was prepared at the request of the G20. While the paper listed a range of financial instruments from a variety of sources, international and domestic, public and private, including the emerging Green Climate Fund, progress achieved in securing financial resources for low-carbon and climate-resilient development has been somewhat limited.

The Climate Policy Initiative estimates that climate-related bilateral ODA grew from US\$9.5 billion in 2009 to USD23 billion in 2010 (a significant portion of total ODA), largely as a result of the US\$30 billion “fast-start” commitment for 2010-2012 by developed countries. The same study estimates the total climate finance flows from all sources in 2010 at US\$343-385 billion of which 74 percent come from the private sector and 21 percent from development finance institutions. About US\$172 billion (equivalent to 47 percent) financed projects in developing countries, notably in Brazil, China and India. What concrete steps can countries take to mobilize long-term climate finance? Given the complementary nature between public and private capital, public funds can be invested so as to catalyze climate finance from the private sector on a larger scale. *Mobilizing Climate Finance* estimates that a public finance of US\$36-73 billion could trigger an additional US\$150-340 billion in climate finance from the private sector.

Comprehensive carbon pricing policies, such as carbon taxes or emissions trading combined with the auctioning of allowances, are viewed as a promising option to mobilize larger investments. Pricing policies are designed to incorporate environmental externalities into investment decisions, thereby altering incentives so as to make low-carbon technologies more competitive and to level the playing field. They can also be structured so as to raise new financial resources that can then be reinvested in green infrastructure.

A first step requires removing harmful subsidies, thereby freeing public resources that can then be directed towards investments with higher social returns. Energy subsidies – particularly fossil fuel subsidies - are costly, and these costs are quantifiable and can be measured. According to the IMF, pre-tax subsidies for petroleum products, electricity, natural gas, and coal reached US\$480 billion in 2011 (0.7 percent of global GDP or 2 percent of total government revenues). Total subsidies amounted to US\$1.9 trillion (2.5 percent of global GDP or 8 percent of total government revenues). Despite their negative environmental impacts, in many countries subsidies artificially increase the incentives for using fossil fuels. The main beneficiaries often have political power and lobbying capacity to oppose reforms. Furthermore, the removal of subsidies needs to be complemented by safety nets, new pricing solutions or compensatory transfer to avoid adverse impacts on the poor.

**Open access to knowledge, technology and ideas from the rest of the world to be able to adapt them to local conditions is another global public good.** A critical aspect of success in development strategies over the last few decades has been the ability for some countries to develop knowledge to meet local needs and the use of new technology to produce and interpret “big data”. Without relevant development data, no evidence based policy making or managing for results can be undertaken. **While the availability of data has improved in many developing countries, there is still scope at the country level to build and improve statistical capacity.** Supporting better software and databases, improving measurement and data collection, broadening open-data access, improving methods for development-relevant analyses of data generated by governments, firms and individuals, and more systematically evaluating the impact of policies will strengthen countries’ capacity to learn from and monitor the results of their development efforts. It will also strengthen

<sup>15</sup> Climate Policy Initiative, *The Landscape of Climate Finance*, 2012.

countries' understanding, adaptation and use of knowledge and the promotion of continuous learning societies. The emphasis proposed here is on inter-disciplinary collaboration at a global scale to improve the quality and availability of development data, and speed up the adaptation of knowledge to local contexts.

## Section 2: Mobilizing domestic resources

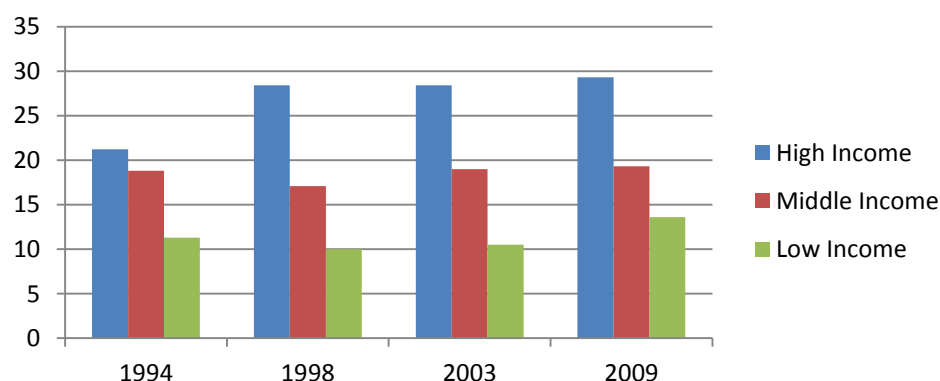
**Developing countries need to take the lead in mobilizing the financing necessary for their development.** Earlier this year, the Post-2015 HLP Secretariat<sup>16</sup> noted that: *Domestic revenues mobilization of emerging and developing economies amounted to \$7.7 trillion in 2012, having grown by 14 percent annually since 2000. That is to say there is over US\$6 trillion more each year coming into developing country Treasuries compared with 2000. These buoyant domestic revenues have also lowered aid dependency and raised country creditworthiness for official and private non-concessional loans, thereby having a multiplier effect on the volume of resources available for development.* In 2010, for example, Sub-Saharan African countries collected nearly US\$10 in own-source revenue for every dollar of foreign assistance received.<sup>17</sup>

**Nevertheless, increasing domestic revenue mobilization (DRM) remains a challenge for many governments, particularly in low-income countries.** Low tax-to-GDP ratios are exacerbated by high levels of capital flight and limited capacity to collect revenues from multinationals, particularly those engaged in natural resource extraction. Inefficient expenditures further compound the problem. Progress will be needed on expanding tax coverage, strengthening accountability, and increasing expenditure efficiency. Many of these efforts are likely to generate positive externalities. For instance, efforts to address problems in transfer pricing will reduce illicit financial flows and improve revenue collection.

### 2.1. Improving taxation capacity

**Broadening the tax base, improving tax administration, and closing loopholes could make a significant difference in lower-income countries,** where tax revenues account for only about 10 to 14 percent of GDP, one-third less than in middle-income countries and far below the 20-30 percent of GDP in high-income countries (Figure 2.1).

Figure 2.1: Tax revenue (as a percentage of GDP) by country income group, 1994-2009



Source: World Bank classification and World Development Indicators.

Low-income countries differ from their high-income counterparts in their formal tax structures and tax collection capacity. LIC tax bases tend to be quite narrow, reflecting the smaller share of the formal sector in employment and business activity. Large informal economies and agricultural sectors are rarely taxed.

As Table 2.1 illustrates, LICs have the lowest tax-to-GDP ratio, although there has been some improvement over the last two decades. For this group, the average ratio of taxes to GDP increased from 10 percent in 1998 to 13.6 percent in 2009. The share of taxes as a percentage of GDP is almost 6 percentage points higher

<sup>16</sup> Summary of Financing for Development, Bali meeting, March 2013.

<sup>17</sup> See "Public Resource Mobilization and Aid," in *Africa Economic Outlook*, 2010.

and rising for MICs. High-income countries have the highest tax-to-GDP ratio, collecting two to three times more taxes as a share of GDP than LICs.<sup>18</sup>

**Table 2.1: Greater taxation capacity in MICs than in LICs**

Country	Tax Revenue as % of GDP (2004-2011)
<b>LICs</b>	
Congo, Republic of	9.3
Ethiopia	9.4
Uganda	10.6
Zambia	18.0
Bangladesh	7.6
Pakistan	12.3
Sri Lanka	16.0
<b>MICs</b>	
Colombia	11.0
Bulgaria	26.7
Vietnam	24.9
South Africa	21.8

*Source: World Development Indicators.*

Aggressive transfer pricing, which can inflate profits in low-tax jurisdictions and lower profits in high-tax jurisdictions, is a problem affecting developed and developing nations alike. According to one widely quoted estimate, the amount of tax revenue lost by developing countries to abusive transfer pricing averaged between \$98 billion and \$106 billion annually from 2002 to 2006.<sup>19</sup> There is growing awareness of the risks posed by transfer pricing in developing countries, but thus far, few have been able to develop the capacity to effectively combat it.

Revenue mobilization is also frequently hampered by the preferential treatment granted to specific taxpayers through targeted tax deductions, credits, exclusions or exemptions. Although these incentives are ostensibly meant to support growth and other socioeconomic objectives, their impact is often difficult to predict and the foregone revenue may significantly exceed the value of the benefits gained.<sup>20</sup>

In the end, even a well-designed tax regime is only as efficient as the administration in place to implement it.<sup>21</sup> Tax administrations in developing countries are often staffed with poorly trained and poorly paid officials. They may have rigid structures that do not encourage an integrated approach to different tax categories. Low salaries, in combination with paper-based systems with little oversight or differentiation of functions, create incentives for corruption and tax evasion. Staff in large taxpayer offices are frequently paid on par with other tax administrators and equipped with only basic IT infrastructure, although the requirements for such positions are highly complex and specialized.

In light of these challenges, how can reforms in tax policy and administration best be achieved? International organizations and bilateral aid agencies have provided technical tax advice to developing countries for many years. Looking forward, it is essential that tax reforms are seen as egalitarian, socially just and fair in

<sup>18</sup> The World Bank classification and World Development Indicators.

<sup>19</sup> Hollingshead, *Summary: The Implied Tax Revenue Loss from Trade Mispricing*, Global Financial Integrity, 2010. These figures must be treated with some caution since they are based on models for assessing the loss of tax revenues which are still being developed.

<sup>20</sup> Keen and Mansour, *Revenue Mobilization in Sub-Saharan Africa: Challenges from Globalization*, IMF, 2009.

<sup>21</sup> Bird, *Tax challenges facing developing countries*, 2008.



distributing the tax burden. This will also require that challenges posed by informality are addressed, including by identifying ways to tax the informal sector and by improving financial records for such businesses.

## 2.2 Harnessing sustainable streams of natural resource revenue

**Capacity constraints often prevent developing countries from effectively and efficiently obtaining revenues from extractive industries.**<sup>22</sup> Investments in natural resources commonly involve high sunk costs for a project that can last decades. Rents can be substantial and represent a large share of the home country's GDP and government revenue.<sup>23</sup> Moreover, governments are usually dealing with large multinational companies, with recourse to highly qualified lawyers and the capacity to engage in transfer pricing and aggressive tax planning.<sup>24</sup> Tax and royalty-based regimes negotiated with mining companies, are frequently perceived as unfair to the home country. Raising taxes and royalty rates is not always easy, especially given that developing countries need to take into account investment promotion objectives and often have limited capacity to negotiate the licensing of extraction rights.

**Natural resource-rich developing countries could improve their capacity to negotiate fair contracts in extractive industries.** To help developing countries retain more of their natural resource rents, governments could pursue initiatives like the Extractive Industries Transparency Initiative (EITI) that promote greater transparency in revenue flows and contract disclosure. Governments will require support to: (i) build capacity for qualified negotiation of the licensing of extraction rights, whether in-country or outsourced; (ii) establish well-equipped large taxpayer offices, or separate tax units for the extractive industries, offering conditions that are competitive in recruiting and retaining highly specialized staff; (iii) deepen cooperation and information sharing with tax administrations of resource-rich developing countries, in order to confront aggressive tax planning by multinationals in the extractives sector; and (iv) ensure that relevant ministries have the specialist capacity and laboratory equipment to undertake physical verification of ore grades, quantity, and price. The World Bank, for example, is providing support for EITI implementation through the EITI multi-donor trust fund and for contract negotiations through the Extractive Industries Technical Assistance Facility and the new Africa Extractive Industries Facility.

On the positive side, since the extractive sectors in most countries consist of only a small number of very large taxpayers, revenue administration can be undertaken by a few highly specialized staff equipped with the necessary infrastructure.<sup>25</sup> For many countries, investing the financial resources required to effectively run the tax administration, with resources sufficient to train and retain highly qualified specialists, would be repaid many times over.

**Additionally, countries need to manage their natural resource wealth in a way these assets can generate revenues in the long-run.** For renewable resources, this means not harvesting beyond the regrowth rate. Revenues from non-renewable resources should be reinvested so as to build long-term wealth and to contribute to post-2015 development. Natural Capital Accounting (NCA) is a useful tool for countries to inform decisions on natural resource use so as to generate sustainable revenue streams. The World Bank-run Wealth Accounting and Valuation of Ecosystem Services (WAVES) partnership helps countries to adopt NCA as currently implemented in Botswana, Colombia, Costa Rica, Madagascar, and the Philippines.

<sup>22</sup> World Bank and Centre for Exploration Targeting. *Source Book on How to Improve Mining Tax Administration and Collection Frameworks*. Forthcoming.

<sup>23</sup> IMF. "Revenue Mobilization in Developing Countries". March 2011.

<sup>24</sup> Okonjo-Iweala, Ngozi, "Good Governance of Natural Resources", HLP Working Paper Series, January, 2013, discusses the potential role of the global community in the governance of natural resources.

<sup>25</sup> Calder, Jack. "Resource tax Administration: Functions, Procedures and Institutions" in Philip Daniel et al., *The Taxation of Petroleum and Minerals, Principles, Problems and Practice*. Routledge: London and New York, 2010.

