Chapter 3. Increasing complexity in the financing for sustainable development system - instruments, income and interlinkages

Each actor and type of finance for sustainable development has its own comparative advantages, costs and benefits. The wide range and variety of financing actors suggests new opportunities to diversify between and combine financing sources to increase their contribution to sustainable development. In an ideal world, actors would be well informed about these strengths and weaknesses, enabling them to strategically exploit each source to meet the financing needs of Agenda 2030.

This Chapter provides an overview of features and factors that increase the diversity of financing available, but also increase the complexity of financing choices. The Chapter outlines the different instruments available, as well as the way a country's income level affects the financing options it faces. Finally, the Chapter surveys some of the complex interactions between actors and financing sources. These three elements – instruments, income levels, and interactions – reinforce the need for a coherent, holistic approach across actors.

In brief

The wide range and variety of financing for sustainable development actors and their resources bring opportunity as well as complexity. In an ideal world, each of the different actors would make informed decisions about where and how to provide financing to achieve its objectives in the most effective way. Given the individual choices of external actors, developing country governments and private actors could choose the financing that meets their needs and helps to achieve the 2030 Agenda at the lowest cost. They would be well versed about the costs and benefits of choosing a particular resource over another, and could strategically exploit the comparative strengths and advantages of each resource.

Unfortunately, the financing for sustainable development (FSD) system is far from this ideal world and finding that optimal financing mix is challenging for a number of reasons. These can be summarised as three "I's": instruments, income levels and interactions.

Instruments – The first complicating factor is the multitude of financing approaches that are available to the various actors. One defining feature of the new financing for sustainable development system is the emphasis on innovative approaches that widen the choice of instruments.

- Many official providers are exploring this potential, with 33% of bilateral providers who responded to the "Global Outlook Survey on Financing for Sustainable Development" planning to use guarantees in the future and another 13% considering the use of hybrid instruments.
- Despite the buzz around innovation, its promise is nevertheless yet to be realised. The actual volumes raised through innovative approaches remain small. Instruments other than grants and loans account for only 2% of all official development financing.

Income levels –Types of financing available seem to be strongly correlated to income level and changes in country contexts. As countries develop, the financing mix moves from a reliance on external to domestic, and from public to private, finance.

- While tax revenues are slightly less than half the volume of total financing for low-income countries (LICs), they make up more than 70% for lower middle-income countries and around 90% for upper middle-income countries (UMICs).
- While for LICs private flows represent around 30% of external finance, they make up almost 70% for the wealthiest UMICs.

Interlinkages – Interlinkages among actors and resources create synergies and trade-offs, and choices in one domain (such as aid) can impact financing in another (such as tax), increasing or decreasing financing capacities. A lack of understanding of these interlinkages can result in missed opportunities and inefficient policies on the part of both development partners and developing countries:

- Over 80% of LICs and lower middle-income countries (LMICs) offer tax holidays and tax exemptions on investment, while investors report that tax incentives are among the least important factors for investment and location decisions.
- Although some official providers, among them Netherlands and Norway, have changed their policy and no longer seek tax exemptions on goods and services

funded by official development assistance (ODA), this is not yet common practice.

This chapter deconstructs these interconnected factors as a necessary step to design the best solutions for sustainable development. Chapters 4, 5 and 6 will expand on this effort and focus on more holistically measuring, maximising and implementing financing for sustainable development.

Increasing variation in instruments complicate the choice of the financing mix

Instruments can be categorised according to the terms and conditions whereby actors provide financing for sustainable development: as grants, debt, equity, and a miscellaneous category that includes mezzanine finance and contingent instruments such as guarantees.

Traditionally, the different actors engaged in financing for sustainable development used a relatively fixed set of instruments. Bilateral donors and philanthropists largely relied on grants, multilateral development banks mainly provided loans, and private investments took the form of debt and equity.

While these remain the mainstay, actors are exploring new instruments and approaches.

Financing for sustainable development actors choose among a variety of instruments

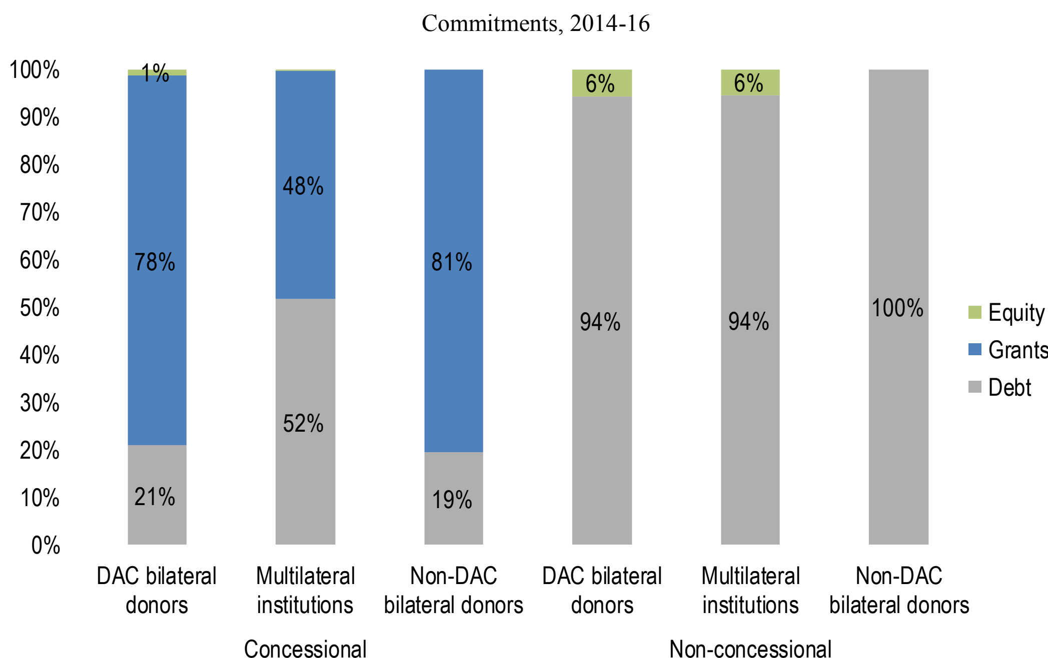
Grants remain the most popular form of official finance

Grants committed by official providers[1] represented 78% of all bilateral concessional finance committed in 2016 and 48% of multilateral concessional finance.[2] (Figure 3.1).

Grants are also provided by private actors, i.e. private corporations, households and non-profit institutions such as philanthropic foundations. Almost all financing provided by philanthropic foundations takes the form of grants. For example, 99% of the disbursements of the Bill & Melinda Gates Foundation in 2016 were grants.[3]

Figure 3.1. Portfolio of official providers

Commitments, 2014-16



Note: The estimates are based on data on concessional and non-concessional finance excluding debt relief. Guarantees, insurance and hybrid investments, each taking up less than 1% of the portfolio, are not shown in the figure.
Source: OECD (2018[1]), "Creditor Reporting System" (database), https://stats.oecd.org/Index.aspx?DataSetCode=crs1.

StatLink https://doi.org/10.1787/888933852920

The choice between grants and loans is sometimes guided by the World Bank/International Monetary Fund Debt Sustainability Framework (DSF) for low-income countries. The World Bank determines the allocation of grants on the basis of debt sustainability assessment results. Countries with a low risk of debt distress receive loans; countries with a moderate risk receive a mix of 50% loans and 50% grants; and countries with a high risk of debt distress and those in debt distress receive only grants. A number of bilateral providers have adopted a similar grant allocation strategy (Cassimon, Verbeke and Essers, 2016[2]).

Debt brings benefits and risks, and is widely used

Debt financing is a widely used instrument, publicly and privately. Since debt needs to be repaid, it can create positive incentives for borrowers to exercise fiscal discipline. Once debt is repaid, it can be used to finance other needs. At the same time, the obligation to pay back the debt, in many cases with accrued interest, can place a fiscal burden on the borrower[4] and unsustainable debt levels can lead to currency and banking crises, especially in a developing country context (Aghion, Bacchetta and Banerjee, 2004[3]).

Debt finance from official providers mostly takes the form of loans, both on concessional and non-concessional terms.[5] Standard loans constitute a relatively small portion of concessional flows but make up the majority of non-concessional flows, ranging from a share of 94% for bilateral OECD Development Assistance Committee (DAC) providers

to 100% for non-DAC providers (Figure 3.1). Multilateral providers tend to have a relatively larger portion of non-concessional finance in their portfolios and so are leading providers of loans. In 2016, loans comprised 94% of their non-concessional commitments and 75% of their total commitments.

Debt is also the most commonly used instrument for private sector flows. Most privately extended debt in developing countries takes the form of loans. However, in line with a global shift towards more capital market and bond financing (OECD, 2017[4]), the portion of tradable securities (e.g. bonds) to total debt levels of developing countries has risen steadily.[6] While this is especially true in upper middle-income countries, governments and companies in lower middle-income and even low-income countries are increasingly accessing capital markets.

This increasing use of debt capital markets has led to a change in the composition of the providers of financing. Unlike the providers of non-tradable loans, investors in debt capital markets can easily sell their debt to new creditors. This can have negative consequences for any required debt restructuring, as it can become more difficult to ensure the creditor co-ordination needed to produce comprehensive agreements acceptable to all major creditors (IMF, 2018[5]).

Equity investments share risks, and are increasingly popular among public sector actors

Equity, traditionally a private sector instrument, has a more stabilising effect than debt on recipients of finance because the risks of the investments are shared with the providers. However, for providers, this means equity investments are riskier than debt, generally bringing more volatile but higher returns.

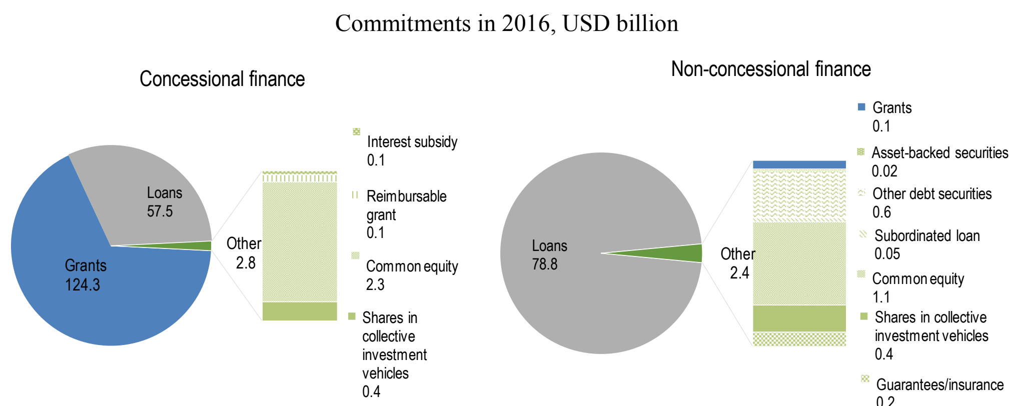
Equity instruments are mainly used for private sector investments, with over 80% of net foreign direct investment (FDI) holdings taking the form of equity.[7] Equity also constitutes a substantial part of portfolio investments, making up more than half of portfolio investment holdings.[8]

Recent years have seen a shift away from equity towards more debt financing in developing countries, with possible repercussions on debt sustainability and vulnerability to macroeconomic shocks (Chapter 5). This shift corresponds to a global pattern driven by a multitude of factors including demographic changes and financial regulatory reforms that make debt more attractive than equity (Roxburgh et al., 2011[6]).

At the same time, equity investments are receiving increasing attention from the public sector.[9] While the equity portion of the finance provided by multilateral actors is still quite low – 6% in 2016 across non-concessional finance, as shown in Figure 3.2 – there is variation across agencies. Equity investments make up 25.5% of the portfolio of the International Finance Corporation (IFC), which holds an equity stake in private companies. Moreover, many bilateral providers make equity investments through their development finance institutions, where the equity portion exceeds 80%. The Annex provides more detail.

Figure 3.2. The portfolio breakdown of bilateral sustainable development finance providers

Commitments in 2016, USD billion



Source: OECD (2018[1]), "Creditor Reporting System" (database), https://stats.oecd.org/Index.aspx?DataSetCode=crs1.

StatLink https://doi.org/10.1787/888933852939

Since equity investments have a different risk-return profile than debt and can produce much more volatile returns, the growth in the equity portfolio of official providers can bring new risks. Most development finance institutions making use of equity instruments obtained double-digit returns before the 2008 financial crisis, but then suffered major losses (Michelitsch et al., 2017[7]).

