FINANCING FOR DEVELOPMENT POST -2015: IMPROVING THE CONTRIBUTION OF PRIVATE FINANCE

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Abstract

This overview of financing for developing countries finds that government spending is the largest domestic resource, domestic private investment is also growing, outflows of private financial resources are very large, real net financial private flows are overstated, and ODA is the largest flow to least developed countries. Global public finance cannot be directly substituted by private finance, as it pays for public goods, is more predictable and counter-cyclical, and can be targeted at the poorest countries. Global private finance mainly goes to higher income countries and has difficulty targeting MSMEs or paying for public services. Leveraging private finance has faced many problems including in proving additionality, intransparency and lack of ownership, and poor evidence of development impact. Instead, we should focus on how international public flows can reduce barriers to private sector investment through investing in essential services, and how the EU can alter policies including by reforming investment treaties, curbing illicit financial flows, supporting fair debt workout mechanisms and developing responsible financing standards.
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EXECUTIVE SUMMARY

While the post-2015 debate has taken shape in the last six months, financing discussions are a long way from being resolved. United Nations (UN) processes are yet to address financing goals and targets.

This paper provides a comprehensive overview of all financing sources, finding that:

- **Government spending is the largest domestic resource** in most developing countries, and is growing rapidly in many countries, but more than three billion people live in countries where government spending is extremely low – less than purchasing power parity (PPP) USD 1,000 per person each year.

- **Domestic private investment is also growing.** Public and private investment, taken together, have grown as a proportion of GDP, from 24.1 % in 2000 to 32.3 % in 2011.

- **Outflows of private financial resources are extremely large.** Most are not productive investments in other countries but repayments on loans (over USD 500 billion in 2011), repatriated profits on foreign direct investment (FDI) (USD 420 billion) or illicit financial flows (USD 620 billion).

- **Figures greatly overstate the real net financial private flows to developing countries.** FDI is the largest resource flow to developing countries, but outflows of profits made on FDI were equivalent to almost 90 % of new FDI in 2011. In addition, FDI includes the reinvestment of earnings from within the ‘destination’ country: not an inflow.

- **Official Development Assistance (ODA) is the largest flow to least developed countries** and those with the lowest levels of domestic resources. By contrast, 70 % of FDI in developing countries in 2011 went to just 10 countries, with China alone accounting for over a quarter of total FDI.

Through its 2013 Communication, the European Commission proposes a future financing framework for development that reinforces the linkages between public and private finance, and domestic and international resources. However, its promotion of the use of public resources to leverage private finance suggests a belief that the two are interchangeable.

This report finds that this assumption is not warranted, with global public finance filling a number of roles that cannot easily be substituted by private finance:

- It pays for an important share of essential public services, helps ensure universal access, and can provide and protect global public goods.

- It is also more flexible, predictable, counter-cyclical, and less volatile than private flows, and should play an important stabilising role during crises.

- It can be targeted at the poorest countries, where private investment flows are weak.

Policy makers seeking to maximise the role that external private finance can play in development must recognise three key limitations of private finance:
Financing for development post 2015: improving the contribution of private finance

- It predominantly flows towards higher income countries.

- It has proved very difficult to target it towards micro, small and medium enterprises (MSMEs), which provide the majority of employment and GDP in developing countries.

- Its for-profit nature means it cannot tackle several key issues, including much public service provision which is vital for private sector growth.

Given this, efforts to incentivise or subsidise increased private investment in developing countries by multilateral development banks, development finance institutions (DFIs) and others have faced a number of problems:

- Difficulties in designing programmes that work for MSMEs in low-income countries. This is why, for example, such programmes accounted for just 0.4% of the portfolio of the European Investment Bank.

- Little success in generating ‘additional’ private sector investment, with external evaluations showing that many publicly-backed investments replace or supplant pure private sector investments.

- Unproven performance in leveraging private investment in developing countries.

- Low developing country ownership over the institutions and programmes of DFIs.

- Significant problems in providing adequate transparency and accountability.

- Increasing debt risks, and very expensive financing, particularly through public-private partnerships, which have proved the most expensive source of finance for developing country governments.

Therefore, it would be more sensible for post-2015 discussions to focus on how international public flows can help reduce the barriers to private sector investment, through investing in essential services, such as health and education, and infrastructure. The issue of how public regulation, incentives and subsidies can be used to direct, increase and improve the impacts of private investment on poverty reduction and sustainable development would be better resolved at the national level, rather than by focussing on the limited role of development finance institutions, or promoting greater use of blending mechanisms to leverage private finance.