## 2.3 Improving expenditure efficiency

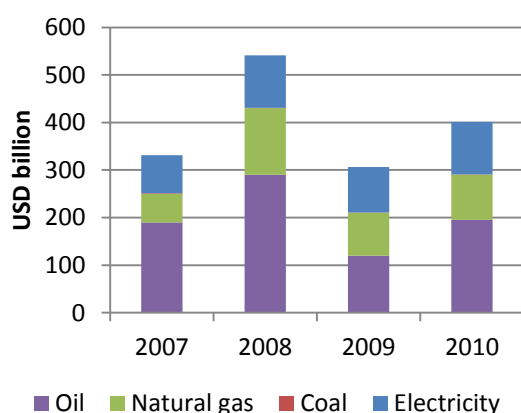
**Considerable resources could be realized from public sector efficiency gains and reallocated towards development objectives.** Strengthening public expenditure and investment management can help limit waste and graft and improve the quality of public expenditure, including through better selection, design and management of public investment projects, thereby improving the enabling environment for investment. Reforms in subsidy regime and procurement in particular can increase public expenditure efficiency and allow more spending supporting progress in poverty reduction.

### 2.3.1 Subsidy Reform

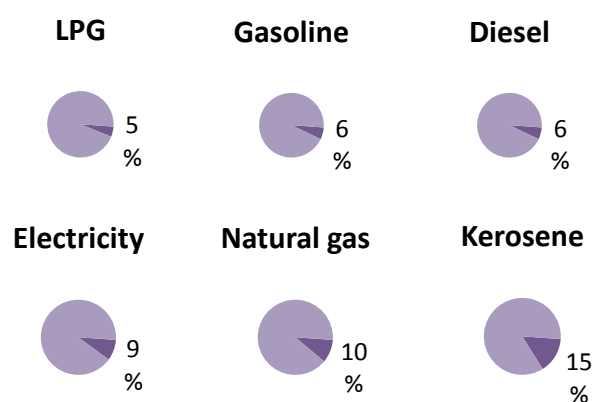
**Subsidy reform is one of the main areas in which public resources can be redirected to more effective uses.** It is not only important for mobilizing domestic resources but also for getting incentives right. While it is important to remove harmful subsidies, increasing subsidies for activities with positive externalities might be the proper course of action. An extensive body of research has demonstrated that food and fuel subsidies are often poorly targeted and end up disproportionately benefiting the wealthy and middle class. The IEA has noted, for example, that only an estimated eight percent of the \$409 billion spent on fossil fuel subsidies throughout the developing world in 2010 went to the poorest 20 percent of the population.<sup>26</sup> Earlier analysis noted that the bottom 40 percent of the income distribution received on average no more than 15-20 percent of the total value of these subsidies.<sup>27</sup>

Subsidy reforms can be successful as illustrated in Iran, in 2010, when extensive public communication was combined with a safety net program of direct cash transfers. The success of subsidy reforms depends on their timing, analysis of their social impact, design of alternative support measures; early introduction of an effective outreach strategy; and political will to see the reform through.<sup>28</sup> Such reforms should also be framed within a broader set of energy sector reforms. Yet subsidy reforms are likely to be highly contextual and will be particularly challenging in countries already struggling with social unrest (including many fragile and conflict-affected states).

**Figure 2.2: World subsidies to fossil-fuel consumption**



**Figure 2.3: Share of fossil-fuel subsidies received by the lowest 20% income group, 2010**



Source: IEA, *World Energy Outlook*, 2011

<sup>26</sup> International Energy Agency (IEA), *World Energy Outlook*, 2011:

<sup>27</sup> Independent Evaluation Group, "Climate change and the World Bank Group. Phase I – An Evaluation of World Bank Win-Win Energy Policy Reforms", Washington, D.C.: World Bank, 2008.

<sup>28</sup> See Zlatko Nikoloski, "The Political Economy of Energy Subsidies: Country Narratives", Washington D.C.: World Bank, 2011.

### 2.3.2 Procurement

**Another area for potential savings is procurement.** Every year, developing countries purchase trillions of dollars' worth of goods and services. In Mexico, for example, public procurement costs around \$55 billion annually, or around 8 percent of GDP. A recent set of innovative procurement reforms allowed the government to realize \$650 million in savings between 2009 and 2011. By some estimates, these reforms could ultimately generate an annual savings of around 15 percent of government purchases, or roughly \$8 billion per year.<sup>29</sup> Beyond increasing value for money, good practices in procurement can bring additional benefits to developing countries, including the development of domestic industries and services; better service delivery, e.g., through sound management of PPP contracts in several sectors (health, education, power distribution, and water and sanitation); and transparency, including through public participation in procurement at the local level through community driven development approaches.

Procurement reforms can be difficult and complicated to achieve. They can be technically demanding and meet with resistance from various vested interests. Reforms may require new legislation, identifying and eliminating antiquated regulations, and intervention throughout the entire project cycle, from design to planning, tendering, contract execution, and completion. Many developing countries struggle with weak capacity, small economies with poorly developed domestic markets, and limited options for economies of scale and competition.

Yet progress is possible on a variety of fronts. This is particularly true in the area of e-procurement, which can make procedures more transparent, promote higher levels of participation, make it easier to track down anomalies, and generate data more efficiently. An emerging body of good practice exists, including framework agreements, consolidated purchases, as well as a legacy of successful reform in Mexico, Chile, South Korea, and Poland, from which other countries can learn from. The expanded use of country systems by multilateral donors can provide additional incentives for many countries to undertake procurement reforms and for the donor community to support them.

Beyond subsidy and procurement reform, there are additional opportunities to streamline and improve efficiency of public expenditures. In many countries, improving public sector administration and the efficiency of state-owned enterprises still provides significant scope for expenditure rationalization. Likewise, there is much scope in many countries, especially MICs, to improve efficiency and service delivery in the social sectors by systematically measuring outputs and outcomes across service providers and using the findings to improve the performance of the weaker ones. The latter is a relatively new agenda in high-income countries, and MICs in particular have a good opportunity to make a strong start, including by learning from the experiences of other countries. Furthermore, reforms to improve public financial management can also play an important role in increasing expenditure efficiency across sectors, as well as enhancing the confidence of donors and encouraging other sources of development financing.

## 2.4 Curbing illicit financial flows

Illicit financial flows (IFFs) are outward cross-border capital flows of illegal origin. IFFs encompass: (i) funds obtained through drug trafficking, smuggling, fraud and any other serious crime; (ii) the proceeds from corruption, bribery and embezzlement; and (iii) tax evasion. The term can also refer to practices such as transfer pricing (or mispricing), which falls in a gray area, but is not illegal.

<sup>29</sup> See World Bank, "Mexico Slashes Rules, Focuses on Results Instead," <http://intranet.worldbank.org/WBSITE/INTRANET/INTRANETHOME/0,,contentMDK:23103934~menuPK:64140059~pagePK:6426483~piPK:6402841~theSitePK:86048,00.html> and World Bank, "Mexico Federal Procurement System Saves Room for Social Programs," <http://www.worldbank.org/en/news/feature/2012/05/07/mexico-federal-procurement-system-saves-money-for-social-projects.print>.

Estimates of the magnitude of IFFs from developing countries vary. One widely cited estimate places the flow from developing or transitional countries between \$539 and \$778 billion annually.<sup>30</sup> According to Global Financial Integrity (GFI), a Washington-based NGO, IFFs from developing countries in 2010 ranged from \$859 to \$1,138 billion. GFI maintains that the developing world lost a staggering \$5.86 trillion in the decade from 2001-2010, although such figures are disputed.<sup>31</sup> According to GFI, Asia accounted for 61 percent of total illicit flows from the developing world during this period, followed by the Western Hemisphere (15 percent); the Middle East and North Africa (10 percent); developing Europe (7 percent); and Sub-Saharan Africa (7 percent). Even if the actual funds were only a fraction of this magnitude, the sums involved are huge. IFFs could be larger than official development assistance and foreign direct investment combined.

There is little doubt that such outflows have a pernicious impact on development. They contribute to a reduction in both the domestic resources and tax revenues available for productive purposes. Indirectly, they can impact domestic investment, interest rates, and inflation. An estimated 80 percent of IFFs involve trade mispricing—an area notoriously difficult to identify and prove—and the boundary between illegal pricing and aggressive strategies for tax minimization is often blurry and contentious.<sup>32</sup>

Country efforts to address IFFs need to occur at two levels. The more complex and difficult path involves tackling the underlying dynamics that help drive such flows. Here, the problems are both extensive and pervasive, ranging from kleptocratic regimes, to political instability, to weak tax administration and chronic evasion, to unfavorable exchange rates and constraints on currency conversion, to a lack of an attractive investment environment and opportunities at home. While it is possible for countries to make progress along each of these dimensions, gains typically do not come quickly, and there is often a significant lag between institutional improvements and public perceptions and behavior.

Other approaches aim to reduce international financial flows directly rather than targeting their underlying causes. Such efforts can focus on improving transparency in declaring revenues and payments by multinational corporations, tightening the regulation of tax havens and secrecy jurisdictions, or strengthening efforts to curb money laundering.<sup>33</sup> In particular, governments working with private companies should ensure beneficial ownership information on legal entities and legal arrangements. This is crucial to halt illicit financial flows, promote anti-corruption, recover stolen assets, and combat terrorism financing, tax evasion, and other financial crimes. The Lough Erne agreement (June 2013), which commits G8 nations to collaborate more intensively against global tax evasion and avoidance schemes, provides a good example of what countries can do. Recent progress under the auspices of the OECD to promote a standard for the automatic exchange of information between governments and financial institutions is a step in the right direction but for many developing countries, significant technical assistance and capacity building will be needed before they can fully benefit from the enhanced transparency.

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<sup>30</sup> Baker, Raymond, *Capitalism's Achilles Heel: Dirty Money and How to Renew the Free Market System*. Hoboken, NJ: John Wiley & Sons, 2005.

<sup>31</sup> See Dev Kar and Sara Freltas, *Illicit Financial Flows from Developing Countries: 2001-2010*, [http://iff.gfintegrity.org/documents/dec2012Update/Illicit\\_Financial\\_Flows\\_from\\_Developing\\_Countries\\_2001-2010-HighRes.pdf](http://iff.gfintegrity.org/documents/dec2012Update/Illicit_Financial_Flows_from_Developing_Countries_2001-2010-HighRes.pdf). For a discussion of the methodology and veracity behind these numbers, see Peter Reuter, *Draining Development?*, Washington, D.C.: The World Bank, 2012.

<sup>32</sup> For an interesting discussion of the challenges involved in addressing trade mispricing, see Volker Nitsch, "Chapter 10: Trade Mispricing and Illicit Flows" in Reuter, 2012.

<sup>33</sup> On this point, see Peter Reuter, "Chapter 15: Policy and Research Implications of Illicit Flows" in Reuter, 2012.

## Section 3: Better and smarter aid

Over the last few decades, aid has played an essential role in helping LICs to accelerate economic growth and lift people from extreme poverty. ODA progressed significantly over that period, and IDA-eligible countries achieved a significant reduction in absolute poverty, from 58 percent of the population in 1981 down to 38 percent in 2008.

Today, aid remains essential in countries where private investment is limited, particularly in LICs and fragile states, which struggle to attract private investors, including in infrastructure.<sup>34</sup> With 1.3 billion people still living in absolute poverty in 2008, ODA is expected to remain a critical input to achieve new development goals by 2030.

### 3.1 Aid's contribution to development

**ODA has been a relatively stable source of development financing for the poorest economies with limited or no access to international capital markets.** The Monterrey Declaration (2002) rightly identified the comparative advantage of aid: *“Official development assistance (ODA) plays an essential role as a complement to other sources of financing for development, especially in those countries with the least capacity to attract private direct investment... For many countries in Africa, least developed countries, Small Island developing States and landlocked developing countries, ODA is still the largest source of external financing and is critical to the achievement of the development goals and targets of the Millennium Declaration and other internationally agreed development targets.”*

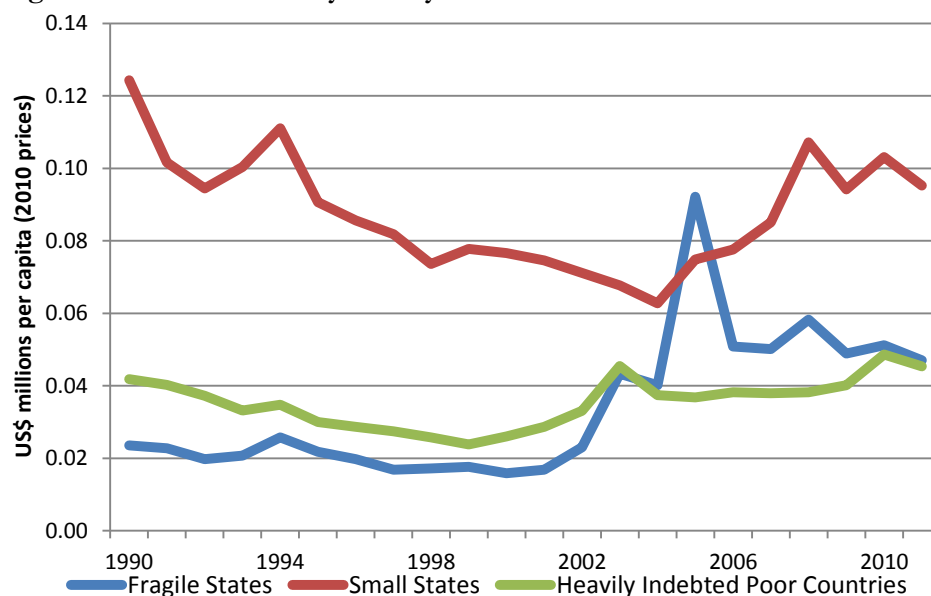
**Over the last two decades, ODA per capita has been maintained and sometimes increased in these countries.** Net ODA from the 25 member countries of the OECD's Development Assistance Committee (DAC) grew by about 37 percent in real terms between 2004 and 2010, reaching an all-time high. Of this amount, 60 percent went to LICs and 40 percent to MICs. The largest donors in 2012 were the United States, the United Kingdom, Germany, France, and Japan. By 2012, Denmark, Luxembourg, the Netherlands, Norway, and Sweden continued to provide 0.7 percent or more of their GNI as ODA. However, these five countries accounted for only 11 percent of total aid from DAC members. A number of other donors increased their ODA contribution,<sup>35</sup> while the UK stepped up its efforts to meet its Monterrey commitment by 2013, despite an aggressive domestic austerity policy.