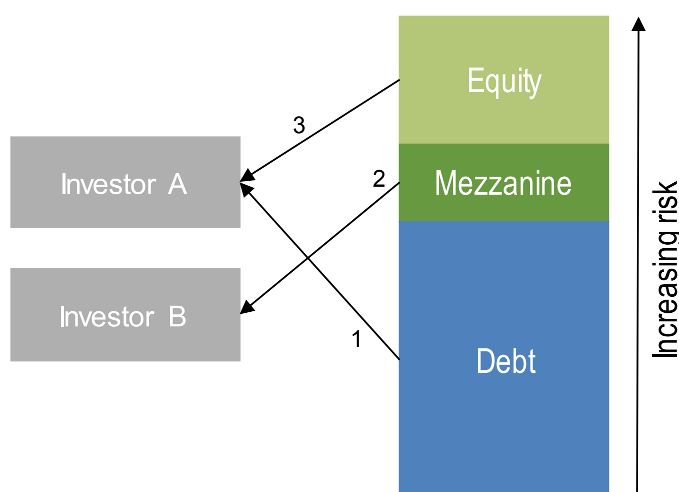
Other instruments that share risks are also drawing increased interest

Instruments that go beyond standard grants and loans are drawing increasing interest from (official) FSD providers. Mezzanine finance and guarantees both have variable returns and outflows, since they involve sharing risk between the provider and recipient.

Mezzanine finance

Mezzanine finance is a hybrid instrument situated between debt and equity and used mostly by private sector actors[10] and institutional investors. In the event of bankruptcy, mezzanine investors have lower rankings than other creditors but higher rankings than equity investors. In an investment transaction depicted in Figure 3.3, profits would be first used to pay back debt finance provided by Investor A. Only after all debt is paid back would Investor B be paid back his investment in mezzanine finance. Because of the later pay-out, Investor B would be promised a higher return than that obtained by Investor A in terms of interest on the debt financing portion. Returns on equity financing from Investor A would correspond to how much is left after both debt and mezzanine finance have been repaid.

Figure 3.3. The pay-out from mezzanine finance



Source: Author

From its beginnings in the 1980s, the commercial mezzanine finance market has developed mostly in advanced economies. Investors usually use mezzanine instruments to hold long-term positions in relatively large and growing companies. Policy makers in some OECD countries and in international organisations have sought to use mezzanine instruments to provide finance to small and medium-sized enterprises, either by creating investment funds targeting specific companies or by providing direct financing (Cusmano and Thompson, 2013[8]).

The share of mezzanine finance is small, estimated at less than 1% of official provider portfolios[11] However, some bilateral development finance institutions and multilateral development banks have adopted the practice of using mezzanine finance backed by official funds. It is also used to finance the operations of private sector entities in developing countries. Often, the use of mezzanine finance serves the purpose of private sector mobilisation.

Guarantees

Guarantees provide protection against political and/or commercial risks of an investment. A guarantee obliges the provider of the guarantee to pay to the investor (e.g. lender) an agreed-upon amount in the event the guaranteed party is not able to pay back claims. Both private and public entities provide guarantees, typically in return for a premium. Private entities[12] are profit-motivated in the pricing of the premium, while official providers take other objectives into consideration (OECD, 2018[9]).

Although guarantee activity is still relatively small compared to other forms of development finance, guarantees are receiving increasing attention from official providers. They especially are being considered as a tool for blended finance, an approach to use development finance for the explicit purpose of mobilising different resources. Since guarantees involve the risk of disbursement rather than the immediate disbursement of donor funds, some donors allocate a smaller proportion of capital to the guarantee than they would to an equivalent loan. This means that, depending on the donor's risk management policies, guarantees can be very efficient mobilisers (Box 3.1). The 2016 OECD-DAC Survey on amounts mobilised from the private sector in 2012-15 found that 20 of the 35 development finance organisations surveyed issue guarantees for the purpose of leveraging private resources (Benn, Sangaré and Hos, 2017[10]).

Box 3.1. Guarantees can leverage private resources: the Bosnia and Herzegovina example

The use of guarantees to leverage private resources is at the heart of a programme of USAID and the Swedish International Development Cooperation Agency (Sida), which issued guarantees to ProCredit Bank and Sparkasse Bank in Bosnia and Herzegovina to cover 50% of the loan principal extended to local small and medium-sized enterprises. These guarantees lowered the risk exposure of the banks, enabling them to make loans to borrowers who otherwise would not be eligible and/or to make loans at terms more favourable than what would be possible under each bank's regular lending parameters (USAID, 2017[11]).

The financial instruments discussed in this section are used for cross-border flows. It should be noted that the same instruments are also used within developing countries. For example, domestic debt is taking on a bigger role as a source of public finance in developing countries, due largely to significant development of their financial sectors (IMF, 2015[12]). Tax is another key instrument in financing sustainable development used by domestic public sector actors, as described in more detail in Box 3.2.

Box 3.2. Taxation as an instrument of financing for sustainable development

Taxation is an important component of fiscal policy and a key public sector instrument to augment financing for sustainable development.

- Revenues raised through taxation can be used to provide public goods that otherwise would not be financed. Tax revenues in developing countries are 2.5 times larger than all cross-border financing combined (Chapter 2) and can be used for public investments in infrastructure, agriculture, health, education and other sectors.
- Taxation can also be used to enable redistribution and reduce inequalities (Chapter 2).
- Taxes can set incentives to promote behaviour that is conducive to Sustainable Development Goals (SDGs) such as climate change mitigation. The government of Viet Nam announced in April 2018, that it would raise the consumption tax on gasoline by 33.3% to Dongs 4 000 (USD 0.1754) per litre, to reduce pollution and pay off public debt (Vu, 2018[13]).

However, for tax to work as an instrument to finance sustainable development, the revenues that are raised must be directed towards sustainable development. Unfortunately, this is not always the case.

Analysis on public expenditure in support of the Millennium Development Goals (MDGs) found that in a sample of 66 low-income and middle-income countries, public spending rose by 3.2% of GDP, to 29.8% from 26.6% of GDP, between 2008 and 2014. However, this rise in expenditure was not matched by a rise in spending on MDGs. MDG spending as a share of GDP stagnated at around 11% since 2010 (Martin and Walker, 2015[14]).

To ensure that the revenues raised through taxes are effectively contributing to sustainable development, accountable and transparent systems governing the use of public resources need to be put in place. This calls for the active implementation of measures to align public expenditures with sustainable development objectives by integrating SDGs into national budgeting and tracking spending on SDGs (Hege and Brimont, 2018[15]).

The case for innovation: delivering more and smarter financing for sustainable development

Expansion of the financing for sustainable development system, as described in Chapter 2, calls for and gives rise to innovative approaches that will embrace the different strengths of actors and instruments and enable collaboration across the different actors. The Addis Ababa Action Agenda (AAAA) emphasises the need to harness the potential of new instruments and innovations to mobilise more resources for sustainable development (paragraphs 43, 45, 48, 69, 75, 102 and 107).

While the quest for innovative financing mechanisms is not new, it is more urgent than ever (Chapter 1). The development community began exploring and experimenting with new initiatives in the early 2000s to help assure achievement of the Millennium Development Goals. The 2030 Agenda, with its increased ambitions, requires enormous financing efforts that cannot be met by traditional methods alone. Every year, an investment gap of USD 2.5 trillion needs to be filled to achieve the SDGs (Chapter 4).

Innovation in financing sustainable development covers a wide range of approaches that aim to raise more resources for sustainable development or enhance the efficiency and development impact of existing resources (World Bank, 2010[16]). As Box 3.3 "Official development assistance remains essential to make innovative financing work" argues, the objective of innovation is to mobilise "more money" and "smarter money". The implicit baseline is a world where development finance comes mainly from official providers who predominantly rely on traditional instruments such as grants and loans.

Instruments that adopt elements of private sector practices are often referred to as innovative even if they have been in existence for a long time and have been widely used in commercial investments. The example of mezzanine finance cited above illustrates this point. Although private sector investors have used mezzanine finance for several decades, the fact that official providers are increasingly embracing it to finance development projects is deemed innovative.

Innovation in instruments thus reflects the sweeping changes that are taking place in the sustainable development finance system. With the proliferation of actors, new opportunities for collaboration and mutual learning arise to increase financing volumes and/or impact for sustainable development. The examples discussed in this chapter of blended finance, social impact investment and triangular co-operation further demonstrate this paradigm shift in the financing for sustainable development system. These help to shift and reallocate the risks and returns related to sustainable development efforts among public and private actors, thereby introducing collaborative models in which different types of actors leverage their comparative advantages to increase financing for sustainable development.

Box 3.3. In My View: Official development assistance remains essential to make innovative financing work, by Jérôme Olympie, Ministry of Foreign Affairs and International Development, France

Donors originally advocated for innovative financing so as to raise additional resources to invest in sustainable development, stabilise and improve the predictability of aid, address market failures, and ensure a fairer distribution of wealth. Innovative financing, then, must be understood both as a way to mobilise more money and a way to mobilise smarter money.

Mobilising more money

Solidarity taxes (such as the financial transaction tax and the air ticket levy) are good examples of innovative sources. These two examples have proven to be very effective, especially in France where both have been implemented, and they have raised more than EUR 3.715 million since 2006.They also contribute to a better distribution of wealth and help to address global challenges. Several characteristics define them as innovative. First, they allow ring-fencing resources for development. Second, they provide more predictability. Third, they allow new contributions from globalised activities.

However, solidarity levies are now seen as complementing a broader paradigm shift where public development finance is increasingly used to catalyse more private investments for sustainable development. New tools have been emerging in recent years, such as guarantee mechanisms to incentivise private investments and other instruments (blending mechanisms, matching funds, etc.) based on leverage effects.

Mobilising smarter money

Engaging in sustainable development is an issue not only of the quantity but also the quality of the resources. Result-based mechanisms allow to incentivise beneficiaries and implementing actors, therefore improving development results and ownership of policies. However, such mechanisms usually rely on official development assistance (ODA) as the donor country acts as the "outcome payer". Examples include risk transfer mechanisms and new insurance mechanisms including financing products like the very concessional countercyclical loans offered by the French Development Agency (AFD) and regional-led facilities such as the African Risk Capacity.

The need to strike a right balance between public and private funds

Mobilisation of both private sector and domestic resources in developing countries is key to any long-term sustainable development. But public funds are still needed. Indeed, they can have a real impact in least developed countries, which the private sector too often overlooks; maximise the leverage of private funds; or even help to accelerate the take-up of innovative instruments through technical assistance. Their potential impact is one reason France committed to expanding its ODA to 0.55% (from 0.43% in 2017) of national income by 2022.

The way forward

Promising food for thought is likely to emerge from discussions in the coming months within the Leading Group on Innovative Financing for Development, a gathering of 66 stakeholders who include states, foundations, nongovernmental organisations and companies. They will be focused on some of the following questions. How can better mechanisms be introduced to encourage migrant workers to invest their assets (i.e. remittances) in development activities? How can greater responsibility be required of those operating in the maritime transport sector and how can they be encouraged to actively reduce their environmental footprint. And can development impact bonds contribute to increasing the impact of ODA?

Feeling hungry for innovative thinking on innovative financing? Come and join us.

Certain innovative instruments are intended to mobilise additional resources in support of targeted development outcomes.

- The collection of international solidarity levies from air passengers when they purchase their tickets. The governments of Brazil, Chile, France, Norway and the United Kingdom launched this initiative in 2006, aiming to directly tap household and industry resources and link them to sustainable development efforts. Most of the funds raised are used to finance UNITAID, the United Nations agency charged with funding the treatment and care for patients affected by HIV/AIDS, tuberculosis and malaria.
- Green bonds, which are debt securities that tap capital markets to raise financing specifically to support climate-related or environmental projects: Most green bonds carry a green "use of proceeds" proviso, meaning that proceeds from these bonds are earmarked for green projects, and provide for the issuer's entire balance sheet to back repayment of the principal and interest. Water bonds, also known as blue bonds, are a special subcategory of green bonds that raise capital for the sustainable ocean economy.

Other innovative instruments are devised to increase the efficiency of financing efforts. These instruments reduce the time and costs involved in matching the supply of financing with needs, e.g. by bringing together public and private actors or by adopting structures that have been tried in the private sector.

- An example is the Caribbean Catastrophe Risk Insurance Facility (CCRIF), a multi-country risk pool that provides natural disaster insurance to member governments. Unlike traditional insurance settlements that require an on-the-ground assessment of individual losses before a payment can be made, the parametric mechanism of the CCIRF makes pay-outs once a pre-agreed threshold value of an index is met. Resembling the settlement mechanism for financial derivatives, this structure allows for faster compensation, but carries a trade-off in that the contracted compensation can differ markedly from actual assessed damage.
- Another instrument is advance market commitments, contractual partnerships between donors and pharmaceutical companies that aim to ensure research on neglected diseases. Donor governments commit to ensuring predictable demand for the products once research is completed, while companies have the contractual obligation to do the necessary research and commit to the distribution of medicines on the market at affordable prices for developing countries.

Some instruments are intended to enhance development quality by aligning financing with development outcomes. Often, these instruments make financing conditional upon the delivery of concrete development results. Results-based financing is an umbrella term for mechanisms such as output-based aid and pay-for-performance that use incentive schemes, traditionally a private sector practice, to enhance the performance of aid. In this group of instruments, the payment is not made for the input required for the project or programme but for achieving an effect.

