DCF Republic of Korea High-level Symposium

Workshop in preparation for the Third International Conference on Financing for Development: the role of catalytic aid in financing sustainable development

Wednesday, 8 April 2015, 2 - 4.30 p.m., Songdo Convensia, Incheon, Republic of Korea

Introduction

The post-2015 development agenda will be comprehensive in scope, aiming to end poverty and achieve sustainable development for all. The financing needs to achieve such transformative outcomes are enormous. ODA will continue to play a central role in complementing domestic public resources to finance its implementation, particularly in the poorest countries. But it is also widely recognized that ODA alone will not be sufficient. As the international community prepares for the Third International Conference on Financing for Development in Addis Ababa, Ethiopia, in July 2015, there is increasing attention on ODA's potential to 'crowd in' other financial flows, both by blending it with non-concessional public finance, and by leveraging private finance.

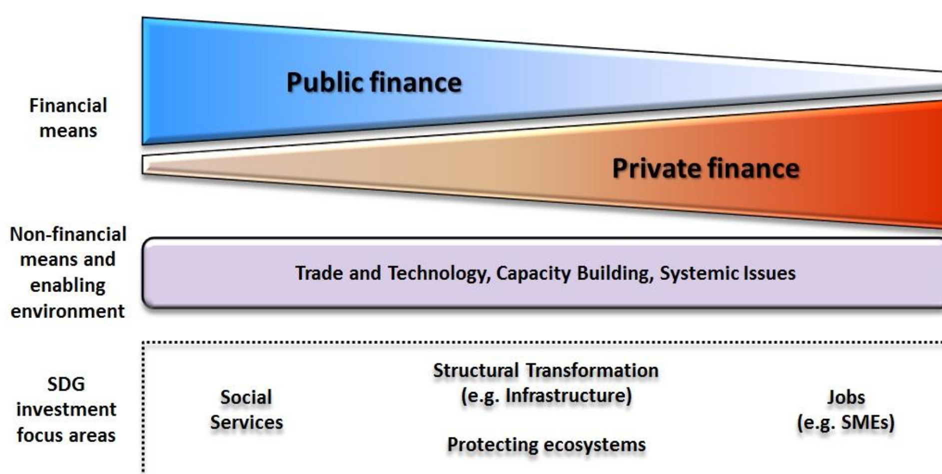
Currently, instruments that target leveraging of private finance are only partially reflected in ODA statistics. Some have argued that such activities should be incentivized by recognizing the public effort involved more consistently, either in ODA statistics or in a new measure of Total Official Support for Sustainable Development (TOSD). Others have expressed concerns that this could divert ODA from its core functions to meet social needs of the poorest and other services that markets and private finance would not provide.

This workshop has three purposes: to bring greater clarity on the concept of catalytic aid and the instruments used in this context; to consider how such instruments should be accounted for in development finance statistics beyond 2015, as well as which should qualify as ODA; and to explore the benefits and risks of using these instruments.

The role of pooled financing in the post-2015 development agenda

As the zero draft of the Addis Ababa outcome document notes, achieving the SDGs will require a comprehensive approach, combining different financing modalities and instruments. The zero draft identifies a range of cross-cutting investment areas – such as essential social services, infrastructure, agriculture, small and medium sized enterprises, and investing in the planet's ecosystems – to facilitate their achievement. Each of these areas depends on different combinations of public, private, domestic and international investments financing, as shown in the figure below. Essential social services will be financed overwhelmingly publicly, while promoting job creation and SME financing will largely be private. Investments in infrastructure and structural transformation on the other hand will require a combination of public and private resources. It is in this area where estimates of needs have reached the trillions, and where there has been the most interest in pooled financing mechanisms.

The continuum of public and private financing for sustainable development



The discussion about the catalytic role of aid is not new. Countries agreed to 'promote the use of ODA to leverage additional financing for development, such as foreign investment, trade and domestic resources' in the 2002 Monterrey Consensus.[1] This concept has become more prominent in recent years, partly in light of the post-2015 development agenda and the Sustainable Development Goals (SDGs), which are much broader in scope than the Millennium Development Goals.

Different concepts of catalytic aid – overlapping but still distinct – can be distinguished in the literature.[2] First, **aid can be catalytic by promoting growth enhancing change in domestic policies and institutions**. This includes measures to strengthen the domestic enabling environment, strengthening capacity for mobilizing taxes and other forms of domestic resource mobilization, and other forms of capacity building. Second, **aid can be invested directly in structural transformation**, such as investments in infrastructure, aid to productive sectors, and aid for trade. Third, catalytic aid can refer to **specific market-like instruments that crowd-in (or leverage) private financing and other financing flows.** Such instruments are generally used by development banks and development finance institutions (DFIs), and will be the main focus of this workshop.