**Official sources of development financing, including from multilateral development banks (MDBs), also played a countercyclical role in the wake of the global financial crisis** (Figure 3.1). Today, more than 30 LICs are receiving assistance amounting to over 12 percent of their GNI per year, with ODA grants representing almost 60 percent of their total net financial flows. Even after taking into account private transfers, ODA represents 40 percent of total financial flows to fragile states (Box 3.1). While aid accounts for a much smaller share of total development finance in middle-income countries, it has remained a valuable resource to help finance social service delivery and catalyze additional private and official flows.

<sup>34</sup> In 2011, while \$390 billion of net FDI and \$250 billion in net bonds and credits went to developing economies, LICs only received about \$13.5 billion in private commercial flows (and \$1.4 billion official non-concessional net disbursement). Africa has attracted only about 9 percent developing world PPP investments by number of projects and 8 percent by investment in the last decade (Public-Private Infrastructure Advisory Facility (PPIAF)). Of the top 15 infrastructure investors in 2010 and 2011, none committed capital in Sub-Saharan Africa outside of the Republic of South Africa.

<sup>35</sup> Korea increased its contributions by almost 18 percent, and, to a lesser extent, Australia, Luxembourg, Austria, and Iceland.

Figure 3.1: Aid's counter-cyclicality



Source: OECD DAC, 2012.

### Box 3.1 Financing fragile and conflict-affected states

ODA represents the biggest financial inflow to fragile states, followed by remittances and FDI<sup>36</sup> (Figures 3.2). The vast majority of the top 20 most aid-dependent countries are classified as fragile states. Half of all ODA to fragile states goes to only seven countries and remains volatile: every fragile state has had at least one aid shock in the past 10 years. With domestic policy space severely limited, FCSs may have to turn to the international community for assistance.

The 2011 World Development Report<sup>37</sup> has demonstrated how targeted external financial aid can be effective in supporting countries to transition out of fragile situations. A Development Policy Lending (DPL) retrospective conducted by the World Bank in 2013 confirmed that despite high risks, related mainly to the macroeconomic framework, weak economic governance, low technical capacity, weak institutions, and limited policy dialogue, general budget support through grants can carry high returns in FCSs, with varying objectives, ranging from “quick wins” to long-term policy reforms, but often with a focus on security, justice, and jobs.

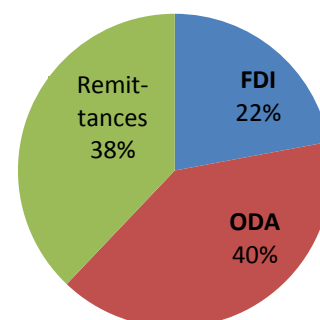


Figure 3.2: Gross financial flows to fragile states, 2010  
Total: USD 125 billion

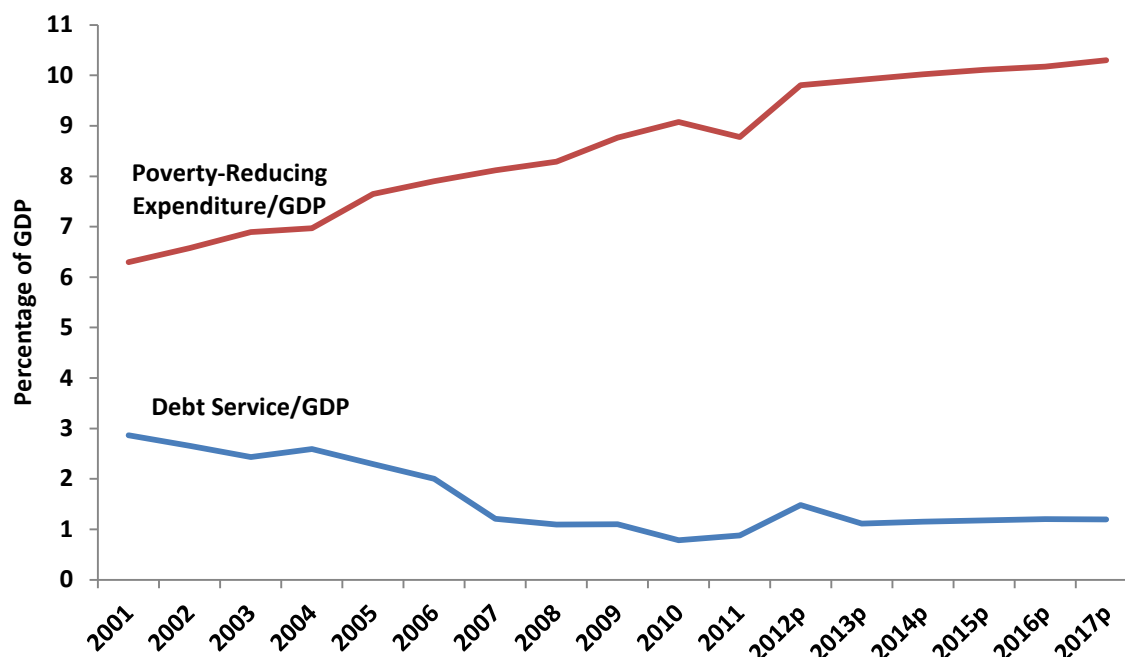
**External debt relief has been a critical component of financing the MDGs.** Debt relief under the combined heavily indebted poor country (HIPC) and multilateral debt relief initiatives (MDRI) and from the Paris Club has substantially lowered debt service requirements, creating space for increased social and other poverty-reducing expenditure (Figure 3.3). For the 36 post-decision point countries, poverty-reducing spending increased by about two and half percentage points of GDP (or from 6.3 to 8.8 percent of GDP), between 2001 and 2011, while debt service payments declined by about 2 percentage points of GDP during

<sup>36</sup> OECD. *Fragile states: Resource Flows and Trends*, 2013.

<sup>37</sup> World Bank. *World Development Report*, 2011.

the same period (from 2.9 to 0.9 percent of GDP). The substantial alleviation of debt burdens in recipient countries combined with new ODA disbursements increased fiscal space and provided impetus to growth.

**Figure 3.2: Average poverty reducing expenditure and debt service in HIPCs**



Sources: HIPC documents and IMF staff estimates

1/ For detailed country data and projections, refer to the forthcoming IMF-World Bank Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI) - Statistical Update, March 2013.

**Debt relief, however, is unlikely to contribute to Post-2015 financing to the same extent that it helped spur the MDG implementation.** Today, debt relief is winding down. The HIPC Initiative is nearly complete. Of the 39 countries that have been assessed eligible or potentially eligible under the Initiative, 35 have already reached the completion point, including Côte d'Ivoire, Guinea, and the Comoros in 2012, while Chad is the only country in the interim phase between the decision and completion points. Only three eligible countries - Eritrea, Somalia, and Sudan - have yet to start the process of qualifying for debt relief under the Initiative.

**Given the budget constraints confronting many DAC donors, a substantial increase in ODA is unlikely in the near future.** The ongoing economic crisis has contributed to a tightening of aid budgets, with a six percent drop in real terms since 2010. While aid flows increased to North Africa in response to the Arab uprising, aid flows to LICs fell for the first time in over a decade in 2011. Net ODA flows were USD133.7 billion in 2011, 2.7 percent less than a year earlier in real terms, reversing the rising aid trend since 1997.<sup>38</sup> ODA fell even more in 2012, reaching US\$128.3 billion (in constant 2011 dollars and exchange rates), a decline of 6 percent from the ongoing financial crisis and consequent tightening of aid budgets. ODA is now equivalent to 0.29 percent of donors' combined gross national income, falling significantly short of the Monterrey commitment.

<sup>38</sup> Aid flows excluding one-off debt.

## 3.2 The growing complexity of the aid landscape

The emerging aid landscape is evolving, becoming increasingly complex and interconnected. This section presents a new taxonomy of development assistance flows<sup>39</sup> proposed by ODI in 2013 (Table 3.1), distinguishing between traditional and non-traditional development assistance flows.

**Table 3.1: Taxonomy of development assistance**

Development assistance flows		Other flows (not considered)
TDA	NTDA	
<ul style="list-style-type: none"> <li>• Traditional bilateral cooperation</li> <li>• Traditional multilateral cooperation</li> </ul>	<ul style="list-style-type: none"> <li>• Non-DAC flows</li> <li>• Philanthropic and institutional giving</li> <li>• Social impact investment</li> <li>• Global vertical funds</li> <li>• Public climate finance</li> <li>• Korea</li> <li>• OOFs</li> </ul>	<ul style="list-style-type: none"> <li>• Domestic resource mobilization</li> <li>• Export credits</li> <li>• DFIs (excluding those covered in OOFs)</li> <li>• Private remittances</li> <li>• FDI</li> <li>• Other private flows</li> </ul>

Source: ODI, *The age of choice: developing countries in the new aid landscape*, 2013.

**Aid from OECD-DAC donors, including through contribution to multilateral agencies, has become a less important source of development finance at the global level, despite growing rapidly over the 2003 to 2009 period.** ODI estimates that total development assistance grew from US\$64.8 billion in 2000 to US\$173.3 billion 2009. In 2009, non-traditional assistance accounted for US\$53.3 billion (equivalent to 31 percent of the total), up from US\$5.3 billion (or 8 percent of the total) in 2000.

**After an increase in lending in 2009 and 2010, other official flows (OOF) are now less dynamic and one of the most volatile components of the international development financing system.** When accounting for OOF, which are not sufficiently concessional to qualify as ODA (such as IBRD), total development assistance has grown from US\$77.1 billion to US\$213.5 billion between 2000 and 2009 and non-traditional flows from US\$17.6 billion (22.8%) in 2000 to US\$93.5 billion (43.8%) in 2009.

**During that time, several non-DAC donors and private institutions have grown to a significant size,** namely China and India; philanthropists such as the Bill and Melinda Gates Foundation or the Ford Foundation; and social impact investors, such as the Shell Foundation and the Acumen Fund.

### 3.2.1 New donors: emerging market economies (EMEs)

**The last decade saw a diverse group of countries gain prominence in the aid landscape:** non-DAC members of the OECD and EU; upper middle-income countries (in Latin America, the Middle East, and East Asia); and other developing countries. Many are ramping up their development engagements through a broad range of channels and activities. This includes the BRICS group of countries (Brazil, Russia, India, China, and South Africa), which account for 25 percent of global GDP and 40 percent of the world's population, and Saudi Arabia, South Korea, and Turkey. The boost in ODA from the new actors illustrated in figures 3.3, 3.4 and 3.5<sup>40</sup> captures only a small piece of the upward trend in external flows contributing to development.<sup>41</sup>

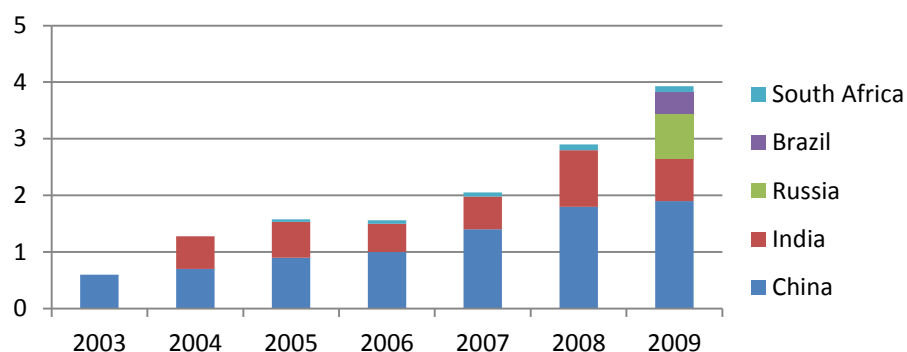
<sup>39</sup> ODI. Greenhill, Romilly, Annalisa Prizzon and Andrew Rogerson. *The age of choice: developing countries in the new aid landscape. A synthesis report*. Working Paper 364, January 2013.

<sup>40</sup> These estimates are only available until 2009.

<sup>41</sup> World Bank. *Finance for Development: trends and Opportunities in a Changing Landscape*, CFP Working Paper, 2011.