Development impact bonds, for example, create a contract between private investors and donors or governments who have agreed on a shared development goal. Private investors provide the principal amount as starting capital to a development service provider. If the project achieves a pre-agreed development outcome, the donors or governments are committed to pay. The donor/government pays back the principal and returns. This

innovative financial instrument shifts the financial risk of development challenges from the public sector to the private sector. One example is the humanitarian impact bond, pioneered by the International Committee of the Red Cross, which is described in Box 3.4.

Box 3.4. The humanitarian impact bond - Innovative bonds can raise financing for humanitarian purposes

The humanitarian impact bond is an innovative financing mechanism developed by the International Committee of the Red Cross (ICRC) and the first of its kind in the humanitarian sector. This new fundraising instrument is intended to catalyse private and public capital to finance vital services for people with disabilities in conflict-hit countries.

The five-year programme funds the construction and operation of three new physical rehabilitation centres run by the ICRC in Maiduguri (Nigeria), Kinshasa (Democratic Republic of the Congo) and Mopti (Mali). The programme also covers the training of new staff and the design and testing of rehabilitation efficiency initiatives in eight existing ICRC physical rehabilitation centres for a period of three years. It additionally includes the development and deployment of an information communication technology tool for physical rehabilitation centre management.

Private capital from social investors of about CHF 18.6 million has been mobilised and provided to ICRC to support humanitarian outcomes and provide services during the five-year programme. The outcome funders (Belgium, Italy, Switzerland, United Kingdom, and the Spanish bank, La Caixa) made a conditional pledge to pay ICRC for concrete results achieved in five years. The higher the efficiency in the new centres, according to the pledge, the higher their contribution. An external provider is in charge of verifying ICRC-reported data and establishing the outcome measure to determine the exact payment owed by the outcome funders.

Although official providers in particular are increasingly interested in the use of innovative instruments in financing for sustainable development, other actors – notably foundations – can also play an important role in increasing innovative finance (Box 3.5).

Box 3.5. Philanthropic foundations can act as innovation catalysts

Most foundations rely exclusively on grants to provide financing for sustainable development. But some foundations are using new financial tools and act as pioneers and catalysts of innovative financing for development. These foundations have relatively low levels of risk aversion and are willing to invest in innovative business concepts and financing models. Consequently, they are also becoming increasingly important players in the blended finance market where their participation aims to mobilise additional finance.

Moreover, foundations are playing a critical role in the evolution of the social impact investment market through market-building activities (research and knowledge exchange) and mission-related investments (MRIs).

MRIs, which are investments of foundations' endowment into ventures that are related to their core mission, can be viewed as a type of social impact investment. Through MRIs, foundations no longer distinguish between investments to maintain and expand their endowment and their grant-making strategies. A foundation focused on fighting climate change, for instance, will give out grants to nongovernmental organisations that are implementing recycling initiatives and it also will invest its endowment in renewable energy companies or funds.

Foundations in the United States are subject to a legal requirement to annually disburse 5% of their assets – called the pay-out – to keep their tax exemptions. Whereas grants are typically included in this pay-out, MRI investments are made directly from the endowment. Thus, MRIs have the potential to leverage the untapped 95% capital. In 2017, the Ford Foundation made the largest commitment to MRIs to date by devoting USD 1 billion out of its USD 12 billion endowment to MRIs over the subsequent ten years. With this move, the Ford Foundation aims to help build the market for MRIs by creating impact funds and to encourage other foundations to follow its lead.

Source: OECD (2018[9]), *Making Blended Finance Work for the Sustainable Development Goals*, http://dx.doi.org/10.1787/9789264288768-en.

Blended finance gains traction as a tool to mobilise the private sector

Beyond the specificities of individual instruments, an overarching paradigm shift underlies financing for sustainable development innovations. The rising popularity of blended finance practices especially reflects this. Blended finance is not an instrument. It is a new approach to better use existing and new financial instruments. The OECD defines blended finance as the "strategic use of development finance for the mobilisation

of additional finance towards sustainable development" in developing countries, where additional finance is primarily private commercial finance (OECD, 2018[9]).

Official providers increasingly engage in blended finance operations. At least 17 members of the OECD DAC currently undertake blended finance operations at different stages, using a range of financial instruments and sometimes differing in how blending is carried out. According to one estimate, over 300 blended finance transactions have been closed from 2005-2017, representing an aggregate amount of over USD 100 billion in financing for sustainable development in developing countries (Convergence, 2018[17]).

Many bilateral providers rely on development finance institutions (DFI) to engage in blended finance. DFIs are government-controlled institutions that invest in sustainable private sector projects. While many DFIs have a long track record of investing in private sector projects, having done so since the 1960s and 1970s, the amount of support they are offering to the private sector has increased sharply in recent years. At the European level, the consolidated portfolio of the 15 members of the association of European Development Finance Institutions (EDFI) has more than tripled, to EUR 37 billion in 2017 from EUR 11 billion in 2005 (EDFI, 2018[18]).

Blended finance transactions often are innovative in the way they structure and/or calibrate traditional financial instruments to address private investor concerns regarding the risk-return profile of investment opportunities. If equity and debt are provided on concessional terms, they can shift the risk-return relationship of a project in order to facilitate commercial investment. Even if non-concessional terms are applied, the mere presence of DFIs as investors can contribute to raising investor confidence, thanks to their due diligence capacities and ability to deal with political risks. This benefit is even amplified when DFIs are invested in the riskier parts of the balance sheet – for example, when they use equity or mezzanine instruments (Benn, Sangaré and Hos, 2017[10]).

Mobilisation through blended finance also can take the form of indirect investments. For example, collective investment vehicles (CIVs) or funds are legal entities in which different actors pool their resources to make collective investments in specific segments, such as climate finance or small and medium-sized enterprises. CIVs utilise different kinds of instruments including equity, debt or guarantees. A CIV can be structured so that all investors are exposed to the same risk-return profile (flat structure). In this case, the presence of development finance providers can have a signalling or demonstration effect. Development finance providers also can provide technical assistance to support the project and make it more attractive to private investors. However, CIV can also be structured in such a way that some investors, especially official providers, have subordinated repayment claims. Taking a first-loss position, development finance providers thus can act as a cushion for private investors (OECD, 2018[9]).

Guarantees are a commonly used instrument in blended finance. During the period from 2012 to 2015, development finance organisations mobilised USD 35.9 billion,[13] according to the 2016 OECD-DAC Survey, which also finds that guarantees are the main leveraging instrument used by development finance agencies (OECD, 2018[9]). The Elazig Integrated Health Campus project, described in Box 3.6, illustrates how official finance can be combined with private sector resources from commercial investors to finance a development project, including through the use of guarantees.

Box 3.6. Mobilisation through blended finance - Elazig Integrated Health Campus project

Promoting the participation of untapped investor classes in the healthcare sector through the Elazig Integrated Health Campus project

The Elazig Health Campus project, initiated by the government of Turkey as part of its health transformation programme to improve the healthcare services across the country, is an example of strategic use of blended finance on a non-concessional basis to mobilise additional commercial investment (OECD, 2018[9]).

The project is a EUR 360-million greenfield[14] project structured as a public private partnership that handles the design, construction, finance and maintenance. The Turkish Ministry of Health will be responsible for the core medical services. The Elazig project was realised with the help of innovative financing structures and credit enhancements that resulted in the issuance of bonds with an investment-grade rating (Baa2 by Moody's), two notches above Turkey's sovereign rating at that time. The combination of Multilateral Investment Guarantee Agency (MIGA) political risk insurance and European Bank for Reconstruction and Development (EBRD) liquidity facilities during both construction and operation, helped to make this rating possible. The Euro-denominated project bonds were issued in different tranches; the senior A1 bonds are enhanced by EBRD liquidity facilities and the MIGA political risk insurance guarantee. Bond investors include Mitsubishi UFJ Financial Group (Japan), Intesa Sanpaolo (Italy), Siemens Financial Services (Germany), PROPARCO (France), the Netherlands Development Finance Company (FMO), and the Industrial and Commercial Bank of China. The International Finance Corporation invested in the unenhanced A2 bonds.

Social impact investment is in the early stages but can help to engage private sector actors more directly in the financing of the SDGs

Social impact investment (SII) encompasses a variety of innovative approaches to deliver on the SDG, and can be defined as the provision of finance to organisations addressing social needs with the explicit expectation of a measurable social, environmental and/or financial return (OECD, 2015[19]). The Transforming Education in Cocoa Communities project in Côte d'Ivoire (Box 3.7) is an example of innovative use of financing instruments – in this case, with a philanthropic foundation providing seed finance for investment in education programmes. The private sector brings capital to the market as well as innovative approaches to address the pressing issues framed by the SDGs.[15]

SII uses innovative instruments, among them pay-for-performance instruments like the development impact bond and the social success note. However, SII also makes use of traditional instruments such as debt and equity in innovative ways. Social enterprises often struggle to raise funding in their early stages of development. Grants, from foundations or the public sector, are also used alongside SII to provide first loss or catalytic funding. The grant provider bears the business risk of the enterprise at the seed stage, which serves to attract additional funding (GIIN, 2013[20]). The goal, however, is to help the enterprise to ultimately make profits while generating sustainable impact.

Box 3.7. Social impact investment helps to provide quality education in Côte d'Ivoire

In 2015-16, only 5.32% of the bilateral ODA going to Côte d'Ivoire targeted education.[16] The Transforming Education in Cocoa Communities (TRECC) programme, using a social impact fund set up by the Jacobs Foundation of Switzerland, aims to improve the livelihoods of individual households by providing quality education, empowering women and assuring child labour remediation. The programme will run from 2015 to 2022.

The impact fund is dedicated to investments in the education sector and has CHF 3.7 million in a portfolio of five investees in 2017. It provides risk finance and technical assistance to small and medium-sized enterprises in order to grow innovative solutions to Ivorian education challenges. The TRECC programme brings together governments, civil society and corporate players for partnerships in the cocoa sector. Already these include public-private partnerships with corporations such as Mars, Incorporated, Mondelēz International, and Nestlé. The Jacobs Foundation also has signed a memorandum of understanding with the government of Côte d'Ivoire to improve the quality of education in the country. The programme further has formed alliances with organisations such as Brookings and the International Cocoa Initiative to support research and capacity building.

Social impact investing has the potential to catalyse new capital flows and thus translate experiences, policies and approaches from developed countries for the developing country context. While the social impact investment market is still in the early stages of development and is only a small share of the global capital markets today (OECD, 2015[19]), it has been growing significantly and attracting increasing interest, including in specialist areas such as gender impact investment (Chapter 6). In order to build the SII market, a broader evidence base is needed to inform market stakeholders – governments, development finance institutions, private sector investors and social entrepreneurs – about activity and performance of social impact investments. Greater transparency, measurement and accountability for outcomes and impact are critical to scaling up social impact investment.

Triangular co-operation is on the rise

Triangular co-operation refers to development co-operation partnerships between two or more developing countries, with the support from a developed country or multilateral organisation. Triangular co-operation. It provides another example of how innovative financing can lead to the formation of new constellations of actors to finance sustainable development. Introduced in the 1970s, triangular co-operation gained popularity in recent years as a modality by which partners leverage and combine different types of resources (financial, in-kind, knowledge, technology or other resources). This type of co-operation harnesses and capitalises on the comparative advantages of each partner, resulting in an impact that is greater than the sum of their individual interventions (Box 3.8). Such next- generation partnerships (Chapter 5) have the potential to mobilise more and smarter financing for sustainable development.

Box 3.8. Triangular co-operation brings together diverse resources in support of sustainable development

Triangular co-operation supports innovative and collaborative ways to achieve the Sustainable Development Goals and can provide solutions to overcome today's environmental, economic and social constraints to development. Triangular co-operation is on the rise, according to results of surveys and analyses conducted by the OECD. This trend is confirmed by data collected by the Ibero-American General Secretariat (SEGIB) that show the number of triangular co-operation projects in Latin America and the Caribbean increased eight-fold between 2005 and 2015 (SEGIB, 2017[21]). There are a number of reasons for such growing interest in and demand for this way of working in development co-operation.

First, 1+1+1 > 3. Triangular co-operation multiplies the contributions and participation of the different partners in terms of results in the target country. It also encourages building strong and trusting partnerships that often continue beyond the lifetime of the triangular project.

Second, small can go very far. On average, the budgets of triangular co-operation projects tend to be relatively small, particularly in comparison with bilateral and regional projects. However, technical co-operation can go far without large budgets. Additional funds can also be leveraged through a triangular intervention. Triangular co-operation projects are often funded by DAC and non-DAC providers of development co-operation, international organisations or a partner organisation in the target country. For instance, in a triangular co-operation project of Brazil, Germany and Peru, the DAC member provided EUR 1 million of the EUR 3.9 million project budget and Brazil together with Peru provided the remainder.

For many providers who are not DAC members, triangular co-operation is a way to increase the scale and scope of their development co-operation while sharing the costs (and risks) associated with the intervention. For example, the Islamic Development Bank's reverse linkage modality can fund only one-third of any given triangular project. It should be noted, however, that the budgets of triangular co-operation projects in the Middle East and North Africa tend to be bigger than those of such projects in other regions, suggesting the need to better understand and capture how this modality is being used in all regions and how the leveraging effect can be amplified.