Market-like instruments include:

- *Equity investments and mezzanine finance*: This represents purchases of shares in businesses in developing countries, generally through DFIs, such as specialized investment funds or investments in risk capital of structured finance deals. Such investments are currently reportable as ODA to the DAC, but not all national DFIs do so and there is an ongoing discussion as to how to assess their concessionality and how to reflect them in ODA or new measurements of development finance.

- *Guarantees*: Guarantees increase the recipient's capacity to access financing by mitigating risk. The guarantor agrees to pay part of or the entire amount of a loan (or other instrument) in the

[1] http://www.un.org/esa/ffd/monterrey/MonterreyConsensus.pdf
[2] See for example Rogerson, 2011, *What if development aid were truly catalytic?,* ODI Background Note; Olivié and Perez, 2013, *Public Aid as a Driver for Private* Investment, Background Study for the 2014 DCF; Griffith et al., 2014, *Financing for Development post-2015: Improving the contribution of private finance*, Study commissioned by the European Parliament.

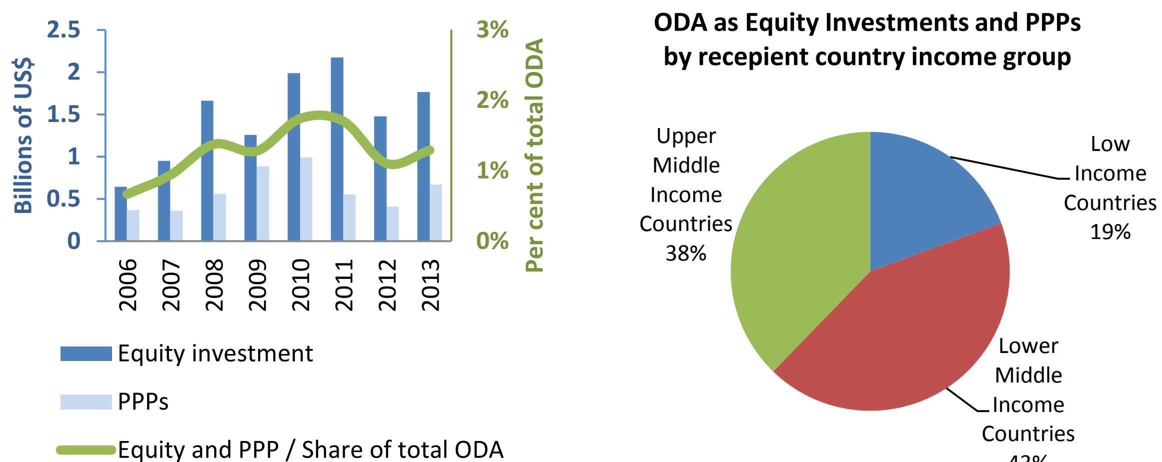
event of non-payment by the recipient. Guarantees for development – that is guarantees extended with the promotion of economic welfare and development as the main objective – have been estimated to have mobilized $15.3 billion from the private sector for development purposes from 2009 to 2011.[3] They have benefited upper-middle income countries disproportionally (53 per cent of the total). Since guarantees are contingent liabilities and do not involve a financial flow until a default occurs, they are only recorded as ODA in the event that the guarantee is called.

- *Blending instruments*: Blending has traditionally referred to grants or grant-equivalent finance combined with non-concessional finance to provide greater finance at below-market rates or with longer maturities than provided by the market. Bilateral and multilateral development banks have long blended their loans with grants to finance infrastructure investments in developing countries. Recently, the term *blended finance* has been used more broadly to also include instruments that blend public and private financing and that support private sector projects. The European Union for example has established seven EU regional blending facilities. Around EUR 2 billion in ODA from the EU and its members have been blended with loans from public finance institutions and partly with private resources to support economic and social infrastructure and private sector development.[4]

Accounting for market-like instruments

Market-like instruments are only partially reflected in ODA statistics. Based on the available evidence, the share of ODA utilised for equity investments and public-private partnerships (PPPs)[5] remains below two per cent, though this has been increasing since 2006. A disproportionate share of these flows is allocated to middle-income countries.