A far better contribution for the EU, and other developed economies, would be to alter policies and practices that can hinder domestic investment in developing countries, including by:

- Recognising that investment treaties have often made it difficult for developing countries to gain full benefits from FDI, and have reduced their space to protect their economies from destabilising exits of capital during difficult times. The development dimension of the EU’s policy on investment treaties must be strengthened.

- Taking action to curb illicit capital flows and reduce tax avoidance and evasion by European companies, for example, by introducing country by country reporting and public registries of beneficial owners.
• Supporting efforts to introduce fair and transparent debt workout mechanisms, conduct audits, and reduce the unsustainable debt burdens in many developing countries.

• Showing global leadership in the creation and adherence to responsible financing standards, including requiring fair terms and conditions, adequate social and environmental standards and accountability to affected peoples.

Both public and private finance have a vital role to play in post-2015 efforts to end global poverty. The EU can make the greatest contribution by recognising the different roles each can play, and by changing their own policies that can hinder developing countries’ efforts to increase, direct and improve development financing.
EXECUTIVE SUMMARY - FRENCH VERSION: SYNTHÈSE

Tandis que le débat pour l'après-2015 a pris forme les six derniers mois, les discussions sur le financement sont loin d'être terminées. Les processus des Nations unies doivent encore fixer les buts et objectifs liés au financement.

Le présent document fournit une synthèse complète de toutes les sources de financement et en arrive aux conclusions suivantes:

- **Les dépenses publiques constituent la source nationale principale** dans la plupart des pays en développement; elles sont en constante augmentation dans de nombreux pays, même si plus de trois milliards de personnes vivent dans des pays où les dépenses publiques sont extrêmement faibles - moins de 1 000 USD par personne et par an en parité de pouvoir d'achat (PPA).

- **Les investissements privés nationaux sont également en augmentation.** Les investissements publics et privés additionnés sont passés de 24,1 % du PIB en 2000 à 32,3 % en 2011.

- **Les sorties de ressources financières privées sont extrêmement importantes.** La majorité d'entre elles ne sont pas des investissements productifs dans d'autres pays mais des remboursements d'emprunts (plus de 500 milliards d'USD en 2011), des bénéfices rapatriés d'investissements étrangers directs (IED) (420 milliards d'USD) ou des flux financiers illicites (620 milliards d'USD).

- **Les chiffres surévaluent le véritable montant des flux financiers nets vers les pays en développement.** Les IED constituent le principal flux de ressources vers les pays en développement mais les sorties de bénéfices sur les IED étaient équivalentes à environ 90 % des nouveaux IED en 2011. En outre, les IED comprennent le réinvestissement des bénéfices depuis le pays de "destination", ce qui ne constitue pas une entrée.

- **L'aide publique au développement (APD) constitue la source principale pour les pays les moins développés** et pour ceux qui ont le niveau le plus faible de ressources nationales. Inversement, en 2011, 70 % des IED dans les pays en développement n'ont concerné que dix pays, et notamment la Chine, qui représentait plus d'un quart du total des IED.

Dans sa communication de 2013, la Commission européenne propose un futur cadre de financement du développement qui renforce les liens entre le financement public et le financement privé et entre les ressources nationales et internationales. Toutefois, la promotion de l'utilisation des ressources publiques afin qu'elles servent de levier au financement privé sous-entend l'assomption que ces deux éléments sont interchangeables.

Le présent rapport considère que cette hypothèse n'est pas justifiée, puisque le financement public global assume un certain nombre de tâches que le financement privé aurait des difficultés à accomplir:

- il finance une part importante des services publics essentiels, aide à garantir un accès universel, et peut fournir et protéger des biens publics mondiaux.

- il est également plus flexible, plus prévisible, plus anticyclique et moins instable que les flux privés, et doit jouer un rôle important de stabilisation lors de crises.
• il peut être destiné aux pays les plus pauvres, là où les flux d'investissement privé sont faibles.

Les décideurs politiques qui cherchent à maximiser le rôle que peuvent jouer les financements extérieurs privés pour le développement doivent tenir compte de trois limites principales du financement privé:

• il privilégie principalement les pays au revenu plus élevé.

• il s'est avéré très difficile de le diriger vers les micro, petites et moyennes entreprises (MPME), qui contribuent à la plus grande part de l'emploi et du PIB dans les pays en développement.