Third, knowledge is gold and sharing it is cost efficient. Knowledge, solution sharing and joint learning are core elements of triangular co-operation. In the spirit of mutual interest and benefit, countries share their experiences and expertise. The partners in triangular co-operation can often find innovative, cost-effective, flexible and context-specific solutions to development challenges. These solutions may have been tested by a country with similar conditions, often in the immediate neighbourhood, and can most likely be better adapted to the context of the beneficiary partner through the financial or technical support of a third

partner. The impact may be large and affect the lives of many people while the financial cost is low. Triangular co-operation activities increasingly are being used to provide solutions and answers to some of the most pressing global challenges such as the refugee crisis and climate change. As such, triangular co-operation is increasingly being used beyond niche thematic areas.

Fourth, triangular co-operation offers flexibility in fast-changing environments. The ideas for triangular initiatives often are born in bilateral co-operation projects that can be scaled up or, in the case of larger bilateral or regional programmes, can include a trilateral component. Triangular co-operation is flexible in its forms and in the way that the partners work together. If major events such as elections or natural disasters affect the political priorities and implementation capacities of one partner, other partners can step in and ensure that the project delivers.

Fifth, triangular co-operation transcend divides between South-South and North-South co-operation. Triangular co-operation has a strong strategic and political dimension. Partners build trust through negotiating and jointly implementing projects. Over time, they understand the perspectives, management methods and policies of the other partners. This mutual understanding can contribute to overcoming divides between South-South and North-South co-operation and encourage use of best ways of working to support development for those most in need. Collaboration in development also at times fosters collaboration in other areas such as foreign policy, environment or trade.

Despite such benefits and successes, doubts persist about triangular co-operation. However, OECD analyses find that, contrary to widespread assumptions, triangular co-operation is not scattered, small in scale and scope, and not only relevant in niche areas; that clear planning and implementation mechanisms are followed; that it offers clear value added in comparison to bilateral or regional co-operation; and that it is found beyond Latin America and the Caribbean. To address the persistent doubts, the OECD has been working to track and provide tools to better capture the value added of triangular co-operation and to correct these misconceptions (OECD, 2017[22]), (Casado-Asensio and Piefer, 2018[23]).

Contributed by Nadine Piefer and Juan Casado-Asensio, Policy Analysts, Foresight, Outreach and Policy Reform Unit, OECD Development Co-operation Directorate.

Innovative finance has not yet reached its full potential

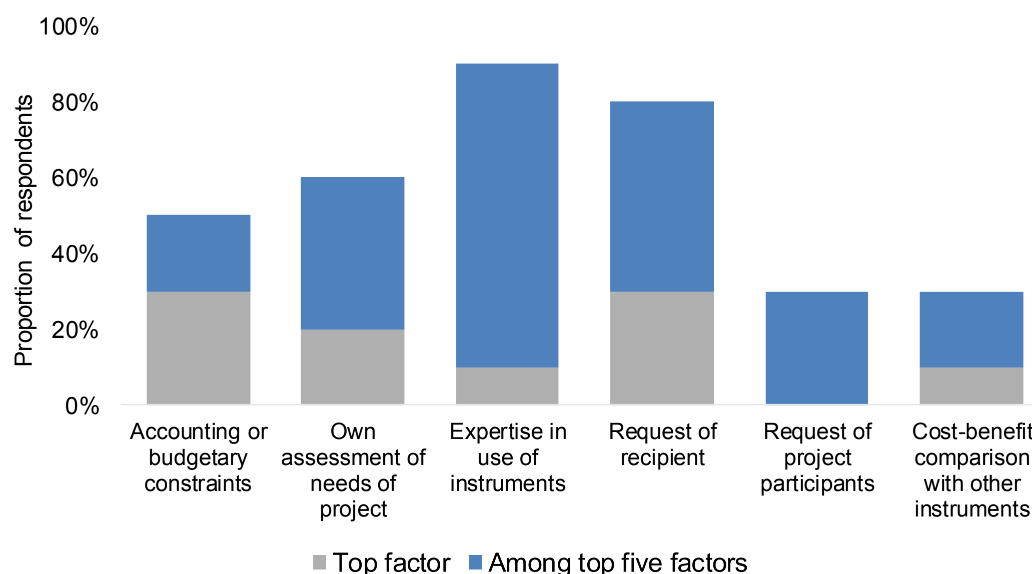
Despite the potential of innovative approaches and the enthusiasm of providers, only a small volume of financing has yet been raised through these approaches. Official providers still rely mostly on standard instruments such as grants and loans. As was shown in Figure 3.2, instruments other than loans or grants still make up a fraction of their portfolio. This also can be seen in the green bond market, whose rapid growth in recent years is a major and much-acclaimed success, with new issuances nearly quadrupling to USD 42 billion in 2015 from USD 11 billion in 2013. However, even with this strong performance, the green bond market remains small in comparison to the overall volume of debt issued by public and private sector borrowers in developing

countries on international markets, which amounted to USD 198 billion in 2015. Similarly, development impact bonds have been slow to gain traction to date, and while 21 of these bonds are being designed but only 6 have been implemented (Instiglio, n.a.[24]).

Because innovative instruments involve a high level of technical and legal expertise, they can bring high transaction costs and opportunity costs. For example, guarantees for investments require that three actors – the guarantee provider, the investor and the recipient of the investment – are brought together and thus are more complex than traditional, bilateral instruments such as grants and loans (Criqui and Vaillé, 2017[25]) and entail higher transaction costs (Humphrey and Prizzon, 2014[26]).The growing popularity of climate and disaster insurance mechanisms is accompanied by concern that their use risks diverting scarce public resources from more effective (and cost-effective) resilience-building strategies (ActionAid, 2015[27]). Spending public resources on insurance premiums involves opportunity costs that must be considered in the adoption of insurance products for financing sustainable development purposes.

Capacity building, exposure and experience are needed to bring innovative instruments to scale, including assessing when their use is most appropriate. The recent "Global Outlook Survey on Financing for Sustainable Development" found that OECD members rank the lack of familiarity with financing sustainable development instruments as one of the main challenges to their use. More than 80% of respondents reported that two of the top five factors influencing their choice of financial instrument are expertise and familiarity with the instrument, while only around 20% of respondents said their choice is influenced by a cost-benefit comparison with other instruments (Figure 3.4). This suggests that harnessing the potential of innovative instruments requires a long-term learning process and targeted investment in capacities.

Figure 3.4. Factors influencing the selection of instruments of bilateral providers



Source: OECD (2018[28]), "Global Outlook Survey on Financing for Sustainable Development", http://www.oecd.org/development/financing-sustainable-development/development-finance-topics/global-outlook-on-financing-for-development.htm.

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Income levels influence sustainable development financing patterns

While the concept of development includes many different dimensions, income per capita remains an important indicator in terms of both growth and economic outcomes and countries' access to finance. A country's gross national income (GNI) is particularly important as it directly affects the country's eligibility to access concessional public finance (ODA) and can be highly correlated with access to non-concessional sources of finance, including international financial markets.

The financing available goes through a dual shift as countries move along the development continuum

As countries experience growth and transition through the development continuum, it is possible to observe some distinctive patterns for each of the resources composing the global financing mix available to developing countries (Kharas, Prizzon and Rogerson, 2014[29]).

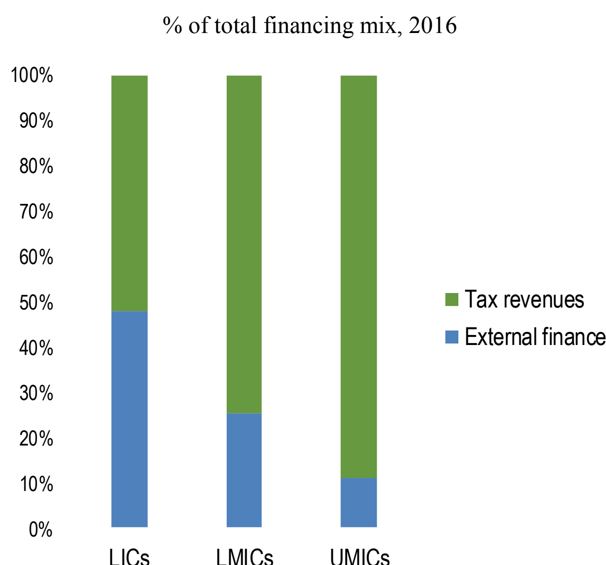
A dual shift in the financing mix accompanies the development transition as countries' income increases – from external to domestic financial resources and from public to private forms of investment in sustainable development.

Countries tend to rely less on external finance and more on their own resources

Reliance on domestic finance increases substantially for middle-income countries. While tax revenues are slightly less than half the volume of total financing for low-income countries, they make up more than 70% for lower middle-income countries and around 90% for upper middle-income countries. (Figure 3.5) The ratio of tax revenue as a share of GDP ranges from 11% for low-income countries to over 18% for some upper middle-income countries. Only lower middle-income countries and upper middle-income countries exceed the threshold of 15% of tax-to-GDP ratio that is considered the minimum for effective state functioning.

Figure 3.5. Domestic vs external resources in the financing mix

% of total financing mix, 2016



Note: The resources include concessional flows (ODA), non-concessional flows (OOF), private flows (foreign direct investments, private securities, and claims from banks and other sources such as bonds, equity, etc.), and remittances.

Sources: OECD (2018[1]), "Creditor Reporting System" (database), https://stats.oecd.org/Index.aspx?DataSetCode=crs1 for official bilateral and multilateral flows; World Bank (2018[30]), "Migration and remittances" (database) http://www.worldbank.org/en/topic/migrationremittancesdiasporaissues/brief/migration-remittances-data for remittances; IMF (2017[31]), "Balance of Payments" (database) http://www.imf.org/external/datamapper/datasets/BOP for FDI, portfolio investments, and long-term and short-term debt.

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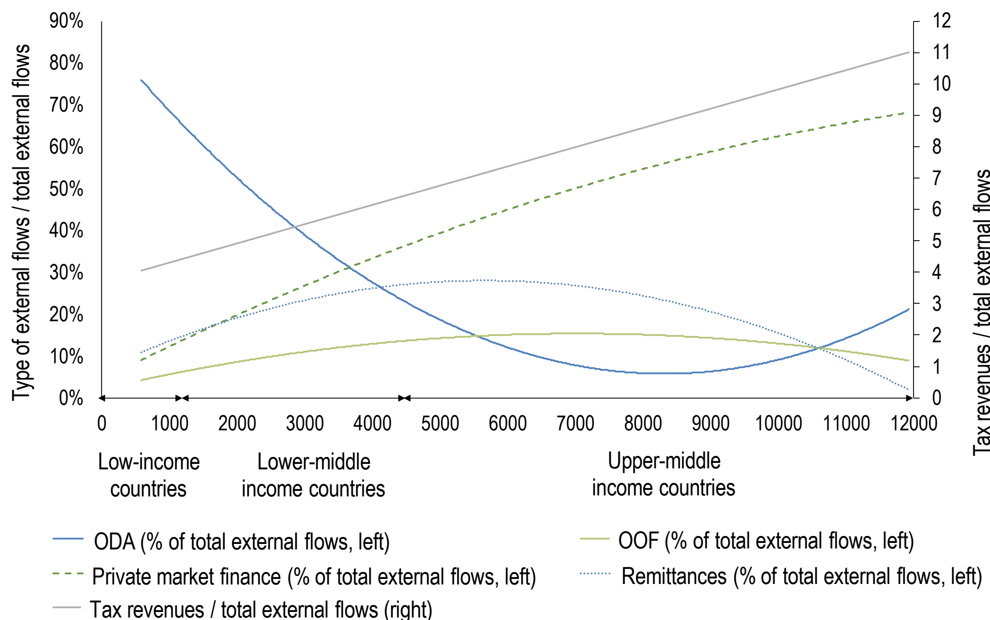
The structure of countries' taxation has generally shifted over time but is generally driven by per capita income levels. During the period from the 1980s to the 2000s, developing countries tended to have a high reliance on indirect taxes such as VAT, which constituted between 70%-75% of total tax revenue, and without significant differences between low-income and middle-income countries. This contrasts with high-income countries, where the split between direct and indirect taxes is roughly 1:1. The difference is mainly driven by differences in the share of personal income taxes and social security contributions, which take up a much greater portion of revenue (35%-40%) in high-income countries than they do in low-income and middle-income countries (10%-11%) (Lemay-Boucher and McNabb, 2014[32]). This phenomenon may be explained partially by the challenges in collecting personal income taxes due to the size of the informal economy in developing countries (UNESCAP, 2017[33]).