**Figure 3.3: Estimated aid from BRICS, 2003-2009 (US\$ billion)**

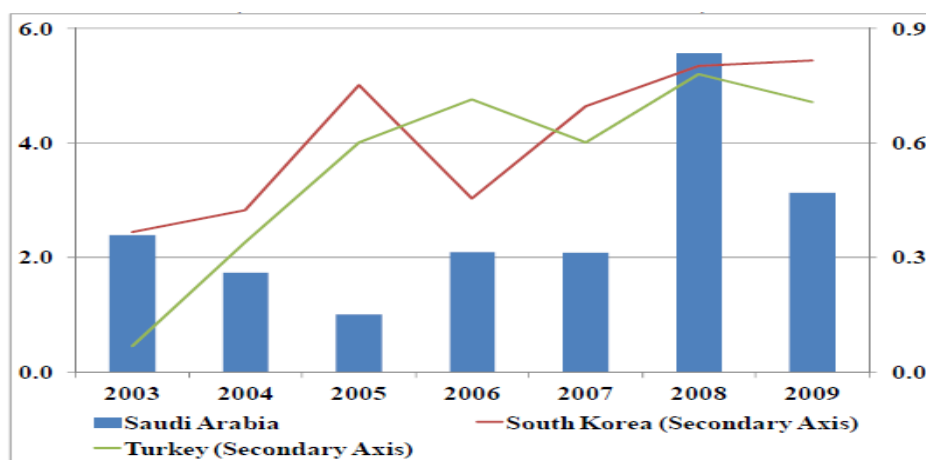


Source: Brautigam (2008); Smith and Zimmerman (2011); and Government budgets for India and South Africa.

Note: 1/ The aid figures for BRICS are a mixture of budget allocations and best estimates, as such not directly comparable with the OECD ODA data. For China, the budgeted expenditures presented above reflect only the interest subsidy, and not the face value of the concessional loans extended by China Eximbank.

**Figure 3.4: ODA from Saudi Arabia, South Korea, and Turkey, 2003-2009**

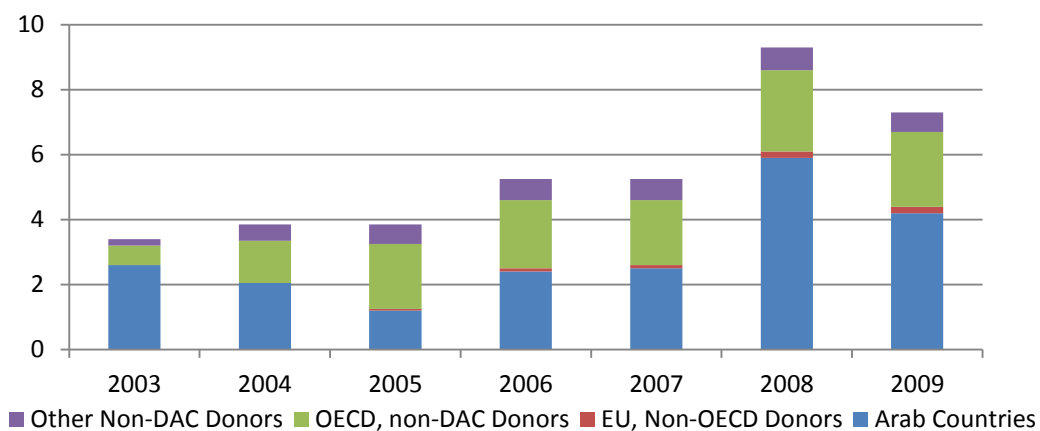
(Gross disbursements, US\$ billion)



Source: DAC Annual Reports and IDS Statistics (Table 1)

**Figure 3.5: ODA from non-DAC donors excluding BRICS, 2003-2009**

(Net disbursements, US\$ billion)



Source: OECD DAC and Zimmerman and Smith (2011).

**Overall, by 2011, the annual concessional flows from emerging economies to LICs was roughly estimated to be between US\$12-15 billion, which represented between 10 percent and 15 percent of the amount of aid provided by developed countries** (the higher range including non-concessional OOF)<sup>42</sup>. This is close to the order of magnitude of the International Development Association (IDA), which provides around US\$16-17 billion a year in grants and highly concessional loans. China, which contributes about half of total aid flows from the BRICS, has grown its technical assistance grants at an annual rate of 25-30 percent, reaching the annual amount of US\$67 billion, with about 40 percent of these combined flows going to Sub-Saharan Africa and about 60 percent being directed to the development of economic infrastructure<sup>43</sup>. The share of development finance coming from the EMEs may continue to rise, if only because of their increasing share in the world economy.<sup>44</sup>

### 3.2.2 New actors: private philanthropy and vertical funds

**The new aid landscape has evolved to include a number of foundations and non-governmental organizations.** Private aid today amounts to approximately US\$60-70 billion per year, equivalent to nearly half the net ODA disbursed in one year by all OECD-DAC members. The US dominates philanthropic private flows to the developing world with US\$39 billion transferred in 2010<sup>45</sup>. Philanthropy has been growing fast, with more than 100 billionaires meeting Bill Gates' challenge to leave at least half of their wealth to charity over time. Private philanthropy to fragile states has increased in recent years, as well as South-South philanthropic flows, particularly in the Arab world.

**Vertical funds are multi-stakeholder global programs that provide earmarked funding for specified purposes.** They have proved very effective to channel assistance to core but chronically underfunded development sectors, such as disease eradication or climate change. However, the proliferation of vertical funds has not always been conducive to aid effectiveness, creating distortions, particularly in low-capacity environments with weak planning and budgeting systems. Many of these were created in the hopes of attracting substantial private contributions, but all remain overwhelmingly dependent on traditional ODA providers. Some have reached a critical size. The Global Fund to Fight AIDS, Tuberculosis, and Malaria has secured pledges totaling about US\$30 billion since its creation in 2002, 95 percent of which come from the public sector. Over 60 percent of the pledges have been paid to date. The Global Environment Fund (GEF), a partnership between 182 countries, international agencies, civil society, and private sector has provided US\$11.5 billion in grants since its creation in 1991 and leveraged US\$57 billion in co-financing for over 3,215 projects in over 165 countries.

**New development partners are breaking out of the mold of traditional ODA financing, promoting their own economic and strategic interests, while at least partially meeting needs not addressed by traditional donors.** This flexibility is often made possible by different transparency and safeguard standards than those governing traditional donors. Rather than grant financing for budget support and health, education, and social infrastructure, new actors frequently offer concessional or semi-concessional loans emphasizing physical infrastructure development<sup>46</sup>. For instance, the Public-Private Infrastructure Advisory Facility (PPIAF) study indicates that non-traditional partners contribute 38 percent of total infrastructure financing (US\$8 billion in 2006), the same order of magnitude as private participation in infrastructure financing, and significantly greater than traditional ODA financing (US\$5 billion or 22 percent of total

<sup>42</sup> World Bank Dialogue Series with New Development Partners: Learning from National Experiences and Building Global Partnerships, June 22-23, 2012, New Delhi.

<sup>43</sup> World Bank Dialogue Series with New Development Partners: Learning from National Experiences and Building Global Partnerships, June 22-23, 2012, New Delhi.

<sup>44</sup> China and India combined are expected to represent about half of the world's GDP by 2050.

<sup>45</sup> The 2012 Index of Global Philanthropy and Remittances, Hudson Institute Center for Global Prosperity.

<sup>46</sup> G24 Secretariat. *Financing Development in Africa: the Growing Role of Non-DAC Development Partners*, 2008.

financing).<sup>47</sup> Moreover, non-traditional financiers are mainly concentrated in power and transport sectors, whereas traditional donors are also a dominant source of financing for water and sanitation, and the private sector is the dominant source of financing for telecommunications. Thus, beyond increasing the volume of resources, new actors engaged in South-South cooperation are playing a complementary role, entering the areas left out of traditional financing with the greatest need.

### 3.3 Aid effectiveness: an ongoing effort

**Aid has become increasingly fragmented and earmarked, increasing its complexity, volatility, and the administrative burden for both aid recipients, potentially decreasing its effectiveness<sup>48</sup>.** The average size of donor-funded transactions has declined from close to US\$3 million in 1997 to about US\$1.3 million in 2009, while the number of donor activities reached about 120,000 in 2009<sup>49</sup>. Earmarked multilateral and bilateral ODA is estimated to account for over 40 percent of total ODA. Earmarking can help raise financing for specific issues that may be high priority for donors and rally public support for aid, but it is less predictable than performance-driven aid, may reduce reform incentives, skew resources towards specific items and away from other, more critical priorities, and undermine country ownership by altering the priorities that countries place on specific programs<sup>50</sup>. At the same time, an estimated 70% of all ODA channeled through multi-lateral institutions remains core, i.e. is not earmarked.<sup>51</sup> According to several external assessments of multi-lateral institutions, the effectiveness of core multilateral aid continues to improve, including in areas such as value for money and a focus on results and development impact.

Relative to traditional donors, new actors operate according to a very different set of motivations, interests, and experiences. As a result, their approach generally involves mutually beneficial, integrated packages combining ODA with trade, investment, and other commercial deals.

**In this context, improving aid effectiveness plays an important role in attracting new sources of development finance.** Global aid effectiveness principles and objectives have been defined in the Paris Declaration (2005), the Accra Agenda for Action (2008), and the Busan Outcome Document (2011), all sharing a focus on improving country ownership, transparency, and results. Reflecting the growing share of non-ODA actors, the international aid effectiveness architecture has evolved from a focus on donor harmonization and alignment to a broader approach of inclusive development partnerships. The Global Partnership for Effective Development Co-operation (GPEDC) created at the 4th High Level Forum on Aid Effectiveness in Busan (2011) brings together multi- and bilateral donors, emerging economies that are both recipients and providers of development cooperation, recipient countries (including fragile and conflict affected states), the private sector, CSOs, and parliamentarians.

**Since 2005, several analyses of aid effectiveness at the global and institutional levels have been conducted.** At the global level, the Paris Declaration Monitoring Survey 2005-2010 assessed progress on 13 indicators against their 5-year target. While only one indicator met its target at the global level (strengthen capacity by coordinated support), country ownership (evidenced by the number of countries with sound national development strategies and results-oriented monitoring frameworks) increased substantially. The survey identified the need for further progress in using country systems, harmonizing donor procedures, reducing aid fragmentation, and improving aid predictability. Building on the Paris Declaration indicators, the GPEDC is developing a Monitoring Framework of the Global Partnership for development effectiveness, including updated targets for 2015 on selected indicators of the Paris Declaration survey and additional indicators for private sector and civil society participation, gender equality, and transparency.

<sup>47</sup> World Bank. V. Foster, et al., *Building Bridges: China's Growing role as Infrastructure Financier for Africa*, PPIAF, 2008.

<sup>48</sup> Kharas, H. *The New Reality of Aid*. Washington, DC: The Brookings Institution, 2007.

<sup>49</sup> World Bank. *Finance for Development: Trends and Opportunities in a Changing Landscape*, CFP Working Paper, Nov. 2011.

<sup>50</sup> World Bank. *The Demand for IDA17 Resources and the Strategy for their Effective Use*, IDA 17 Paper, June 2013.

<sup>51</sup> OECD/DAC, 2012 DAC Report on Multi-lateral Aid.

**Significant progress has been achieved in aid transparency and accountability**, notably since the creation of the International Aid Transparency Initiative (IATI) in Accra in 2008. Based on an open data standard, IATI aims to increase the transparency and accountability of aid by publishing aid data from aid providers, aid users, and civil society on a timely basis. To date, 116 organizations have published their aid information to the IATI registry.<sup>52</sup> Ongoing work aims to strengthen links between IATI and partner countries' aid information management systems, publish detailed geographical information on aid projects (geo-mapping), and develop a common, open transparency standard<sup>53</sup> in line with Busan commitments.

### 3.4 Towards a more catalytic role for ODA

In all likelihood, the impact of the economic crisis on aid will persist for several years. Faced with limited direct lending capacity going forward, and the fiscal constraints of many of their major shareholders, it is increasingly important for MDBs to fully utilize their catalytic role and leveraging potential to mobilize additional financing from diverse sources. In countries that struggle to attract private investment, such as fragile or small states, official finance remains critical. It can also play an important complementary role, by supporting improvements in project quality with development impact, and in so doing encourage private investors to engage in productive investments.

MDBs and bilateral donors can enhance their impact by supporting improvements in business and investment climate that can facilitate access to private sources of finance. In addition, innovative financing mechanisms can play an important catalytic role and help attract new sources of financing, especially from the private sector. Using ODA as credit enhancement (for instance, through the World Bank's partial risk and partial credit guarantees and MIGA's guarantees) has catalyzed private sector finance for infrastructure projects in countries that investors and commercial banks would otherwise have judged too risky. For example, the World Bank helped to establish a number of regional risk pooling initiatives in small island developing states to secure catastrophe coverage on the international reinsurance market at an attractive price, underwritten by IDA. Climate finance is witnessing new approaches to finance low-carbon energy access in LDCs and with private sector participation, such as the World Bank's Carbon Initiative for Development (Ci-Dev). Other innovations for leverage include project bond credit enhancements and equity tranches covering first loss provisions.

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<sup>52</sup> [www.iatiregistry.org](http://www.iatiregistry.org)

<sup>53</sup> The common standard is in the process of being developed based on IATI and the OECD's Creditor Reporting System (CRS) and Forward Spending Survey (FSS).

**Box 3.2 Collaborating across the WBG to leverage investments for energy generation***The Kenya Private Sector Power Generation Support Project***Development Challenge**

In recent years, Kenya has been facing severe power shortages, which have put pressure on the country's economic growth aspirations and its efforts to improve the day-to-day lives of Kenyans. Only 25 percent of the population has access to electricity, and rural grid access is only 5 percent. Scaling up access to electricity and ensuring reliable power supply are key elements of *Vision 2030*, the Government's national development strategy to promoting economic development, growth and competitiveness, and creating jobs.