• en raison de sa nature tournée vers le bénéfice, il ne peut toucher à plusieurs questions fondamentales, notamment la prestation de services publics vitaux au développement du secteur privé.

Étant donné cette situation, les efforts d'incitation ou d'aide au renforcement de l'investissement privé dans les pays en développement par les banques multilatérales de développement, les institutions de financement du développement et d'autres ont fait face à une série de problèmes:

• des difficultés quant à la conception de programmes fonctionnels pour les MPME dans les pays à faible revenu. C'est la raison pour laquelle, par exemple, ces programmes n'ont représenté que 0,4 % du portefeuille de la Banque européenne d'investissement.

• une faible capacité à générer des investissements supplémentaires de la part du secteur privé, avec des évaluations externes qui montrent que nombre d'investissements soutenus par l'État remplacent ou supplantent des investissements purement privés.

• une capacité non démontrée à stimuler les investissements privés dans les pays en développement.

• une faible appropriation par le pays à l'égard des institutions et des programmes d'IED.

• des problèmes significatifs à fournir la transparence adéquate et la responsabilité requise.

• une augmentation des risques d'endettement et un financement très onéreux, notamment par l'intermédiaire de partenariats public-privé, qui se sont montrés les sources les plus onéreuses de financement pour les gouvernements des pays en développement.

Il serait donc plus opportun pour les discussions sur l'après-2015 de se concentrer sur la manière dont les flux publics internationaux pourraient permettre de réduire les obstacles à l'investissement du secteur privé, par l'intermédiaire d'investissements dans des services essentiels, comme la santé et l'éducation ainsi que l'infrastructure. Les questions de la réglementation, des incitations et des subventions publiques et de la manière dont celles-ci peuvent aider à diriger, augmenter et améliorer les effets de l'investissement privé sur la réduction de la pauvreté et sur le développement durable seraient mieux traitées au niveau national, plutôt qu'en se focalisant sur le rôle limité des institutions de financement du développement ou en faisant la promotion d'un recours accru aux mécanismes mixtes visant à stimuler le financement privé.
Il serait bien plus bénéfique à l'Union ainsi qu'aux autres économies développées de modifier des politiques et des pratiques qui peuvent entraver l'investissement national dans les pays en développement, et notamment:

- reconnaître que les traités d'investissement ont souvent empêché les pays en développement de bénéficier pleinement des IED et qu'ils ont diminué leur marge de manœuvre quant à la protection de leur économie face à des sorties de capitaux déstabilisantes en période de crise. L'aspect "développement" de la politique de l'Union dans les traités d'investissement doit être renforcé.

- mener les actions nécessaires pour réduire les mouvements illicites de capitaux et faire baisser l'optimisation et l'évasion fiscales des entreprises européennes, en élaborant, par exemple, pour chaque pays, des rapports et des registres publics concernant les bénéficiaires effectifs.

- soutenir les efforts de mise en place de mécanismes justes et transparents de réaménagement de la dette, mener des auditions, et réduire les dettes insurmontables de plusieurs pays en développement.

- être à la pointe au niveau international pour la création de normes de financement responsables et le respect de celles-ci, notamment l'obligation de conditions équitables, de normes sociales et environnementales adéquates et de responsabilité face aux populations touchées.

Le financement public et le financement privé ont tous deux un rôle primordial à jouer dans les efforts de l'après-2015 pour la diminution de la pauvreté. La plus grande contribution que peut faire l'Union est de reconnaître les différents rôles de chaque type de financement, et de modifier certaines de ses politiques qui peuvent constituer un frein aux efforts des pays en développement pour augmenter, diriger et améliorer le financement du développement.
1. OVERVIEW - RESOURCES AND POLICY PROCESSES

The financial landscape facing developing countries has evolved considerably since 2000. This chapter presents the key facts about development and private finance at the national and international levels and highlights key discussions at the UN and EU. Domestic resources are the largest source of development finance. Public resources are larger than private investment in most developing countries, and are growing, although government spending remains low in absolute terms in many countries. A fluid mix of international resources flow to and from developing countries, but the mix varies considerably across countries. For many countries, outflows – such as the repatriation of profits on FDI, repayments on loans and illicit finance are a significant issue – and can drain the domestic resources available to address poverty. Official Development Assistance (ODA) remains vital where domestic resources are lowest.