Countries tend to shift from public to private financing as income rises

The composition of cross-border finance also changes along the development continuum. The weight of international public finance declines as national income status improves. Official flows, and concessional finance (ODA) in particular, are the dominant component of external resources for low-income countries and lower middle-income countries. They become less important for upper middle-income countries.[17] Low-income countries are highly dependent on official flows, especially ODA; concessional flows

constitute 50%-60% of total external flows to these countries. ODA and other official flows (OOF) become less relevant for upper middle-income countries, making up less than 10% of external finance (Figure 3.6).

Figure 3.6. The availability of financing resources at different income levels



Note: The resources include concessional flows (ODA), non-concessional flows (OOF), private flows (foreign direct investments, private securities, and claims from banks and other sources such as bonds, equity, etc.), and remittances.
Sources: OECD (2018[1]), "Creditor Reporting System" (database), https://stats.oecd.org/Index.aspx?DataSetCode=crs1 for official bilateral and multilateral flows; World Bank (2018[30]), "Migration and Remittances" (database) http://www.worldbank.org/en/topic/migrationremittancesdiasporaissues/brief/migration-remittances-data for remittances; IMF (2017[31]), "Balance of Payments" (database), http://www.imf.org/external/datamapper/datasets/BOP for FDI, portfolio investments and long-term and short-term debt.

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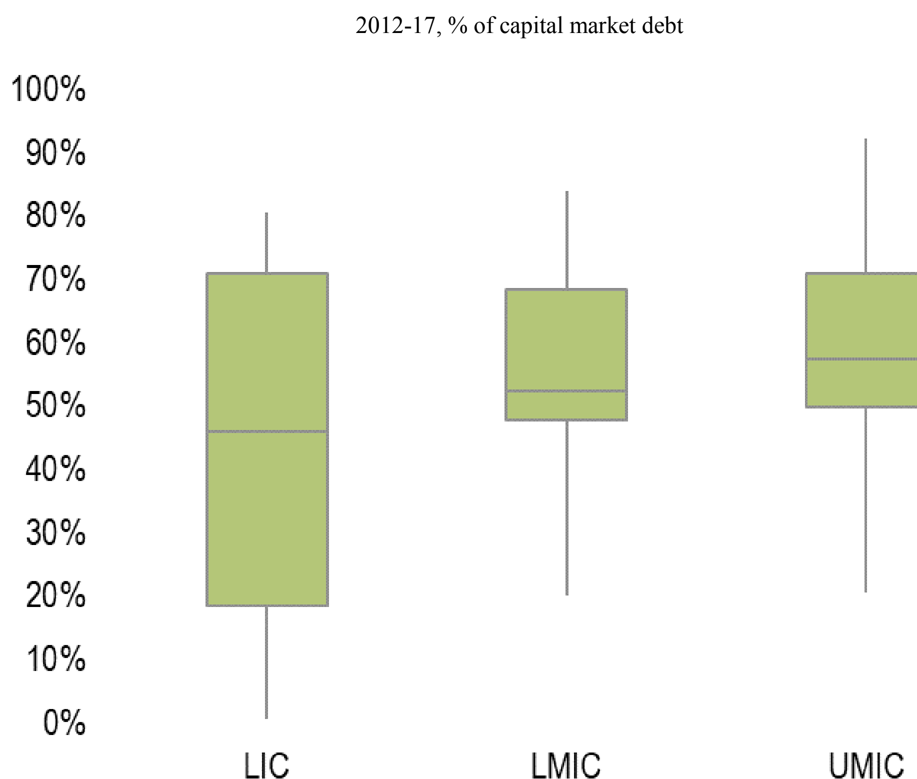
Private finance dramatically rises in importance at higher income levels as access to international capital markets offers a greater choice. Remittances are important for low-income countries, but their share in external financing is highest for LMICs and UMICs. While private flows represent around 30% of all external financing for low-income countries, they make up 70% of external finance for the richest of upper middle-income countries.

As countries develop and move towards more reliance on private finance, they also gain access to a larger set of capital sources and available instruments. For example, middle-income countries have easier access to international debt capital markets than do low-income countries. Between 2012 and 2017, only 4 out of 31 low-income countries had access to cross-border loans but no outstanding tradable debt, while 22 out of 51 lower middle-income countries and most upper middle-income countries (37 out of 50) raised debt in international markets during the same period.[18] While there is great variation in the share of tradable over total external debt, it appears that with higher income levels the portion of debt raised in international capital markets tends to rise (Figure 3.7).

Figure 3.7. Share of tradable debt securities in overall external debt

2012-17, % of capital market debt



Note: The share of capital market debt was estimated on the basis of the average outstanding international debt securities between 2012 and 2017, as compared to the share of outstanding cross-border loans from BIS-reporting banks in the same period.
Sources: Author's calculations based on Bank of International Settlements (2018[34]), "Debt securities statistics", https://www.bis.org/statistics/secstats.htm.

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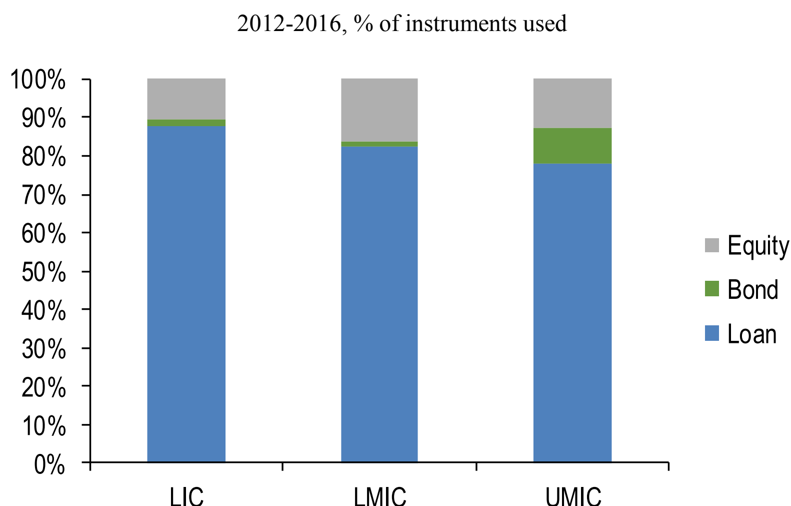
The financing mix of debt to equity finance also tends to vary according to income level. Typically, financing in low-income countries has a higher debt to equity ratio, which is due to the higher risks and makes fixed return investments more attractive than variable returns. This is evident in project finance, for example (Figure 3.8). Project finance can take the form of loans, bonds and equity. The loan component is proportionately highest for low-income countries (88%) and lowest for upper middle-income countries (78%). For upper middle-income countries, on the other hand, capital market bonds present a viable alternative to loans and equity investments and constitute close to 10% of overall investments.

Figure 3.8. Use of instruments in project finance transactions

2012-2016, % of instruments used



Note: Average values over the period between 2012 and 2016.
Source: OECD calculations based on data from Dealogic (2018[35]), https://www.dealogic.com/content/.

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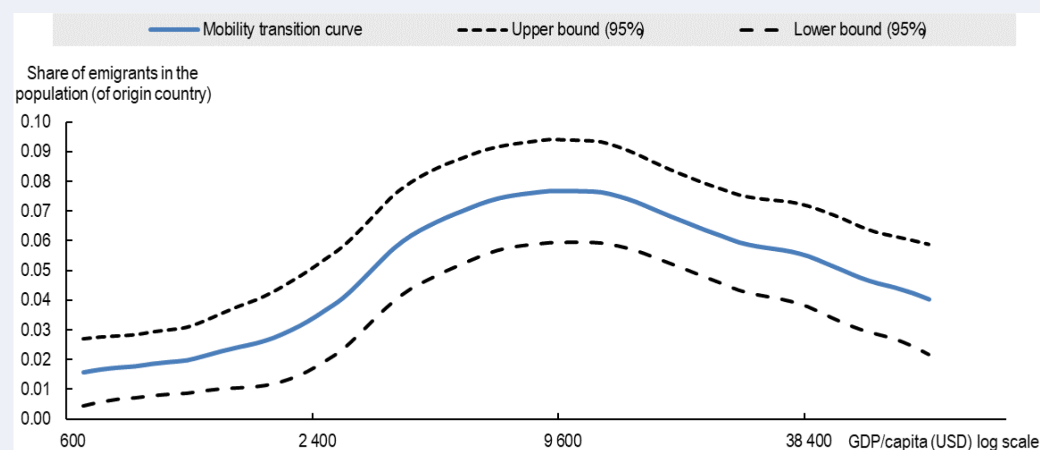
Economic growth also drives changes in migration that lead to changes in remittances (Box 3.9). At low national income levels, increasing incomes lead to more opportunities to migrate. At higher income levels, people may have access to greater domestic opportunities and so migrate at a lesser rate. This does not mean that remittances are not important for low-income countries, which rely overall on external financing to a much greater extent than do middle-income countries. Five of the top ten remittance-receiving countries in terms of percentage of GDP are low-income countries.

Box 3.9. Migration hump

The relationship between economic development and the emigration rate is called the mobility transition curve (Zelinsky, 1971[36]) or migration hump. When the GDP per capita increases in countries with low incomes, the emigration rate rises. Additional income can allow people to migrate who had aspired to do so but were constrained by a lack of financial resources. In countries with high levels of GDP per capita, financial constraints are less relevant and the aspiration to migrate diminishes as domestic opportunities increase.

Emigration first increases as income levels in a country rise, but it eventually decreases. The estimated turning point in 2010 was around USD 7 200 (in 2011 PPP). As Figure 3.9 illustrates, in the countries with per capita income above this threshold, an increase in the GDP per capita translates into lower emigration rates. On the other hand, the share of emigrants in the population is expected to increase in the countries with GDP per capita that is lower than this threshold. This suggests that economic development is likely to spur emigration from these countries (OECD, 2016[37]).

Figure 3.9. The share of emigrants in terms of percentage of population rises with GDP per capita, 2010



Source: OECD (2016[37]), *Perspectives on Global Development 2017: International Migration in a Shifting World,* http://dx.doi.org/10.1787/persp_glob_dev-2017-en.

StatLink https://doi.org/10.1787/888933853053

This is reflected in the inverse U-shape of remittance flows in Figure 3.6. Remittances first tend to rise as countries transition from low income to lower middle income. As is the case with the emigration rate, the trend is reversed as the per capita income growth level passes from the lower to the upper middle-income level.

Remittances also are significant in some middle-income countries and can constitute the largest proportion of external flows, or close to 20% on average. An income level of around USD 6 000 to USD 7 000 per capita, on average, is the turning point at which remittances reach a peak in terms of the share in total external finance. Another reason is that at this stage of a country's progression on the development continuum, concessional financing decreases and private sector investments are increasing at a lower rate.

The case for holistic approaches: accommodating and supporting transition

As discussed above, the availability of different sources of finance evolve with growing levels of income, with implications on financing for sustainable development. This is further illustrated by the essay "Transitioning to middle-income status: Implications for financing development".

The actual financing mix might not reflect the changing needs of a country. Currently, a lack of understanding on the evolving needs of countries limits the ability to adapt development finance to take account of these needs and shifting financing patterns as countries transition. Part of the future work is to identify any potential gap between availability of financing and the needs.

Moreover, if the phase-out of concessional finance is not well co-ordinated with the increase in other sources, countries may struggle to address core development needs to continue their progress. However, existing processes overseeing graduation from concessional finance do not sufficiently address the challenges related to the changes in the financing mix.

Box 3.10. In My View: Transitioning to middle-income status: Implications for financing development, by Annalisa Prizzon, Senior Research Fellow, ODI

Over the past 15 years, 35 poor countries have joined the ranks of the world's middle-income countries, a reflection of the strong and sustained economic growth achieved in most parts of the developing world. An improved income status is likely to affect every aspect of a country's development finance and notably the volume, terms and conditions of external finance as well as the type of projects supported (Prizzon and Rogerson, 2017[38]). Some examples of these likely impacts include:

- Falling volumes. A country might find itself stuck in the missing middle of development finance until it is well into middle-income status (Kharas, Prizzon and Rogerson, 2014[29]). This is because middle-income countries are likely to see a reduction in funding from bilateral donors, especially grant financing, as they grow. Additionally, when countries start to emerge from very low income, their growth often is constrained as domestic revenue mobilisation fails to expand fast enough to compensate for the fall in external assistance. This trend is particularly acute for lower middle-income countries.
- Changing terms and conditions of external finance. Middle-income countries are usually in a better position than low-income countries to borrow from capital markets and to service loan repayments. Grants tend to be prioritised in countries that do not have alternative financing options or cannot afford external borrowing. Multilateral development banks impose harder terms and conditions on sovereign loans once a country meets the criteria to graduate from the concessional windows.
- Shifting sectoral composition of external finance. The shift from grants to so-called soft loans and then hard loans also can alter the way in which aid is allocated among sectors. Economic infrastructure projects (e.g. toll roads and utilities) tend to attract funding that is less concessional, given their potential returns and/or ability to generate cash flows. Conversely, the social sectors (e.g. education and health) tend to be supported either by public taxation or grants rather than loans from donor governments. There is mixed evidence on this point, though. For example, in the case of Indonesia, the share of external assistance to the education sector expanded during the transition back to non-concessional finance (Prizzon and Rogerson, 2017[38]). Some countries are also willing to borrow to support projects in the education sector (Rogerson and d'Orey, 2016[39]).