In the wake of the ongoing global economic and financial crisis, it was challenging for the Government of Kenya (GoK) and Kenya Power (KPLC), the national utility, to mobilize the resources needed to publicly finance new investments in electricity generation to help meet critical power shortages. The key was to attract the private sector to develop and implement the projects and mobilize long-term commercial financing. However, despite extensive energy sector reforms with improved governance and a strong track record of sustaining previous Independent Power Producer (IPP) projects supported by Development Finance Institutions (DFIs), private investors were hesitant to invest in the energy sector, partly due to their perception of the high level of political risk in Kenya. Investors expected that the GoK would offer sovereign guarantees as part of the security package to attract investment for energy generation. Given the tight macroeconomic environment and debt ceiling agreed as part of an IMF-supported program, the GoK wanted to optimize its use of security instruments to attract investors, including commercial banks that had not provided support to earlier rounds of IPPs. The GoK approached the World Bank to explore options to overcome these challenges.

**WBG Response to Challenge**

The World Bank leveraged scarce IDA resources through Partial Risk Guarantees (PRG) in the amount of US\$166 million equivalent (involving an IDA allocation of US\$41.5 million) to back-stop liquidity support for certain ongoing PPA payment obligations from Kenya's national power utility to private project developers. IDA involvement enabled KPLC to offer security arrangements on favorable terms under their agreements with the IPPs.

Under the structure approved by the Board in February 2013, IDA support is complemented by MIGA guarantees to cover the relatively larger amounts required in the event that the specific IPP projects were terminated. The complementary risk mitigation structure was able to provide the necessary comfort to investors and commercial lenders, with minimal resort to sovereign guarantees. In addition, IFC stepped in to provide long-term financing for two of the four IPPs, which is generally unavailable for long-term infrastructure projects in Kenya. WBG support unlocked a total financing package of US\$623 million, including US\$357 million in private sector investment and lending.

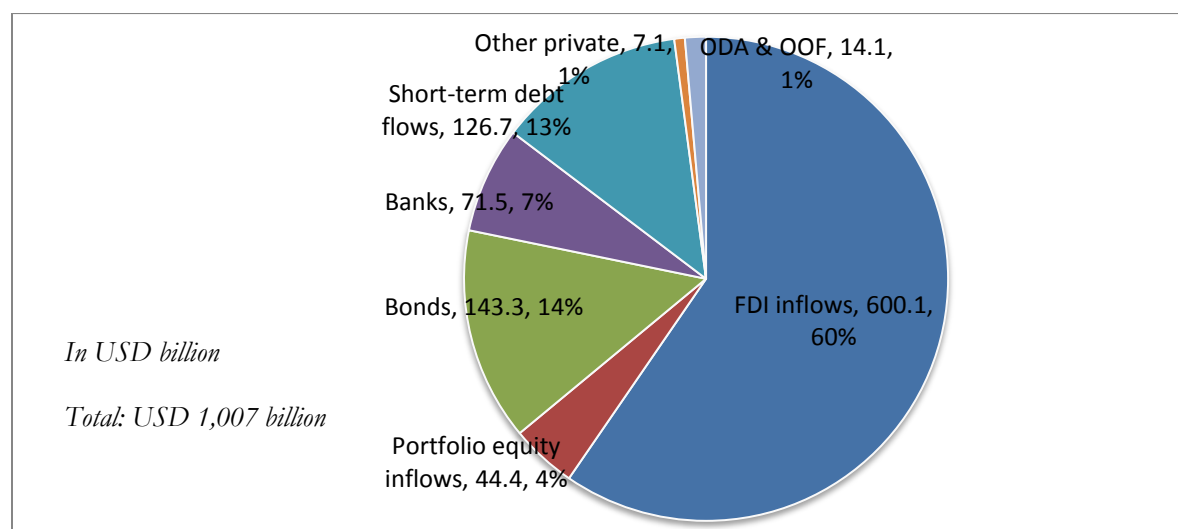
## Section 4: Private finance for development

### 4.1 Private financial flows to developing countries

Achieving Post-2015 development goals will require the mobilization of resources from private sources including FDI, bank loans, bond issuance, institutional investors and private transfers (notably remittances, estimated to be approximately US\$400 billion in 2012). The good news is that globally, there are ample savings, amounting to US\$17 trillion, and liquidity is at historical highs.<sup>54</sup> The challenge will be to direct savings to support the achievement of global development objectives.

**FDI is a dominant private financing modality in most developing countries.** It is vital for private sector productivity and growth and can help to diversify the economy. By comparison, official inflows, net of debt repayment, only accounted for 1 percent of international capital inflows in 2012 (Figure 4.1). Net FDI inflows to developing countries are projected to rebound by 17 percent to US\$697 billion in 2013 and reach close to US\$800 billion in 2014<sup>55</sup> as global economic growth is anticipated to accelerate modestly.

**Figure 4.1: International capital flows to developing countries (LICs and MICs), 2012**



Source: Long-term financing for growth and development. G20 Umbrella Paper, Feb. 2013 and Global Economic Prospects, 2013, World Bank.

Note: FDI inflows are net of disinvestments by non-residents. Debt Inflows are debt disbursements net of repayments. Official flows include bilateral and multilateral lending and are not equivalent to ODA. Data on official capital inflows are “debt enhancing official assistance”, and thus not the same as ODA, which is concessional in character with a grant element.

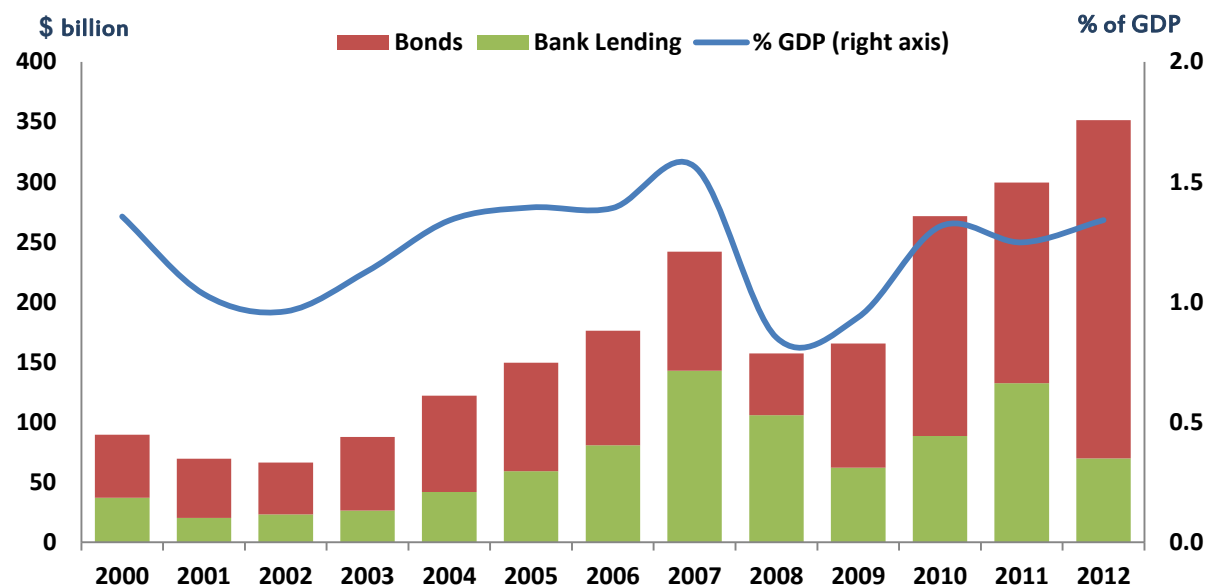
**Over the past decade, many developing economies have demonstrated an increasing ability to access international capital markets.** International long-term debt flows to developing countries – bonds and syndicated bank-lending with at least five years of maturity – increased four-fold from 2000 to 2012 (Figure 4.2). However, the global financial crisis led to a sharp contraction in long-term international debt flows, with a protracted retrenchment in global banking lending, particularly affecting MICs (by 2009, private capital flows to MICs were at about half their 2007 level). As a group, LICs have seen an increase in private capital flows, with flows reaching their highest level, nearly 4.5 percent of aggregate GDP, in 2011, despite a

<sup>54</sup> World Bank. “Capital for the Future: Saving and Investment in an Interdependent World”. *Global Development Horizons*, 2013.

<sup>55</sup> MIGA. *World Investment and Political Risk*, 2012.

17 percent cut in FDI inflows and a sharp contraction in bank lending, as financial market volatility spread globally.

Figure 4.2: International long-term private debt to developing countries



Source: World Bank Development Prospects Group (DECPG).

Nevertheless, the world is experiencing a growing mismatch between available financing and investment needs. Much of the developing world has limited access to long-term financing through capital markets. Across the developing world, only twenty MICs have the ability to access private capital markets at the national level. The rest of the developing world's governments as well as most sub-national governments have little or no market access, severely constraining the public provision of infrastructure.

The problem is compounded by fragile market conditions in the wake of the global financial crisis, which are constraining the availability of the kind of long-term finance needed to support productivity-enhancing investment for sustainable growth.<sup>56</sup> Lending is retreating as banks recover from the global financial crisis and adjust to tighter regulatory requirements - including Basel III. Historically, during crises, banks restructure their balance sheets by cutting back on lending. Investors search for safer and more liquid assets, and usually sell off emerging-market debt perceived to be higher risk. This fallout from the most recent global financial crisis was compounded by regulatory changes that raised capital ratios and liquidity buffers.

## 4.2 Mobilizing long-term infrastructure finance

### 4.2.1 Removing existing bottlenecks

Unlocking long-term finance for infrastructure is critical to achieving the development goals. Despite potentially high socio-economic rates of return, infrastructure projects in many countries are often not financially viable, with expected revenues frequently unable to cover project costs given existing tariffs. Time horizons - infrastructure projects often have very long pay-back periods, ranging from 15 to 25 years- do not match investors' preference for short-term funds. Given the unattractive risk-return profiles of many long-

<sup>56</sup> *Umbrella paper on Long-Term Investment Financing for Growth and Development*, prepared by the World Bank and other International Organizations for the G20, 2013.

term investments, the actual duration of investors' portfolios can be fewer than 10 years. Moreover, many investors are driven by annual performance measures.

Only a few developing countries have developed capital markets or banking institutions with the ability to transform short-term deposits into long-term products.<sup>57</sup> Infrastructure finance is a highly specialized area of finance, traditionally dominated by European banks. Deleveraging as a result of the global financial crisis and incentives created by Basel III regulations (to increase the amount of regulatory capital for loans and dampen the scale of maturity transformation risks) is reducing banks' appetite for financing projects in developing countries.<sup>58</sup>

Few infrastructure sectors recover costs easily. It is rare to be able to charge full-cost tariffs. Telecommunication services are an exception and the success in setting adequate user fees has been behind the massive expansion of the sector. Yet user fees raise the concern of affordability in poor countries, where energy or transport expenditure can take a large share of the incomes of poor households, raising challenging political economy issues.

Besides capital needs, the limited flow of bankable projects because of underinvestment in project preparation represents a major obstacle to public-private partnerships for infrastructure. Improving the quality of project pipelines with sufficient project preparation, including economic, financial, technical and environmental feasibility studies, is critical to clearing the way for private sector participation.<sup>59</sup>

Bankable projects also require adequate legal or guarantees framework for capital mobilization. These challenges are particularly acute for new and emerging technologies, which carry higher risks that are often difficult to measure and price. New technologies can have high operating expenses and are often riskier in the early stages of development. This is particularly true of most green technologies.

#### 4.2.2 Mainstreaming the use of guarantees and risk insurance

Private capital is attracted by the right combination of risk and return. Heightened market and investor uncertainty means that large pools of capital sit relatively idle with few financial interlocutors to deploy in infrastructure. This calls for greater attention to policies and instruments that can lower risk and strengthen the confidence of investors over a long-term horizon. Sharing risk with the private sector to enhance the viability of investments is one area in which official lenders and MDBs have the capacity to contribute.

Governments can manage risks to reduce vulnerability, particularly from exogenous shocks. Multilaterals can play a major role on the advisory (capacity and strategy building) and financial sides to help countries reduce their vulnerabilities. The provision of credit, saving, and insurance products can facilitate additional private funding for development, and mitigate the negative consequences of crises. IBRD has developed catastrophic risk insurance to transfer disaster risk from the government to the financial market, therefore increasing developing countries' financial resilience. Examples include catastrophic risk insurance pools for homeowners' protection in Romania and Turkey, livestock insurance pool for herders' protection in Mongolia, and market-based crop insurance in India.

The official status and financial structures of MDBs allow for greater absorption of both default and political interference risk, making their engagement particularly useful in the early stages of a deal. MDB guarantees can help draw private capital into higher-risk projects, providing coverage to financially and economically viable projects that would be unlikely to happen without protection against non-commercial risks, and enable investors to access funding on more advantageous terms and conditions. MIGA and the insurance arms of

<sup>57</sup> World Bank. *Inclusive Green Growth*, 2012.

<sup>58</sup> *Umbrella paper on Long-Term Investment Financing for Growth and Development*, prepared by the World Bank and other International Organizations for the G20.

<sup>59</sup> *Infrastructure Action Plan*, Submission to the G20 by the MDB Working Group on Infrastructure, 2011.



other MDBs offer coverage for a number of types of political risk: currency inconvertibility and transfer restriction; expropriation, war, terrorism, and civil disturbance; breach of contract; and non-honoring of sovereign financial obligations.