ODA as equity investments and public-private partnerships (in US$ billions, as share of total ODA, and by recipient country income group)



Source: OECD DAC Stats

[3] Mirabile, Mariana, Julia Benn and Cecile Sangare (2013): Guarantees for Development. OECD Development Cooperation Working Papers, No. 11. Available from: http://dx.doi.org/10.1787/5k407lx5b8f8-en
[4] Mirabile et al., 2014, *Using financial instruments to mobilise private investment for development,* OECD DCR 2014
[5] The PPP component includes ODA channelled through a limited number of formally established and DAC-recognized PPPs such as GAIN, the Global Water Partnership and others.

At its December 2014 High-level meeting, the OECD DAC decided to undertake further work to better reflect official sector efforts in catalysing private sector investments in ODA. Instrument-specific approaches (where specific instruments would be counted) and institutional approaches (where donor support to DFIs would be included) are being considered. The OECD DAC is also considering the introduction of an additional and broader measure of total official support for development (TOSSD), which would cover the totality of public resource flows to developing countries in support of sustainable development. Such a measure could include concessional and non-concessional financing, including grants, loans, equity, mezzanine financing and development-related export credits.

Areas for consideration and discussion

- *Additionality and leveraging:* The core appeal of market-like instruments and blending is the mobilization of additional resources for sustainable development, including private finance. This is the leveraging effect or financial additionality – the public component of the package facilitates a private contribution that would not have otherwise been made. Public involvement can also have impacts on project design to improve its development impact, and can have positive demonstration effects. However, financial additionality is difficult to determine in practice. Instead of catalysing additional private resources, the public finance contribution could also subsidise private investments that would have been undertaken anyway. The larger the leveraging factor, the likelier this scenario becomes. The results of a review of additionality for infrastructure projects of five major DFIs were mixed. It found that a majority of projects has financial additionality, but that more than a third of the projects would have gone ahead without their involvement. DFI involvement tends to enhance growth effects of projects, but does little to increase their direct poverty impacts.[6]

- *Development impact:* There are concerns over the development impact of blending and other market-like instruments. There may well be trade-offs between commercial and sustainable development objectives, which may be difficult to reconcile. The OECD and DFIs themselves have defined environmental, social and fiduciary standards, but levels of transparency vary between institutions. At the same time, there are implications for ODA allocation. ODA's primary focus will remain to meet the needs of the poorest and finance public goods. But views differ as to whether blending and leveraging ODA (for example for infrastructure investments) can free up resources and thus support this focus, or whether it diverts scarce public resources to subsidise private investors.

- *Effectiveness:* The lack of participatory governance structures in many DFIs is seen as an obstacle to ownership, accountability and other effectiveness criteria. Some argue however that a loan component can increase ownership.

- *Risks:* The ICESDF Report noted high annual returns that private investors demand for infrastructure projects in developing countries, as well as the high failure rates of PPPs.[7] Evidence suggests that PPPs are an expensive means to finance projects, [8] which calls for exploration of the most appropriate structure, given the investment. Macroeconomic risks can also arise from increased private sector debt and potential contingent liabilities for the public sector.

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[6] Spratt and Collins, 2012, *Development Finance Institutions and Infrastructure: a systematic review of evidence for development additionality.* Report commissioned by the Private Infrastructure Development Group.

[7] http://www.un.org/esa/ffd/wp-content/uploads/2014/12/ICESDF.pdf

[8] See Griffiths et al.

- *Transparency and accounting:* There is at this point no agreed methodology for measuring leverage, which leads to widely differing estimates and double-counting. Concerns also exist over the transparency of DFIs in general, including over their project selection, development impact of projects, and other aspects, in particular when intermediaries are used.

Questions to be addressed in the workshop

The workshop aims to draw on participants' experience with such instruments to improve the understanding of when such instruments should be considered, and in which contexts they are not suitable. It can provide an evidence-based input to the intergovernmental negotiations in the lead up to Addis Ababa.

- *Public finance is a scarce resource with high opportunity costs. Attracting private finance requires financial returns, which may be difficult to reconcile with development goals. Under which circumstances is it opportune to use ODA to leverage private finance?*
- *How can we ensure that principles of effective development cooperation are adhered to when ODA is used to leverage private flows?*
- *How can we assure that ODA moves private resources towards development purposes and not that private resources move ODA towards market purposes?*
- *How can such instruments be monitored in a transparent manner, identifying accurately public effort and the amount of private financing leveraged?*

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