Most low-income countries aim to become middle-income countries and have strategies in place to reach this goal. Partner country governments and providers of development finance should therefore understand, plan for and address the likely changes to financing volumes, conditions and allocation such transitions entail. This can include developing financing and debt management strategies that reflect the future composition of countries' external resources. They should continue strengthening their tax policies and revenue collection.

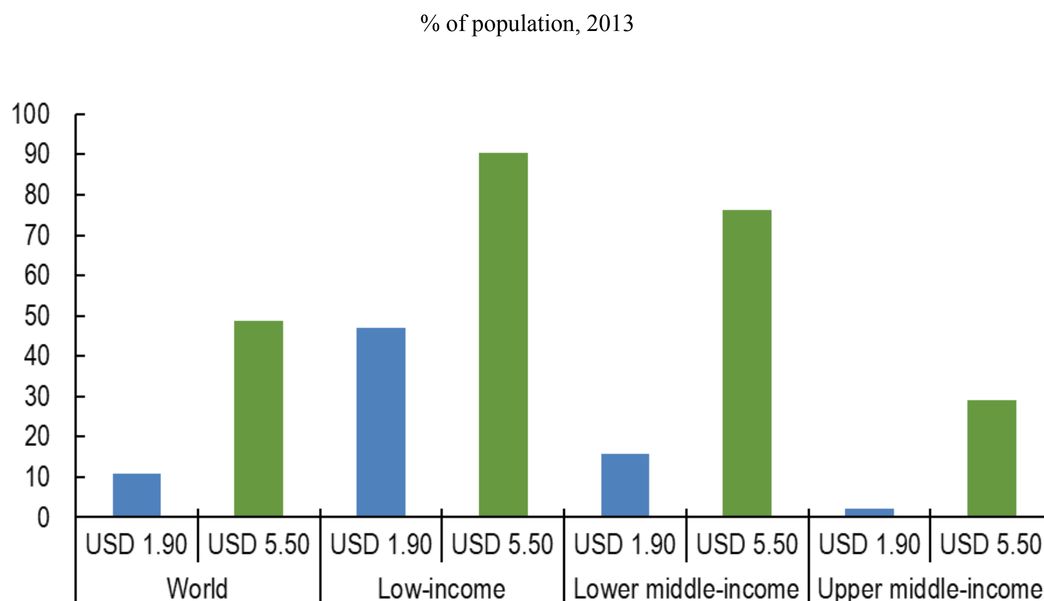
Multilateral development banks should consider smoothing their graduation policies and boosting resources for lower middle-income countries to address the missing middle of development finance. Bilateral donors should also review their approaches to transition and exit strategies; plan and communicate these strategies in advance to governments; and co-ordinate with other development partners.

One of the main reasons that fluctuations in income levels have an impact on the financing mix is that at higher income levels, countries gain and lose access to financing sources and specific instruments. This can be seen in terms of the availability of concessional finance, for instance, because it is partially determined by the national income level. Eligibility for ODA is based on a country's per capita income level,[19] and the process of International Development Association (IDA) graduation is triggered when a country exceeds a certain per capita income level.[20] As this happens, countries also lose preferential market access such as lower tariffs or duty-free and quota-free access to third country markets. Graduating from least developed country status depends on a combination of factors including per capita income, but once a country does make that transition, it is no longer eligible for special and differential treatment regarding World Trade Organization obligations.

At the same time, rising levels of national income can mask large and persistent development challenges. For many countries, economic growth has not been inclusive. Large pockets of the population can remain in extreme poverty, as evidenced by recent findings that, for the first time, a large share of the world's poorest are living in lower and upper middle-income countries. A significant share of the population in middle-income countries lives below the poverty threshold of USD 5.5 per day (Figure 3.10). In addition, almost half of all middle-income countries have high levels of inequality. Key social outcomes and indicators for health literacy and the quality of the urban environment show that many middle-income countries face the same or more severe challenges as low-income countries. In one-fourth of middle-income countries, more than half of the urban population live in conditions qualified as slums by the United Nations. Indeed, 16 lower middle-income countries and 2 upper middle-income countries are still classified as least developed countries.

Figure 3.10. Poverty headcount ratio (2011 PPP) is still high in middle-income countries

% of population, 2013



Source: World Bank (2018[40]), "Poverty and equity database", http://databank.worldbank.org/data/reports.aspx?source=poverty-and-equity-database.

After reaching higher levels of national per capita income, several countries have fallen back to lower income categories and many lower and upper middle-income countries remain trapped, unable to make a transition to high-income status. Since the 1960s, only 13 middle-income countries, among them Korea, have been able to move to high-income status (World Bank, 2013[41]). The Philippines, among others, has not been able to make that transition. Since the founding of the IDA, 44 countries have graduated and 9 of these graduates have since re-entered ("reverse graduated") IDA eligibility (World Bank, 2018[42]).

Higher national income levels also do not automatically translate into access to more private external financing sources. Empirical evidence suggests that domestic enablers such as political stability, fiscal discipline, and the quality of governance and institutions determine not only whether these countries can access international debt markets but also at what cost (Presbitero et al., 2016[43]) (Gelos, Sahay and Sandleris, 2011[44]). FDI in-flows, for example, are not equally distributed among countries with a similar level of national income. FDI is concentrated in a handful of countries, among them the People's Republic of China, Indonesia and Colombia; variables apart from income such as trade openness, infrastructure availability and business environment also weigh heavily in determining access to foreign investment flows (Tampakoudis et al., 2017[45]), (Ranjan and Agrawal, 2011[46]).

To address the financing challenges, different enablers should be prioritised as countries grow. For example, the efficiency of the domestic financial system is importantly related to the growth rate in low-income countries. However, the level of financial system development matters less as countries move up the income scale. As they advance, other variables negatively affect growth including the occurrence of banking or currency crises, the extent of capital inflows excluding FDI, and government debt as a share of GDP (Eichengreen, Park and Shin, 2017[47]).

Given these considerations, the phase-out of concessional finance has to be carefully managed in co-ordination with the increase in other sources. If international assistance tapers faster than improvements in domestic resource mobilisation and an increase in private external financing, countries may struggle to address core development needs to continue their progress. Moreover, a sudden increase in external financing through debt accumulation can affect a country's creditworthiness and lead to financial crises, impeding its growth prospects. Currently, different processes overseeing graduation from concessional finance do not sufficiently address the challenges related to the changes in the financing mix.

Innovative approaches such as blended finance and social impact investment need to address these opportunities and risks; the use of concessional finance in countries preparing to graduate from ODA/IDA eligibility can focus on mobilising and catalysing other sources of external financing that are sustainable and conducive to development in the long term.

Development finance also needs to more carefully work with countries to prepare for these transitions in a holistic way, including through mobilising and catalysing other forms of finance and investing in enablers and support for enabling domestic policies. Box 3.11 and Part II discuss this further.

Box 3.11. Holistic approach in action - The OECD DAC work on transition finance

The holistic approach seeks to leverage the dynamic effects of financing and policy (Chapter 5) to strengthen the FSD system for self-sustaining finance over the long term. The OECD DAC has started to look at the issue of transition finance through the lens of the holistic approach by unpacking the implications of graduation processes. It is also starting to explore how the international community collectively can better support countries as they transition through the development continuum. Concretely, the questions under discussion include the following:

- How can DAC members continue to support countries beyond ODA and through new strategic partnerships and innovative forms of co-operation?
- How can the DAC assist in a phasing-out of ODA; secure the progressive growth of other sources of financing (e.g. private or domestic); and secure long-term, sustainable financing (e.g. by preserving debt sustainability) for transitioning countries?
- How can the DAC increase the effectiveness of ODA by identifying the best and most innovative tools, policies and partnerships available along the development continuum to best serve the financial needs of transitioning countries?
- How should ODA be used to prepare transitions and avoid economic setbacks, given that what matters from a DAC perspective is to ensure long-term sustainability of financing for development as the country transitions?

Source: OECD-DAC (2018[48]), "Transition finance: Update on ongoing discussions and work", https://one.oecd.org/document/DCD/DAC/STAT(2018)9/FINAL/en/pdf

Interlinkages among sustainable development finance resources complicate the financing choice

Expanding the financing for sustainable development system (Chapter 2) means acknowledging that different actors and resources interact with each other, creating synergies and trade-offs for sustainable development. The AAAA makes it a key challenge to understand and fully exploit these interlinkages among different resources.

Yet the impacts that different resources and policies have on each other remain largely underexplored. How can one type of flow help unlock another? How can crowding-in and crowding-out effects among ODA, tax, remittances, philanthropic flows, commercial investment, and domestic public and private resources be harnessed? What do these interactions mean in terms of policy interlinkages?

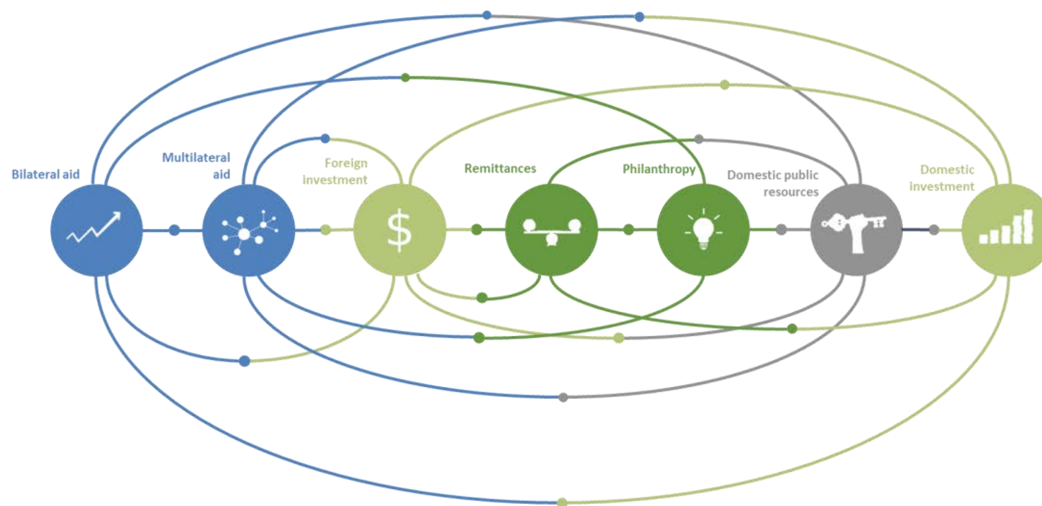
While not exhaustive, this section presents some illustrative examples of possible interlinkages and focuses on the largest external resources by volume: foreign investment and trade, domestic investment, and domestic public resources; and remittances, foreign investment and domestic resources.

Looking forward, different policy communities in various areas such as investment, tax, migration, etc. need to be brought more closely together to deepen the collective understanding of such interlinkages and to translate this understanding into policy action

to collaboratively achieve sustainable development. Part II highlights some of the work that is already underway.

FSD resources can crowd each other in or out

Figure 3.11. Interlinkages among financing sustainable development resources



Source: Authors

Foreign investment can crowd in but also crowd out domestic private investment

Access to international private capital can be a lever for mobilising more resources for sustainable development. For example, foreign direct investment can be a critical part of scaling up domestic private investment. By entering domestic markets, multinational enterprises (MNEs) can enhance competition, resulting in higher productivity levels of domestic firms. By fostering business partnerships with domestic firms, they can bring technology and productivity spill-overs and attract more investments into the intermediate inputs required. Hence, FDI may crowd in domestic private investment. FDI can also promote the development of the domestic private sector by spreading best practices in corporate governance, accounting rules and legal traditions and by providing employee training. Finally, by bringing in external capital resources, FDI can increase local liquidity and loosen financial constraints for domestic investment (Harrison, Love and McMillan, 2004[49]).

FDI may also crowd out domestic investment by displacing domestic players or pre-empting their investment opportunities. For example, competitive pressures due to the entry of MNEs may be so great that domestic players abandon investment projects, reduce production capacities or are altogether driven out of the market (Agosin and Machado, 2005[50]). Moreover, foreign-owned companies may compete for scarce capital resources with domestic players. Since foreign-owned affiliates tend to have higher solvency rates due to the financial guarantees provided by the parent MNE, they could also be favoured by local financial institutions, harming domestic private investment.

The relationship seems to depend on country contexts and sectoral patterns. The relationship between foreign and domestic investment is likely to be complementary when foreign investment takes place in an undeveloped sector of the economy and brings new technologies and knowledge to local markets. Conversely, FDI is more likely to

displace domestic investment when it occurs in sectors where domestic firms already operate (Agosin and Machado, 2005[50]). Foreign affiliates engaged in local production activities also are more likely to spur domestic capital accumulation than are foreign affiliates performing different trade-related activities such as sales, marketing and client support (Amighini, McMillan and Sanfilippo, 2017[51]).