Risk-mitigation tools, such as guarantees, can be structured to limit the level of risk that investors are exposed to, including country or convertibility risk. For instance, India's Solar Power Guarantee Facility (US\$150 million) covers up to 50 percent of the payment default risk on commercial bank loans of up to 15 years to private sector developers of small solar power projects. Modern financial instruments include first loss guarantees in equity or debt funds. As an alternative to charging a fee for first loss guarantees, governments participate in the "equity tranche" of a product in return for taking the first loss risk. In doing so, they provide a first loss guarantee to private investors, while allowing taxpayers to share in potential upside returns associated with the investment. Alternatively, de-risking instruments include currency loans or liquidity facilities, swaps, and derivatives.

### 4.2.3 A catalytic role for the public sector

**Given the limited ability of the public sector to support long-term investments, finding new and better ways to attract private-sector financing is critical.** Scaling-up infrastructure investments, therefore, can only happen if governments ensure that incentives, pricing, and regulations are aligned.

Outsourcing, concessions, private-public partnerships, privatization, and the promotion of social entrepreneurship can increase efficiency and crowd-in private sector resources for development purposes. At a macro or sectorial level, governments can facilitate FDI by providing stable and predictable enabling business environments. Improvement of the investment climate often involves a variety of reforms, including competition policy, consumer protection, property and creditor rights, trade facilitation, judicial reform, fiscal transparency, and market reforms.

The reluctance of the private sector is often due to market failures, such as problems arising from asymmetric information or lack of investor experience with particular types of investments, economic activities, or countries. Closing private investors' financial viability gap (i.e. between costs and expected revenues) is one way to do it, by using public resources complemented by legislative and institutional improvements to facilitate project preparation, risk reduction, and capital provision.

Interventions at the project selection and preparation stage can help expand the pipeline of bankable projects through effective planning, quality design, rigorous project selection, and sound management. Public funds can be used to provide initial seed funding to explore the viability of projects, based on transparent criteria. Public funding of feasibility studies and other project preparation costs, which typically average 5-10% of total project costs, amounting to hundreds of millions of dollars for large infrastructure projects, can crowd-in private investment. Without some public financing of these up-front costs, projects will never become bankable.

MDBs have a unique catalytic role to play.<sup>60</sup> They can add value to their client through a combination of technical expertise; prudent risk management policies; credible application of well-understood standards in project design, execution, and corporate governance; a long-term perspective; and cross-country experience. MDBs, in association with other official-sector entities, can also help overcome capacity bottlenecks and information constraints. In a number of countries, this is done quite efficiently through Project Preparation Facilities (PPFs).

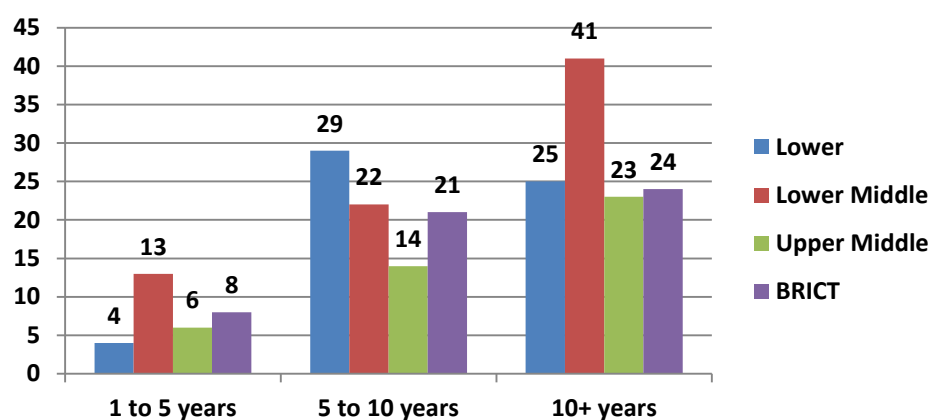
The most direct demonstration of the catalytic role involves actively bringing financing partners into specific deals, for example, in the form of syndications or through a co-financing arrangement. Using MDBs'

<sup>60</sup> *Umbrella paper on Long-Term Investment Financing for Growth and Development*, prepared by the World Bank and other International Organizations for the G20.

preferred creditor status and financial structures helps investors to obtain funding sources on more advantageous terms and conditions. MDBs generally have strong balance sheets and the ability to structure and reduce risks for private funders. Generally, the MDB stamp of approval and role as an “honest broker” in disputes can reassure investors and contribute to a project’s viability. This may be the result of a sense that the official sector is well-positioned or possesses the necessary resources to defend its interests in the event that the terms of the investment are not respected. As a result, multilateral support can reduce the cost of the whole funding package, including from private investors.

In some cases, such as in syndications, MDBs can even provide partners with a similar level of creditor status vis-à-vis official creditors, in the event that the borrower runs into repayment difficulty. Moreover, IFI participation in syndications contributes to extend maturities of private flows to developing countries, which is essential to finance productive investments (Figure 4.3).

**Figure 4.3: Percent of international syndications to the private sector in developing countries where an IFI participated, by income level and maturity, 2007-2012**



*Source: International Finance Institutions and Development through the Private Sector, IFC 2011*

Public entities can take equity stakes directly in a project or indirectly by investing in private equity funds. Funds of funds provide an interesting new financing instrument through which a public entity invests a relatively small amount of long-term capital in a range of private, professionally-managed funds. A hybrid of debt and equity capital from a mix of sources can be leveraged through mezzanine financing.

To overcome their financing constraints without a general capital increase, MDBs are exploring these options. The World Bank Group, in particular, is reviewing conditions to establish a Global Infrastructure Facility (GIF). Financial Intermediary Funds (FIFs) provide useful lessons on how to establish funding mechanisms outside of IBRD and how to design initiatives that encompass customized, inclusive governance structures; innovative features to help leverage core funding to reach scale; and a diversity of instruments to meet the financing needs of clients. For example, capital contributions from interested shareholders could be leveraged through bond issuance.

## Section 5. Emerging, inclusive and innovative sources of finance

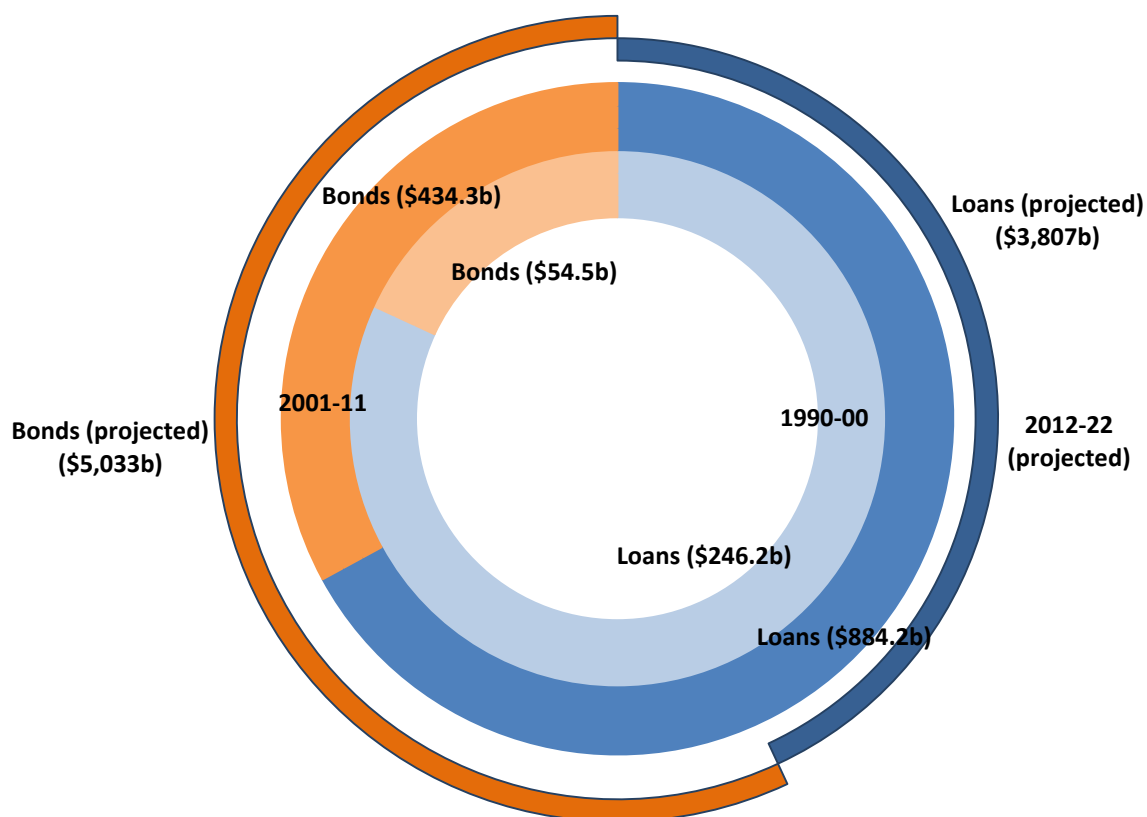
### 5.1 Emerging sources

Given the scarcity of bank lending for infrastructure, the development of non-bank financing for infrastructure is now emerging as the new imperative. **International financial markets present a largely untapped pool of capital to finance infrastructure; and institutional investors have the potential to provide an additional source of long term finance.**

#### 5.1.1 Bond financing and local currency bond markets

International bond flows to developing countries with maturity of at least five years have increased steadily since 2009 as conditions for bond financing have become particularly favorable for middle-income countries. Bond flows rebounded after the global financial crisis, especially in Latin America and emerging Europe, more than offsetting the reduction in bank lending.

**Figure 5.1: Infrastructure investment financing modes have changed over time and will likely favor greater bond financing in the future**



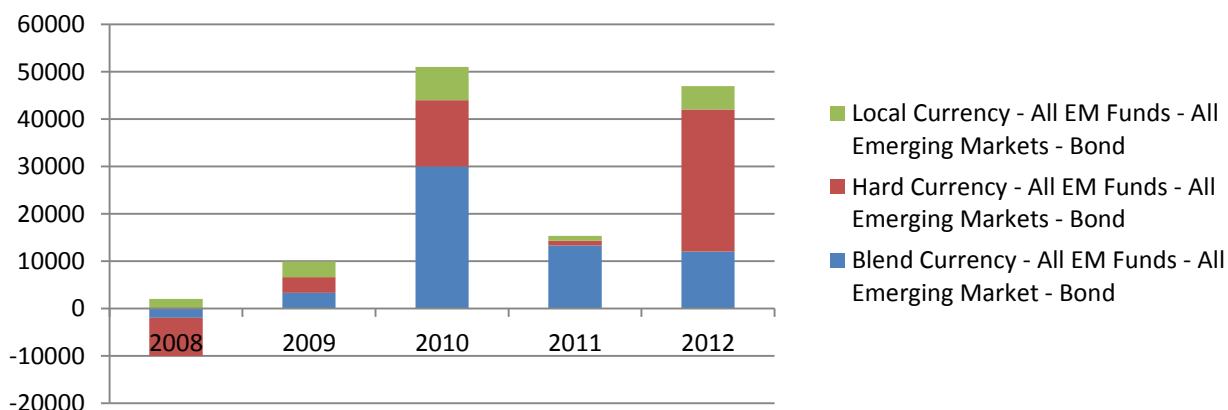
*Source: World Bank projections, supplemented with calculations using data from Dealogic Bondware and Loanware.*

*Note: Infrastructure financing is calculated as a share of cumulative investment financing needs during the respective time periods. Total values, in billions of current dollars, are given in parentheses. Projections for 2012-22 are based on the assumption of similar growth rates between the second two periods as between the first two periods and zero inflation. The cumulative infrastructure investment bill for 2012-22 is US\$8.8 trillion.*

The surge in bond issuance was partly the result of policy-induced low interest rates and quantitative easing in high-income countries, which prompted a search for yield by global investors. It also arose from the recognition of the economic potential of many developing countries with improved credit-quality, which induced many institutional investors to buy securities issued by adequately rated emerging markets, and benefit from long-term returns from infrastructure. The World Bank's 2013 Global Development Horizon Report (Figure 5.1) expects bond financing to grow rapidly as a source of development finance for countries securing a credit rating at or above investment grade.<sup>61</sup>

In emerging market and developing economies, local-currency bond markets (LCBMs) present a potentially important vehicle for developing the domestic investor base and mobilizing domestic savings to support public and private sector investment in productive assets. The development of LCBMs can help promote a deeper and more efficient financial sector, reducing transaction costs and facilitating risk management. LCBMs in these countries have shown resilience in the midst of capital volatility and international market instability and have been among the best performing asset classes over the last few years (Figure 5.2). The viability of LCBMs for long-term investment depends critically on policy credibility and commitment, including through the establishment of the right macroeconomic, institutional, and regulatory preconditions.<sup>62</sup>

**Figure 5.2: Emerging market fixed income fund inflows by hard and local currency**



Source: *Emerging Portfolio Fund Research (EPFR)*

### 5.1.2 Institutional investors, including sovereign wealth funds

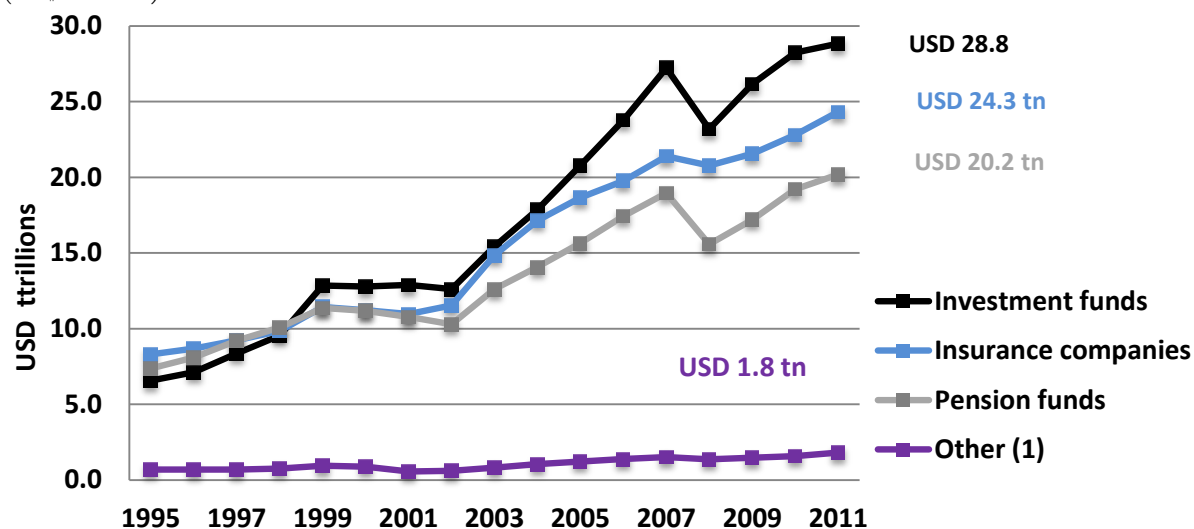
With their growing assets under management and their ability to provide long-term finance, institutional investors, such as pension funds, insurance companies, mutual funds, or sovereign wealth funds have potential as pools of non-bank capital for emerging markets infrastructure. In OECD countries, institutional investors held over US\$70 trillion in assets as of December 2011 (Figure 5.3). Many of these investors are moving towards socially and environmentally responsible investment strategies. Also growing rapidly are Sovereign Wealth Funds (SWFs), with assets under management at end 2011 exceeding US\$5 trillion. Emerging markets are home to some of the largest SWFs in the world.