Domestic private investment and local capacities, notably financial sector development, play critical roles – not just in attracting external investment but also in allowing countries to make the most of external finance. Foreign investment tends to be strongly attracted to countries with high levels of domestic investment that can signal to MNEs the profitability of investments (Lautier and Moreaub, 2012[52]) (Ndikumana and Verick, 2008[53]). Local financial sector development in a country also is a key element to ensure that external financing is allocated in a way that is efficient and conducive to sustainable development. Some research has shown that sectors that are more dependent on external financing grow faster in countries that themselves have greater financial development (Rajan and Zingales, 1998[54]).

Based on this preliminary sketch of the complex relationship between foreign and domestic investment, sustainable development financing strategies should be designed in a way to unleash the crowding-in potential of foreign investment. For example, FDI should be promoted in sectors that are underdeveloped and/or in sectors through which linkages to upstream and downstream sectors will bring most benefits for local private sector development. This is discussed further in Chapter 6.

Foreign investment and trade are highly complementary but not in all sectors

The emergence of global value chains or distribution networks spanning the globe has resulted in an increasing complementarity between foreign direct investment and trade. Firms in developing countries have gained access to the global market through participation in global value chains (GVCs), often specialising in specific stages of production and thereby exploiting their comparative advantage without having to develop all of the capabilities needed for the entire production process (IMF, 2013[55]) As a result, they have become attractive investment destinations for MNEs. Notably, countries in East and Southeast Asia have benefited from FDI linked to their growing participation in global value chains. From 2001 to 2016, Asia's share of global FDI increased to 28% from 12% (Asian Development Bank, 2017[56]).

However, this complementary relationship does not extend across all industries equally. Nor are benefits in terms of global value chain-linked FDI evenly distributed. A significant number of global value chains are associated with little or no foreign direct investment. This is particularly the case in so-called buyer-driven chains, notably in labour-intensive consumer goods sectors such as the apparel and textile industries where global buyers create a supply base of contractors without direct ownership. These can be distinguished from producer-driven supply chains, which are present mainly in capital-intensive and skilled labour-intensive industries, such as automobiles and the IT industry, where the production process tends to be vertically integrated under one corporate entity. Developing countries initially start participating in buyer-driven networks. Some countries enter into producer-driven networks, where the link between trade and FDI is much stronger.

Both the benefits from trade and the benefits from FDI linked to trade vary depending on the position of a country within a global value chain. Countries upstream produce the raw materials or intangibles involved at the beginning of the production process (e.g., research

and/or design), while countries downstream do the assembly of processed products or specialise in customer services. Usually, more downstream specialisation is associated with lower value added, while a higher share is reaped in the initial stage of the production process. This effect is larger in high-tech manufacturing such as electrical equipment and chemicals, where upstream specialisation typically involves research and development activities. However, when upstream activities are confined to the export of primary inputs or basic manufacturing products, the share of benefits from participation in global value chains and structural transformation resulting from it tends to be low.

Recent research also suggests that the participation and position in global value chains determine the size of potential spill-over effects of FDI on the domestic private sector. In countries and sectors heavily involved in global value chains, foreign investors are more likely to source their inputs locally. Moreover, upstream specialisation in phases of the production process that are far from the final demand leads to higher shares of local sourcing from foreign investors (Amendolagine et al., 2017[57]).

Taking into account the impact of trade on FDI and access to foreign resources, promotion of global value chain participation is an important component of sustainable development financing strategies. Especially for countries with an upstream participation, domestic policies to foster local inputs sectors can complement participation in global value chains. Official providers, for example, can also provide targeted support for these sectors through capacity building and/or facilitation of access to credit.

Foreign investment can be conducive to domestic public resource mobilisation

External private investment can increase tax revenues in developing countries by creating and taxing more jobs, profits and consumption. The degree to which FDI may affect the tax base depends on how labour intensive it is (Becker, Fuest and Riedel, 2012[58]) and how effective corporate taxation is. Taxation of MNEs in particular can be challenging to implement, as these enterprises can reduce tax burdens artificially, for example through excessive interest payments back to the parent company. The OECD/G20 BEPS Actions provide a range of tools to help address these challenges. Examples include requiring companies to file country by country reports to help tax authorities undertake better risk analysis and identify potential profit shifting, and new limits on interest deductibility to reduce the payment of excessive interests to affiliated entities offshore that leave the MNE with lower profits to pay taxes on.

Developing countries frequently use tax incentives to attract investment without paying enough attention to whether a proportional increase in investment flows will result (Chapter 5). Over 80% of low-income and lower middle-income countries offer tax holidays and tax exemptions on investment while redundancy rates are high. This can lead to a detrimental race to the bottom. Tax incentives are rarely an important factor in investment and location decisions. Indeed, a UN survey found they were ranked as only the 11th of 12 most important factors in such decisions for investors in Africa (UNIDO, 2011[59]).

More than tax incentives, local capacities and enabling environments greatly influence external private investment decisions. The quality of regulatory and legal capacities in developing countries is often cited as an important factor that encourages external investment flows. This recognises that the investment policy principles of transparency, property protection and non-discrimination underpin efforts to create a sound investment environment for all and underscores the importance of enforcing investment-related and other laws. While many countries have laws and regulations to protect intellectual

property rights, they often lack effective enforcement mechanisms and this lack can discourage foreign direct investment in innovation and technology transfer (OECD, 2014[60]).

Due to the complementarities between tax and foreign investment, then, investment policies may lead to greater availability of overall financing for sustainable development resources if they are based on measures other than tax incentives to encourage foreign investment.

The size and impact of remittances depend on external flows and domestic drivers of financing for sustainable development

Remittances, too, can leverage other external financing flows. Large volumes of remittances sent by diaspora communities appear to encourage other types of capital flows such as foreign investment (Shafqat et al., 2017[61]). Migrants can be important sources of information about their home countries for potential investors. They may also create or integrate into international business and financial networks, thereby enhancing financial transactions between their home and host countries (Kugler, Levintal and Rapoport, 2013[62]).

Remittances also interact with domestic resources. The impact of remittances on domestic investment depends on the level of financial sector development. Remittances can boost domestic investment through an induced rise in savings and easing of financial constraints (Javaid, 2017[63]) (Sabra, 2016[64]). Like FDI, remittances can be considered a substitute for credit opportunities in the presence of market failures and low financial market development (Dzansi, 2013[65]). In this process, remittances can promote financial sector development by increasing the aggregate levels of savings and credits intermediated by the local banking sector. The inverse is also true: lower barriers to bank depositing, for example, facilitates the channelling of remittance flows into formal, loanable funds and increases participation in the formal banking sector, thus stimulating domestic investment (Aggarwal and Martinez-Peria, 2006[66]) (Gupta, Pattillo and Wagh, 2007[67]) (Gheeraert, Mata and Traca, 2010[68]). Policy makers and development partners can harness the potential of remittances to enhance other financing for sustainable development resources by supporting the development of the domestic financial sector – especially by facilitating access to finance for recipient households. Box 3.12 "The impact of remittances on international debt financing" describes how innovative financing mechanisms can be used to leverage interlinkages between remittances and foreign investment.

Box 3.12. In My View: The impact of remittances on international debt financing, by Dilip Ratha, Head, Global Knowledge Partnership on Migration and Development

Remittances can reduce the interest rate on international borrowing

In countries such as Lebanon and the Philippines where remittances provide the largest source of foreign currency earnings, remittances can improve the sovereign rating of the country, which in turn would reduce interest rates on all cross-border borrowings. A more direct path to reduce borrowing costs, especially in times of financial crisis, is to use future flows of remittances as collateral for international bond placements. A well known example is Banco do Brasil's issuance in 2002 of USD 250 million worth of bonds that were backed by remittances from Brazilian migrants in Japan and carried a significantly lower interest rate (9-11%) than sovereign interest rates (over 18%) at the time (Ketkar and Ratha, 2010[69]). Several emerging economies have raised tens of billions of dollars by issuing future-flow, remittance-backed bonds, among them El Salvador, Egypt, Mexico and Turkey.

Remittance channels can be used to sell diaspora bonds

Even as migrants send money home, they also save money in banks and financial institutions in the country of residence. Some studies estimate that the savings of migrants from developing countries exceeds USD 500 billion annually (Mohapatra and Ratha, 2010[70]). Since the interest rate on bank deposits is negligible in many OECD countries, a diaspora bond issued by the country of origin, offering an interest rate of 4% or 5%, say, can attract purchases by diaspora members. It is in the realm of possibilities to raise as much as USD 50 billion, only one-tenth of the total diaspora savings, through diaspora bonds.

Israel has been issuing diaspora bonds since 1951, raising over USD 40 billion over the years. Historically and until the early 1990s, the interest rate on Israel bonds was around 4% even as United States Federal Reserve interest rates rose to double-digit levels in the 1980s. Thus, these diaspora bonds enabled Israel to benefit from a significant "patriotic discount" (Ketkar and Ratha, 2010[69]). India, too, successfully raised USD 9 billion in two separate bonds issued in 1998 and 2000, at a time of financial crisis globally and when it was facing sanctions from the international community. More recently, in June 2017, Nigeria raised USD 330 million by issuing a diaspora bond that carried the same interest rate as the plain sovereign Eurobond.

These types of bonds generally appeal to a wider investor base beyond traditional institutional investors. Diaspora members are more willing than institutional investors to buy a diaspora bond at a lower interest rate because their base comparison rate is the bank deposit rate rather than LIBOR (a discount of over 2.5%). In addition, their perception of the home country's sovereign risk can be more favourable than that of a professional institutional investor.

Before launching a diaspora bond, a country needs to survey its diaspora members in the countries of destination to understand their willingness and abilities to invest back home. Also, it must register the bond with the appropriate securities and exchange authorities (e.g., the Securities and Exchange Commission in the United States) to comply with regulations meant for investor protection. Finally, the bond proceeds must be used for a programme or project that yields sufficient return on time to avoid debt repayment difficulties.

Development finance and policy should be a catalyser

Given these complex interactions, an integrated approach can yield greater results and help to manage potential trade-offs between sources of finance and their related policies. Chapter 5 discusses this in greater depth by explaining the holistic approach to financing for sustainable development. An integrated or holistic approach, however, is extremely challenging to achieve. The relevant decision makers span public and private sectors in a variety of countries. Within the public sector, even when areas of common action can be identified, policy communities still operate in silos and cross-cutting dialogue and collaboration require great political will.

Within this landscape, official development finance and development policy occupy a special position and should play the role of a catalyser. These constitute the one form of (external) finance and policy with an explicit development mandate. For those countries most in need, official development finance remains a lynchpin form of finance. For emerging economies, official development finance and policy can have an important role in catalysing other forms of finance as a mechanism through which OECD member governments can directly and indirectly impact overall FSD. Part II of this report explores this role further.

Development finance is scarce and needs to be deployed strategically to target areas where it has the greatest direct and indirect catalytic effect. The direct catalytic effects of development finance are currently most visible in relation to private sector flows through mobilisation. Mobilisation refers to the use of development finance to address the risk and uncertainty associated with investment opportunities that have a development impact and thereby make them more appealing to other actors.

Development finance can also have indirect effects that promote development enablers, which are domestic capacities in developing countries to achieve finance for sustainable development. These indirect effects can amplify volumes of financing for sustainable development (*quantitative effect*) but they can also improve the development footprint of different sources of financing (*qualitative effect*).

For example, development finance can have a quantitative effect if it provides targeted support to create a sound policy and regulatory framework and a competitive market to attract investment. Thus aid for productive and public infrastructure and for human capital development can have a significant crowding-in impact on foreign investment (Selaya and Sunesen, 2012[71]), (Kapfer, Nielsen and Nielson, 2007[72]); aid in support of good institutions and the banking sector can also have this impact (Karakaplan, Neyapti and Sayek, 2005[73]).

Another channel through which development finance can target enablers to mobilise more volumes of financing is support for tax collection (Box 3.13). The Addis Tax Initiative is a significant recent development in this regard. Donor country signatories commit to collectively double their spending on tax capacity development between 2015 and 2020 and to improve policy coherence for development in tax matters. The Platform for Collaboration on Tax conducted a comprehensive review, finding that political will and country commitment are indispensable prerequisites for revenue collection reform. The Platform identified five key enablers to building tax capacity (IMF-OECD-United Nations-World Bank Group, 2016[74]). These are

- A coherent revenue strategy as part of a development financing plan
- Strong co-ordination among well-informed and results-oriented providers
- A strong knowledge and evidence base
- Strong regional co-operation and support
- Strengthened participation of developing countries in international rule setting

Box 3.13. Development finance in support of domestic resource mobilisation

Development co-operation can help developing countries to strengthen their capacity to generate tax revenues. Since 2015, a dedicated purpose code in ODA reporting[21] has enabled the tracking of ODA commitments to domestic revenue mobilisation. With only two years of data to assess, it is difficult to draw clear conclusions. But some initial findings are worth noting:

- Most financing comes from a few countries. This was clear in 2015, when just three countries provided 61% of the financing, and in 2016, when the top three donors provided 72% of the total.
- Financing also goes to a limited number of recipients. In 2015, 56% of all financing went to only ten recipients; their share rose to 79% in 2016. In 2015, 47% of ODA (USD 85 million) to domestic resource mobilisation was well-targeted to least developed countries. However, the picture changed significantly in 2016, with only 17% (USD 56 million) targeted to these countries.
- The support appears to remain targeted to countries with low levels of taxation measured as tax to GDP ratios below 15%, with 50% of financing going to such countries in 2015 and 57% going to them in 2016.

The potential for returns from ODA to domestic resource mobilisation is likely to be greatest in middle-income countries as they transition, given their larger economies. However, this does not mean that countries of lower national income should not receive support. Tax system reform can play a role in improving the growth environment of a country directly. Additionally, enabling the tax system to adequately capture a share of the proceeds of growth earlier in the development pathway will ultimately lead to significantly higher volumes of funds available for development over the longer term (Box 3.14).

Box 3.14. Removing ODA tax exemptions can amplify the catalytic effect of development finance

The tax status of ODA-provided goods and services is one area where official providers may wish to start using development finance as catalysers for more domestic revenues. In many countries, official providers have requested tax exemptions on goods and services, which can have potentially significant impact on domestic revenue mobilisation, especially for low-income countries where ODA often represents a higher share of the economy. Some countries, among them Netherlands and Norway, have changed their policy and no longer seek such tax exemptions on ODA-funded goods and services. But this is not yet common practice. The Platform for Collaboration on Tax is planning to review the draft guidelines from 2007 to assist countries in reviewing their policies in this area (Chapter 5).

Support for enablers also can have a catalytic effect on the quality and development footprint of other forms of finance. For example, development finance can support policy makers in developing countries to harness investment inflows in order to generate

maximum development benefits through employment, technology transfer, competitiveness, and growth of domestic enterprises and industries in host countries.

Such enabling policies are important to ensure that private sector investments, both international and domestic, are done in a socially and environmentally responsible way. This is a main finding of OECD investment policy reviews that have analysed the experience of developing countries over the past few decades. Similarly, support for development enablers matters for the development impact of remittances, as discussed elsewhere in this chapter. The level of financial development and the institutional environment influence the impact of remittances on domestic investment. High-quality institutional frameworks and well-developed credit markets are seen as enabling environments to increase investment, rather than consumption through remittances. (Bjuggren, Dzansi and Shukur, 2010[75]).

These catalytic effects are only beginning to be understood and they can be highly specific to country contexts. More research and monitoring are needed on these interactions to inform policy choices for developing country governments and for official providers who can provide targeted support for policy areas with the greatest catalytic effect.

Conclusion: New opportunities and risks require new approaches to measurement, policy and implementation

The diversity of actors and their resources offers new opportunities for financing for sustainable development. It also signifies greater complexity. For now, developing countries and the international community do not possess all the capacities required to navigate the complex and increasingly broad range of options. For example, the choice of FSD instruments often cannot be based on a careful evaluation of costs and benefits, but may rather be based on factors such as familiarity and fashion.

The complexity arising from the widening range of instruments, the development continuum and its transitions, and interlinkages among actors and resources highlights the key challenges of the financing sustainable development system. This system is characterised by asymmetric information and lack of transparency as well as the absence of policy guidance and clear mechanisms for implementation. The examples below give an indication of the challenges and opportunities that are emerging:

- The growing use of equity and mezzanine investments by donor agencies can bring higher returns – but with higher volatility – to their own balance sheets. This can hamper agencies' ability to provide stable and predictable funding to developing countries. Most development finance institutions making use of equity instruments obtained double-digit returns before the 2008 financial crisis, but then suffered major losses (Michelitsch et al., 2017[7]). In the absence of the necessary capacities to manage relevant risks, the use of innovative instruments can come at a considerable cost.
- With greater access to debt capital markets, developing countries face new risks from increasing debt levels. This is especially the case in their move away from traditional creditors such as multilateral organisations and official bilateral lenders and towards private sources of lending, a move which threatens to push up servicing costs and make debt resolution harder (IMF, 2018[5]).

- While they are promising, innovative instruments need to be scaled up significantly if they are to fulfil their potential to help to close the financing gap for sustainable development. Fear of risks still unknown and lack of familiarity with the new instruments are barriers that need to be overcome. For innovative financing for sustainable development to reach a critical mass, different groups of actors have to come together and work more closely to share experiences.
- The relative weight of financing flows changes along a country's development continuum. As each flow has different objectives and characteristics, the shift in the financing mix can give rise to gaps and disruptions. It is important to better understand and deploy catalytic effects upstream and to carefully devise exit strategies for development finance so that developing countries can achieve self-sustaining financing flows.
- Tight constraints on public funding are confronting policy makers with a difficult trade-off. Blended finance and innovative approaches to catalyse other financing sustainable development resources can be useful to ensure a smooth transition for countries faced with receding concessional flows. However, a focus on mobilisation should not be considered exclusive, as broader catalytic effects must be seen in terms of poverty eradication, social needs, policy reform, infrastructure and other enablers.
- More research and monitoring are needed on these interactions to inform policy choices for developing country governments and for official providers who can provide targeted support for policy areas with the greatest catalytic effect. For example, developing countries frequently use tax incentives to attract foreign investment without devoting enough attention to whether a proportional increase in investment flows will result.

Given the special place of development finance and policy, Part II of this report explores further how OECD countries and actors can make use of these catalytic effects, taking a more holistic approach to development finance measurement, policy and implementation. An important part of this approach is to embed development perspectives throughout the actors and policies affecting development. The interlinkages will be explored in the future throughout the OECD work programme.

Notes

[1] These include DAC providers, non-DAC bilateral providers who report to the DAC and multilateral providers.

[2] The share is calculated only for the sample of DAC providers.

[3] The share is calculated on the basis of data from OECD (2018[1]), "Creditor Reporting System" (database), https://stats.oecd.org/Index.aspx?DataSetCode=crs1.

[4] The reversal of debt flows also exerts strong downward pressure on the exchange rate. A subsequent depreciation or devaluation will raise the value of the debt service of any debts denominated in foreign currencies. Since almost no developing country borrower can issue debt in its own currency, the borrowing capacity of developing countries is limited. Reinhart, Rogoff and Savastano (2003[86]) discuss this at http://www.nber.org/papers/w9908.

[5] Loans can be concessional or non-concessional, according to the terms at which they are provided. By definition, the share of loans in concessional and non-concessional flows refers to concessional and non-concessional loans, respectively.

[6] The share of tradable securities in developing countries, calculated by dividing the amount of outstanding international debt securities by the sum of cross-border loans outstanding and international debt securities outstanding, has risen to 37% in 2017 from 29% in 2011. The estimates are based on Bank of International Settlement (BIS) statistics on international debt securities and cross-border loans by BIS reporting banks.

[7] FDI financial transactions comprise mainly three types of financing from the private sector: acquisition or disposal of equity capital; reinvestment of earnings that are not distributed as dividends; and inter-company debt (payables and receivables, loans, debt securities). According to IMF Coordinated Direct Investment Survey (http://www.imf.org/en/data) data, inward direct investment positions in developing countries amounted to USD 6.072 billion, of which equity holdings amounted to USD 4.994 billion (82%), at the end of 2016. It is impossible to infer directly from these stock data statements about equity investment flows, as variations in these stocks can result from changes in market valuations, currency rates, etc., rather than arise from the acquisition or disposal of equity.

[8] According to data from the IMF Coordinated Portfolio Investment Survey (http://www.imf.org/en/data), equity investments made up 55% the portfolio investment holdings in developing countries, amounting to USD 1.8 trillion at the end of 2016. It is impossible to infer directly from these stock data statements about equity investment flows, as variations in these stocks can result from changes in market valuations, currency rates etc., rather than arise from the acquisition or disposal of equity.

[9] The share of equity instruments in ODA and OOF flows from bilateral donors was 0.4% (USD 795 million) and 1.4% (USD 218 million), respectively. These figures may underestimate the true equity portion of the flows due to specificities of equity reporting standards under current ODA regulations. The purchase of equity is counted at face value as a positive ODA flow and at the time of disposal, proceeds from that equity constitute a negative ODA flow, which can lead to the underestimation of gross equity flows.

[10] In reported data, mezzanine finance instruments are often grouped into equity or debt categories.

[11] This is an estimate based on the OECD's Creditor Reporting System (OECD, 2018[1]). DAC data on the use of mezzanine finance are subject to under-reporting.

[12] Some private entities also extend guarantees that are not motivated by profit. One example is the Children's Investment Fund Foundation. See https://ciff.org/grant-portfolio/contraceptive-implant-volume-guarantee/.

[13] The non-guaranteed portions of the loan are included in counting the amounts mobilised through guarantees, the implicit assumption being that the private investor would not have provided the loan without the official guarantee.

[14] Greenfield projects occur when investors begin a new business by constructing new facilities as opposed to purchasing existing facilities.

[15] An upcoming OECD publication will examine the role of SII for the SDGs, including an analysis of regions, policies and data on social impact investment. The report will be published in January 2019.

[16] For bilateral ODA by sector to Côte d'Ivoire, 2015-16 average, see http://www.oecd.org/dac/financing-sustainable-development/development-finance-data/aid-at-a-glance.htm.

[17] The upward slope of the curve in Figure 3.6 is due to the quadratic fitting model and does not reflect a real trend.

[18] These data are based on Bank of International Settlement (BIS) statistics on international debt securities. See https://www.bis.org/statistics/secstats.htm.

[19] The list of ODA-eligible countries consists of all low-income and middle-income countries (based on gross national income per capita, as published by the World Bank) with the exception of Group of Eight (G8) members, European Union members and countries with a firm date for entry into the European Union. The list also includes all of the least developed countries as defined by the United Nations.

[20] Eligibility for International Development Association support depends first on a country's relative poverty, defined as GNI per capita below an established threshold that is updated annually and in fiscal year 2018/19 is USD 1 165. IDA also supports some countries, including several small island economies that are above the operational cut-off but lack the creditworthiness needed to borrow from the International Bank for Reconstruction and Development.

[21] In the OECD Creditor Reporting System, data on the sectoral destination of a development finance contribution are recorded using purpose codes.

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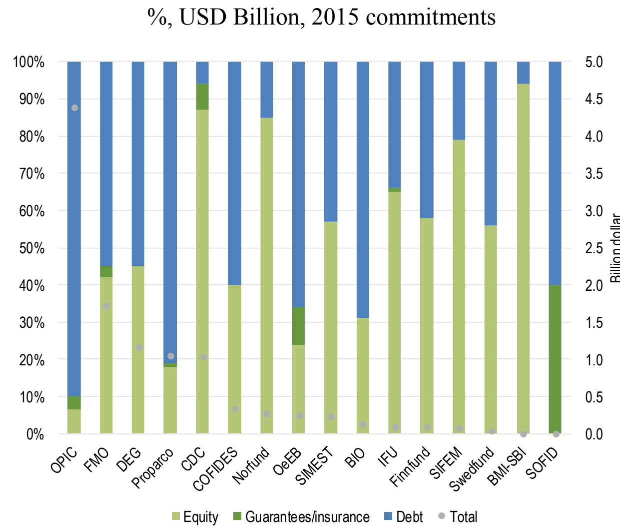
Annex 3.A.

Annex Figure 3.A.1. Instruments used by bilateral development finance institutions

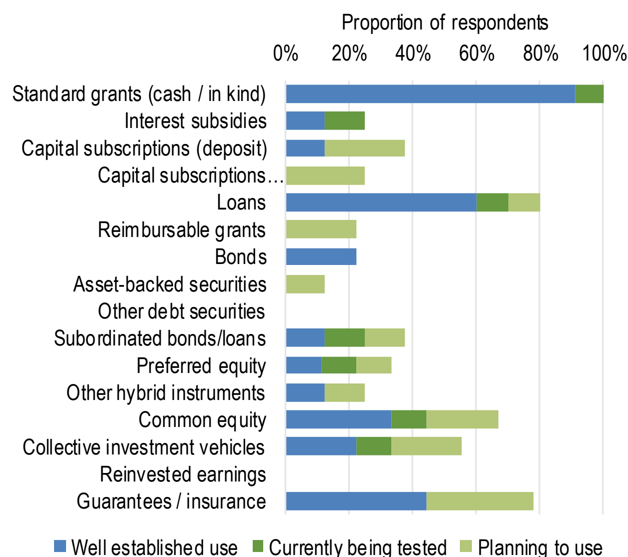
%, USD Billion, 2015 commitments



Source: OECD (2018[1]), "Creditor Reporting System" *(database)*, https://stats.oecd.org/index.aspx?DataSetCode=CRS1.

StatLink https://doi.org/10.1787/888933855276

Annex Figure 3.A.2. Planned and current use of sustainable development finance instruments by DAC members



Source: OECD (2018[28]), "Global Outlook Survey on Financing for Sustainable Development", http://www.oecd.org/development/financing-sustainable-development/development-finance-topics/global-outlook-on-financing-for-development.htm.

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