<sup>61</sup> LICs are receiving less than 0.5 percent of their GDP in bond financing.

<sup>62</sup> Guarantees for local currency bonds are also available to facilitate local capital market development, such as those provided by the UK's GuarantCo. In addition, IFC issues local currency bonds in a number of regions, including Central Africa, to kick-start the development of local currency bond markets.

**Figure 5.3: Total assets by type of institutional investors in the OECD, 1995-2011**

(US\$ trillions)



Source: OECD Global Pension Statistics, Global Insurance Statistics, and Institutional Investors databases, OECD estimates.

Traditionally, institutional investors have been considered sources of long-term capital with investment portfolios built around the two main asset classes, bonds and equities, and an investment horizon tied to the often long-term nature of their liabilities. Investor exposure to alternative assets has been growing, reflecting an appetite for diversification, a search for yield, and the attraction of valuation methods for unlisted assets. Despite this, it is estimated that less than 1 percent of institutional investors' portfolios are allocated to infrastructure investments.

Some of the reasons explaining this situation include: weaknesses in the enabling environment and lack of 'bankable' projects; the capacity of institutional investors, which often lack the experience to analyze infrastructure investments; and a lack of suitable investment vehicles structured to provide institutional investors with the risk-return profile they require. Infrastructure investment in developing markets poses an additional set of challenges – from sovereign risk to regulatory issues. Moreover, the global economic downturn is likely to have had a lasting impact on the fund management industry and the long-term asset allocation strategies of institutional investors by encouraging more cautious investment strategies and a greater focus on portfolio risk management in the coming years.

While some leading institutional investors are gradually increasing their exposure to infrastructure and other real assets, the vast majority of these investments are concentrated in their home markets. This could change, given the current low interest rate environment in advanced economies and the volatile stock markets in recent years necessitating higher portfolio diversification.

SWFs could potentially channel institutional and sovereign non-bank capital into infrastructure investment. Other structures, such as country funds, are used to invest in infrastructure while reducing poverty and facilitating technological adaptation and diffusion. For example, rural energy funds have been set up in countries such as Bangladesh, Mali, Senegal and Sri Lanka.

At the same time, many developing countries are currently reforming and developing their pension systems to introduce funded pillars that could provide local currency sources of long-term financing. Pension fund assets in developing economies currently amount to US\$2.5 trillion, which is expected to rise to US\$25 trillion by 2050. However, institutional investors exist to provide pensions and vital coverage and support in difficult times. They should not be forced to invest in infrastructure projects with limited economic viability for broader social or development considerations.

### 5.1.3 Diasporas

Global diaspora resources represent another key source of funding for development. There are an estimated 215 million migrants in the world, and in 2012, they sent about US\$529 billion in officially recorded remittances to their countries of origin. Of this, developing countries received over US\$401 billion in remittances, and the figure is projected to grow to US\$515 billion by 2015. Actual remittances are much higher, as many resources are transferred through informal channels.<sup>63</sup> These resource flows are more than three times ODA, acting as a lifeline to the poor and boosting growth and development.

The cost of sending remittances remains too high. In 2008, recognizing the huge amount of resources used in making these transfers and the importance of cost in determining the amount migrants send, the G20 articulated the “5 by 5 objective,” to lower the global average cost of making remittances to below 5 percent within 5 years. The average cost of sending remittances, including fees and exchange rate margins, has fallen by 20 percent since 2005 to 9 percent (US\$18) in 2012 for a remittance of US\$200, as measured by the World Bank’s Remittance Prices Worldwide (RPW) database.<sup>64</sup> While this cost reduction saved remitters (and their families) over \$8 billion last year alone, it is not enough. Meeting this goal implies an additional reduction of four percentage points from the 9 percent average cost currently, which could boost resource flows to developing countries by over US\$16 billion annually. For some countries, the remaining margin is considerable. South Africa, for instance, remains the most expensive sending country in the G20, with an average cost of remittances of 20.56% (US\$40.1) for a remittance of US\$200. Evidently, significant barriers to cost-effective remittance services continue to exist.

Competition is essential for lowering the cost of sending remittances. Large remittance corridors by volume tend to have a greater number of money transfer operators and more competition, leading to lower prices and more transparency. This is reflected in persistent differences between the simple average remittance cost and the weighted average, which is weighted by the size of bilateral remittance flows. The global weighted average has generally been declining over the past few years, and reached an all-time low of 6.9 percent in the first quarter of 2013. Prices are decreasing in bigger volume corridors, but remain high in smaller remittance markets, involving transfers to smaller countries that are typically far more dependent on remittances as a share of GDP.

More needs to be done to lower the cost of sending remittances, especially by increasing transparency and boosting competition. Money transfer operators continue to reduce their prices and are also the most transparent – with 98 percent disclosing full information to their customers. For banks and post offices, the figures are only 76 and 45 percent respectively. Competition will be helped by improved disclosure requirements, as contained in the US Remittance Transfer Rule (to take effect in October 2013).<sup>65</sup> Technological advances in mobile telephony and internet-based mechanisms are also boosting competition. Still, meeting the requirements of Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) regulations without imposing undue costs remains challenging, as they discourage commercial banks from acting as correspondent banks for money transfer operators. Exclusive contracts between national post office networks and leading money transfer operators also appear to be stifling competition in several remittance corridors.

<sup>63</sup> Between 25 percent (CIS - Commonwealth of Independent States) and 49 percent (Sub-Saharan Africa) of respondents report the receipt of remittances through people rather than official channels such as banks or money transfer companies (Source: Gallup World Poll).

<sup>64</sup> See Remittance Prices Worldwide – Issue No. 5, March 2013 at <http://remittanceprices.worldbank.org>.

<sup>65</sup> See Migration and Development Brief 20, April 2013 at [www.worldbank.org/migration](http://www.worldbank.org/migration).

## 5.2 Finance sector development and financial services for small and medium enterprises (SME)

**Promoting financial deepening and inclusion could accelerate private-sector growth, an important driver for poverty reduction and fostering shared prosperity.** Financial institutions facilitate economic growth by mobilizing savings and allocating these savings to the most productive investments. There exists a large body of evidence finding a strong, positive relationship between financial sector development and growth. A well-developed and inclusive financial system also has positive impacts on equality by providing poorer individuals with savings opportunities and much-needed credit. Without inclusive financial systems, poor people must rely on their own limited savings to invest in their education or become entrepreneurs—and small enterprises must rely on their limited earnings to pursue promising growth opportunities. This can contribute to persistent income inequality and slower economic growth. There exists huge untapped potential in developing countries: around 29 percent of savers worldwide and more than half of savers in 55 economies which report having saved or set aside money in the past 12 months did not use any formal or semi-formal savings mechanisms such as formal financial institutions or informal savings clubs.<sup>66</sup>

Improve SMEs' access to finance will help create more economic opportunities. Access to finance is a major constraint to growth for entrepreneurs in LICs. Access to credit and payment services is crucial for self-employed business, as well as small- and medium-size enterprises. Broader access to financial services would help the estimated 400 million micro, small, and medium-sized enterprises in developing countries to prosper. They need unconstrained financial access to expand their activities, take on new workers, and generate income.

There are 420-510 million micro, small, and medium enterprises worldwide, of which 360-440 million are in emerging markets. When asked to list their main constraints to growth, access to finance tops the list for entrepreneurs in lower income countries. Globally, fewer than 30 percent of these firms use external financing, of which half are underfinanced. The total unmet need for credit among MSMEs in emerging markets is estimated at US\$2.1-2.5 trillion, approximately 14 percent of the total GDP of these countries.

SMEs pose a difficult challenge for financial institutions everywhere, but particularly so in lower income countries. Unlike larger corporates, they offer very little public information, and rarely keep accounts in standard and comprehensive formats (much less audited formats). SMEs possess limited fixed assets, and few LICs have legal and regulatory environments that encourage the use of movable assets (equipment, inventory, accounts receivable, etc.) as collateral. SMEs also need “high touch” services, involving physical access points, while in most LICs expanding financial institutions' points of presence is limited to relatively expensive new branch construction.

The Global Partnership for Financial Inclusion (GPII) recently identified a wide range of new business models providing financial services to fill this gap in a cost-effective manner. Their list includes: i) legal and regulatory reforms; ii) improvements to financial markets infrastructure (financial information supply); and iii) financial services innovations involving new products and new institutional relationships. Successful models share common characteristics: they reduce costs to serve, using technology and other means; cross-sell multiple products to SME customers; use advanced risk management techniques to maximize the risk/reward balance; and involve strong institutional focus on this specific market segment. Institutions implementing these models include microfinance institutions reaching up-market (such as the ProCredit Group), commercial banks reaching downwards (DFCU Leasing), and a host of non-bank financial institutions and large firms that command supply/value chains (Box 5.1).

Countries promoting SME access to finance more successfully, in general, have regulatory frameworks that enable a range of financial products and institutions, including leasing and factoring. These countries have

<sup>66</sup> World Bank, The Global Financial Inclusion (Global Findex) Database.

invested in financial markets infrastructure, improved credit information services, strong movable assets systems (including on-line registries), broad electronic payments options (including mobile phone payments channels), and efficient, balanced insolvency.

**Box 5.1 ProCredit Group**

**ProCredit Group** was established in 1998 to invest in both socially responsible and commercially viable microfinance institutions. After consolidating its position in the microfinance market in many countries, the Group began financing small businesses with the aim of diversifying its portfolio. They also began a program of establishing new banks in emerging markets specialized in micro and small business lending. With support from KfW, DEG, Commerzbank, IFC and EBRD, the Group established ProCredit Holdings to support this growing network, which now comprises 22 banks (21 in emerging markets). As of 31 December 2011, the Group had over 1 million business clients, and over 558,000 outstanding loans to MSMEs, with less than 3.8 percent portfolio at risk (30 days). This includes over 335,000 clients in Mozambique, Ghana and the Democratic Republic of Congo.



## 5.3 Examples of innovative financing for development

Innovative development finance involves non-traditional applications of solidarity, PPP, and catalytic mechanisms that (i) support fundraising by tapping new sources and engaging investors beyond the financial dimension of transactions, as partners and stakeholders in development; or (ii) deliver financial solutions to development problems on the ground.<sup>67</sup> This section focuses on some well-established innovations as well as more recent experiments being developed to help generate financing for developing countries, including through the mobilization of private funds. These concepts can help raise development resources by tapping new markets or developing products.

### 5.3.1 Raising to scale pull mechanisms and advance market commitments

*Pull mechanisms for development* involve the ex-post provision of economic incentives for innovation where the aim is to solve a specific, well-defined problem. By linking payments, in a commensurate and generally proportional fashion, to the actual impact of an innovation, they lay the foundations for a self-sustaining, competitive market for the relevant product. One of the earliest and most famous pull mechanisms was the longitude prize, a reward of up to £20,000 offered by the British government in the 18<sup>th</sup> century for the discovery of a method for the precise determination of a ship's longitude which was effectively won by John Harrison for his invention of the marine chronometer.

Pull mechanisms for development, with their emphasis on ends rather than means, are particularly well-suited to the task of overcoming market failures impeding the establishment of commercial markets for agricultural innovations in developing countries. There are two major failures: (i) the failure of markets to reflect the social value (i.e. capture positive externalities associated with) of such innovations; and (ii) imperfect information, which is responsible for low consumer demand for, as well as low public and private investment in, a given innovation. To address these market failures, pull-mechanisms for development will typically provide payments to multiple, competing private sector actors over a certain period of time conditional on their products meeting certain specifications and achieving a certain level of take-up in the target market. These payments, while generally made directly to firms, effectively operate as a consumption subsidy (because payments are linked to levels of consumption and bring down costs to consumers) that eliminates the gap between the unit price firms must charge to recoup their research and development, production, promotion, and distribution costs, and the price that consumers, given adequate information on all of the benefits of the product, are willing to pay. In essence, pull mechanisms for development seek to overcome a price barrier for consumers, while leaving production, marketing, and distribution strategies to the private sector.

The *AgResults Initiative*<sup>68</sup> is a new pull mechanism developed by Canada, the US, the UK and Australia – working in partnership with the Bill and Melinda Gates Foundation, the World Bank, and Dalberg, a global development advisory firm. It uses public financing to reward agricultural innovation in developing countries and, in the process, build sustainable markets for agricultural inputs, products, and services that benefit the poor, while pulling private investment and technological innovation. While it is a small contribution to the estimated US\$83 billion a year investment required to meet the world's food needs in 2050, it proved capable of achieving sustained development impacts, as evidenced by improved food security and food safety increased smallholder incomes, and better health and nutrition. The pilots implemented have a scalable business model. Furthermore, *AgResults* will call upon the ingenuity and drive of the private sector to identify and execute the most effective and efficient strategies to achieve development outcomes. By linking payments to demonstrated results, the initiative is built to guarantee impact and maximize value for money.

*Advance market commitments* gained recognition with the June 2009 launch of the US\$1.5 billion pilot for pneumococcal vaccines, to provide incentives, through per-unit subsidies, for pharmaceutical companies to

<sup>67</sup> Navin Girishankar: *Innovative Development Finance: From Financing Sources to Financial Solutions*. CFP working paper No.1. World Bank, 2009.

<sup>68</sup> *AgResults: Innovation in Research and Delivery*. Concept note. World Bank, 2012.

adapt and produce vaccines for use in developing countries. By end-2012, supply contracts were awarded to GlaxoSmithKline and Pfizer Inc. and 6.9 million vaccines were delivered to 9 countries. In advance market commitments, public financing is used to subsidize the cost of drugs, for instance, not just produced for but actually demanded by target markets in developing countries – no orders, no subsidies. They are truly a results-based mechanism.

The *International Finance Facility for Immunization (IFFIm)* uses long-term pledges from donors to sell 'vaccine bonds' in capital markets, making large volumes of funds immediately available for GAVI<sup>69</sup> programs. Approaches like *IFFIm*, the first aid-financing entity to attract legally-binding commitments of up to 20 years from donors, can offer the "predictability" that developing countries need to make long-term investment planning decisions, in this case for immunization programs.

### 5.3.2 Resources-for-infrastructure deals in fragile states

**The RfI financing mode has been adopted by some countries, mainly in Africa, to overcome obstacles related to limited capital market access and domestic capacity to implement large infrastructure projects.** Under RfI, oil or mineral extraction rights are exchanged for turnkey infrastructure, complementing standard tax and royalty regimes. Here, infrastructure project financing is backed by future oil or mineral revenues, with financing frequently taking the form of export credit. Projects have included roads, regional railway lines, water supply projects, telecommunications, hydropower dams and plants, and other electrical power infrastructure. Much of Angola's post-war infrastructure reconstruction took place under RfI, and significant commitments exist in DRC. The value of signed resources for infrastructure swaps (RfI) in Africa alone amounts to at least \$28 billion, although the value of actual completed and ongoing contracts is likely to be significantly lower, as several of the contracts are reportedly stalled or have been abandoned.<sup>70</sup>

**While RfI has significant potential as a financing source, it also carries considerable risks and challenges on both the private sector and government sides.** From the private sector viewpoint, infrastructure investments under RfI add to the high initial sunk costs involved in mine and offshore oil field development, frequently running into the billions of dollars. The future revenue streams that back these investments are subject to political, market, geological, and other types of risk, and on the infrastructure side there are risks of cost overruns. From a government perspective, the greatest concern is that, if projects are not appropriately valued both on the mining and the infrastructure side, the country risks forgoing a significant share of potential benefits from the extractive project. Assuming that appropriate valuation is undertaken, according to agreed international standards, risks still arise from the uncertainty of future commodity prices and geological estimates of oil and mineral reserves. It is therefore essential that financing commitments are complemented by appropriate extractives tax and royalty regimes.

Assuring the quality of RfI-financed projects, including compliance with pre-specified standards, can be a challenge for governments with little experience in implementing large infrastructure projects. Since construction companies working under RfI agreements are not paid by the government, but by the financial institution backing the agreement, the government may have less leverage to ensure contract compliance. Contractual liabilities thus need to be structured in a way that companies can be held accountable, on the basis of independent third-party supervision. Finally, to ensure enduring benefit from RfI-financed projects, capacity needs to be built for operation and maintenance, whether by public or private sector solutions, or a combination of the two.

To be effective, compliance with the above requisites necessitates RfI licensing and contracting process to be consistent with standards for transparency and accountability. Contracts need to be tendered on a competitive

<sup>69</sup> The Global Alliance for Vaccines and Immunization.

<sup>70</sup> Foster, Vivien, William Butterfield, Chuan Chen, and Nataliya Pushak (2008). *Building Bridges: China's Growing Role as Infrastructure Financier for Africa*. Trends and Policy Options (PPIAF). Washington, DC: World Bank.  
[http://siteresources.worldbank.org/INTAFRICA/Resources/Building\\_Bridges\\_Master\\_Version\\_wo-Embg\\_with\\_cover.pdf](http://siteresources.worldbank.org/INTAFRICA/Resources/Building_Bridges_Master_Version_wo-Embg_with_cover.pdf)

basis<sup>71</sup>, based on a pre-defined list of government infrastructure projects, to reveal the real value of the exchange. To avoid “train lines to nowhere,” standards for public investment management must be applied to select and appraise projects. Reserving a share of the contract value for appropriate legal and financial counsel for host governments, as well as for independent supervision of construction, would contribute to ensuring that countries engaging in RfI receive the benefits to which they are entitled.

Ultimately, RfI is likely to remain a second-best solution in most contexts where public procurement systems have the capacity and integrity to handle large infrastructure investments, and financing can be secured otherwise. However, given the large investments in mineral and oil extraction in many fragile states, RfI may, if implemented according to appropriate standards, hold considerable potential as a source of financing where other sources are scarce and government implementation capacity is low.

### 5.3.3 Diaspora bonds

Many developing countries will have to find innovative ways to finance infrastructure, education, and health projects. Diaspora resources – via diaspora bonds and remittance-backed bonds – have the potential to finance projects such as railways, roads, power plants, and educational institutions. The annual savings of the diasporas from developing countries – \$400 billion by some estimates – represent a hitherto untapped potential source of financing for development efforts. The African continent alone holds an estimated \$52 billion in potential development finance.<sup>72</sup> It makes economic sense to think about channeling some of those savings into development efforts in poor countries. If one in every ten diaspora members, rich or poor, could be persuaded to invest \$1,000 in their own country, developing countries could potentially raise \$20 billion a year for development financing.

**Mobilization of diaspora investments is possible through the issuance of a diaspora bond, a retail saving instrument marketed to the diaspora members.** A developing country government or reputable private corporation can tap into the wealth of relatively poor migrants by selling such bonds in small denominations (from \$100 to \$1,000). The bonds could be sold in larger denominations to wealthier migrants, diaspora groups, or institutional investors. Diaspora bonds can tap into the emotional ties—the desire to give back—of the diaspora, and potentially help lower the cost of financing for development projects back home. Since the diaspora savings are mostly held as cash under the mattress or in low-yielding bank accounts in the diaspora host countries, offering an annual interest rate of 4 or 5 percent on diaspora bonds could be attractive.

**A diaspora bond would have a greater chance of success if the proceeds were to finance projects which interest overseas migrants,** such as housing, schooling, hospitals, and community infrastructure projects that could benefit them and/or their families, or their region in their homeland. It also fits with the concept of delivering results. It would pay a developing country to do its homework beforehand and hold consultations with diaspora groups on their interest. It would be vital to build a knowledge base about the size, income, and wealth characteristics of the diaspora groups in key destination countries. Currently, such information is not easily available.

### 5.3.4 Financial transaction taxes

The use of a Financial Transactions Tax (FTT) as a source of financing for development is highly controversial. While the EU intends to introduce one soon among 11 of its members, only a fraction of its proceeds are likely to be allocated to development outside the region.

<sup>71</sup> Collier, Paul. *Implications for Changed International Condition for EITI*. Oslo: Extractive Industries Transparency Initiative (EITI), 2008.

<sup>72</sup> Ratha, Dilip and Sanket Mohapatra. *Preliminary Estimates of Diaspora Savings*, World Bank, February 2011.

Proponents of the FTT point to its strong revenue-raising potential. The European Commission initially estimated that the implementation of an EU-wide FTT would raise approximately €57 billion a year.<sup>73</sup> The European initiative will impose a 0.1 percent tax for securities and 0.01 percent tax for derivatives, on all transactions with an established link to the FTT zone. Trading in securities, bonds and shares, is expected to generate about one third of this revenue, with taxing derivatives contributing the remaining two thirds. However, these funds will go into consolidated revenue of countries paying the tax although some CSOs have advocated earmarking this for development purposes.

The existence of a potentially large untapped source of revenues in a global environment characterized by spending cuts is attractive. While holding a neutral view on FTTs, the World Bank has nevertheless acknowledged the potential for diversion of financial transactions from countries with FTTs to those that do not have them, and the importance of coordination across major international financial centers to be most effective in implementing FTTs. However, without a clear commitment to channel resources into the achievement of development goals, this cannot be seen as a source of financing for development.

### 5.3.5 Carbon markets

**A relatively novel instrument to generate climate finance can be found in cap-and-trade schemes, which set a limit to the overall emissions, thereby creating carbon credits (emission allowances).** Any surplus carbon credits can be traded at carbon markets, thereby generating a new revenue stream. Similarly, project developers can invest in low-emissions projects (so far mainly renewable energy, energy efficiency, waste management, and reforestation) generating carbon-offsets which can be sold at voluntary carbon markets – to private consumers and companies who want to reduce their carbon footprint.

The *Kyoto Protocol* to the UNFCCC laid the groundwork for a global carbon market that offers a cost-effective way to reduce the greenhouse gas (GHG) emissions of industrialized countries through the Clean Development Mechanism (CDM) and Joint Implementation mechanism (JI) and international emissions trading. The Clean Development Mechanism (CDM) alone generated transactions of about US\$27 billion between 2002 and 2010, while leveraging green investments of about US\$125 billion in developing countries.<sup>74</sup>

The total value of the carbon market reached US\$176 billion in 2011, as compared to US\$159 billion in 2010. While the market size of CDM and JI is relatively small (ca. US\$23 billion), the majority of carbon market values has been generated through national and regional allowance markets (ca. US\$148.8 billion). Most of it is coming from the European Union emission trading schemes (ETS) (ca. US\$147.8 billion).

In addition, domestic and regional carbon market initiatives have gained increasing traction in both developed and developing countries. There are also smaller markets, such as the Regional Greenhouse Gas Initiative (RGGI) New Zealand ETS, emerging national schemes in Australia and South Korea and sub-national ETS in several countries (e.g., Japan, the United States, Canada, and Brazil). China has just launched its first pilot carbon market in Shenzhen province.

At the same time, the urgency of the climate change agenda has supported the emergence of a new profile of buyers, aiming at filling part of the space left from compliance buyers. Some developed country administrations and private companies have demonstrated interest in purchasing credits to meet domestic GHG emission reduction targets or social responsibility objectives. Yet the size of voluntary markets remains limited at about US\$573 million.<sup>75</sup>

<sup>73</sup> [http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/other\\_taxes/financial\\_sector/fact\\_sheet/revenue-estimates.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/other_taxes/financial_sector/fact_sheet/revenue-estimates.pdf)

<sup>74</sup> *Mobilizing Climate Finance*, a paper prepared under the coordination of the World Bank Group at the request of G20 Finance Ministers, 2011.

<sup>75</sup> Based on World Bank, 2012, *State and Trends of the Carbon Market*, Washington DC.

**Overall, however, the size of the carbon market remains relatively small when compared to mitigation and adaptation needs.** Additionally, carbon prices remain too low to make green technologies more competitive than existing ones. In the EU ETS the price per ton of CO<sub>2</sub> has fallen below US\$10 per ton. This is also due to an oversupply caused by emission allowances being determined before the economic crisis. Emission allowances were determined before the crisis based on more optimistic macroeconomic scenarios. Carbon markets face various other challenges, such as the uncertainty about national level mitigation goals (including sector-specific emission targets) and the future of an international climate finance regime supervising market mechanisms after 2020 to be agreed by 2015 under the UNFCCC.

## Conclusion

This paper has attempted to sketch a blueprint for financing development in a world with increasingly scarce concessional resources and in an environment where access to long-term financing for development has become more difficult. Undeniably, aid has helped low-income countries to accelerate economic growth and lift people from extreme poverty, and it will continue to be an important source of development financing for many countries. But with heavy fiscal pressures on major donors, constrained MDBs, and a weak global recovery, the approach to financing development needs to evolve by bringing in more actors and instruments, while continuing to build on enhanced aid effectiveness.

The challenge for individual developing countries is to make themselves more attractive destinations for resource from the private-sector and donors. They can do this by improving the effectiveness with which existing resources are used, enhancing domestic resource mobilization and by making strides to develop and access new sources of financing. This will require a foundation of good policies, supported by the institutional capacity to implement them. It is along these lines that international partners can make the greatest contribution to financing development in the years ahead.