1.1 Overall trends and scale of development finance

1.1.1 Domestic resources

Government spending is the largest domestic resource in most developing countries, and the resources available to many of these governments are growing rapidly. Public expenditure exceeds domestic private investment in most developing countries.1 Governments are key institutions for the domestic effort to end poverty and over half of all developing countries experienced real average growth in total government spending of 5 % per year or more from 2000-2011. In almost 30 countries it was greater than 8 % per year.1

The balance of government revenue streams varies considerably between countries, but many resource-rich developing countries rely heavily on revenue from extractive industries. Natural resources accounted for 40 % of total tax revenue in Africa from 2008-2011.2 This brings risks, including vulnerability to volatile international commodity prices, and the finite nature of these resources means revenues will decline as the resource is exhausted. Many developing countries face challenges of narrow tax bases and significant lost revenue due to illicit financial flows, as detailed below.

Nevertheless, domestic government resources2 remain very low in many countries with more than three billion people living in countries where government spending is less than USD 1,000 per person each year, in purchasing power parity (PPP) terms3. 380 million people living in abject poverty on less than PPP USD 1.25 a day are in countries where the government spends less than PPP USD 500 per person. Given high demand for public services, domestic public institutions in many countries will continue to face major resource constraints.

These countries face considerable challenges to scaling up domestic resource mobilisation and many countries with the lowest current levels of domestic resources are also those where resources are projected to grow most slowly in the next fifteen years.3 There are numerous reasons for this, including low overall levels of resources and wealth in the country as well as the difficulties of broadening a tax base where the economy is characterised by a large informal sector. In addition, failures to efficiently tax

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1 Author’s calculations based on data from IMF World Economic Outlook for countries. 70 of 121 developing countries with data experienced growth exceeding 5% per year or more.
2 The figures quoted are total government expenditure minus general budget support ODA and disbursements of foreign loans to the public sector
3 2011 data
major taxpayers – whether the wealthy elite or major corporations – due to tax exemptions or treaties, weak institutions, offshore registrations and illicit finance also reduce domestic resource mobilisation.

Domestic governments will therefore have a pivotal role to play in realising the post-2015 goals, but domestic institutions in many countries face continued and severe constraints in absolute terms, despite high percentage growth in resources since the MDGs were agreed. It is widely recognised that domestic institutions will drive the eradication of poverty and lead efforts to achieve the Millennium Development Goals (MDGs) and post-2015 goals. However, even in countries where resources are growing rapidly, institutions face the challenges of technical and delivery capacity as well as political and other implementation challenges. Within this context, international public finance has an important role to play supporting developing countries over the post-2015 timeframe, as explored in chapter 2.

**Figure 1: Government spending per person for different country groups**

Domestic private investment is also growing, although the available figures do not give a good indication of scale. Total domestic investment\(^4\) in developing countries has grown as a proportion of GDP, rising from 24.1% in 2000 to 32.3% in 2011. While this includes investment by both the private and public sectors (data distinguishing the two are unavailable), it suggests substantial growth in private investment. Almost 60 countries experienced real growth in total domestic investment exceeding 5% per year over the period, and 18 experienced growth over 10%\(^5\).

The private sector has an important role to play in development, through job creation (especially in micro, small and medium enterprises\(^6\)), payment of taxes and by providing goods and services. Growth in domestic private investment can therefore contribute towards sustainable development, but the benefits depend on the nature and inclusivity of this growth, of the type of investments being made and the context within which they are being made, as explored further in chapter 2.

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\(^4\) Based on total gross capital formation minus foreign direct investment, with data from the World Bank and UNCTAD Stat. This data covers 113 of 148 developing countries. As noted it covers investment by both the public and private sectors, and covers investment funded by earnings, equity and borrowing.

\(^5\) Author’s calculations based on data from the World Development Indicators, the World Economic Outlook and UNCTAD Stat.
1.2 International resources

Total international resource flows to developing countries have grown from around USD 1 trillion in 1990 to USD 2.1 trillion in 2011\(^5\), largely driven by expansion in foreign direct investment (FDI), lending and remittances. The mix of resources flowing to many developing countries has changed dramatically. In the early 1990s ODA was the largest resource flow to almost 100 developing countries, in 2011 it was the largest for 43.

The largest flows to developing countries in aggregate are commercial or private, although ODA is the largest flow to least developed countries and those with the lowest levels of domestic resources. In 2011, FDI, remittances and loans accounted for the largest flows to all developing countries at USD 472 billion, USD 343 billion and USD 340 billion respectively (see section A.3 for a discussion on FDI data). However, ODA was the largest resource flow received by least developed countries, and the largest flow for countries with the lowest levels of government spending per person\(^6\).

Despite this, inflows of financial resources may be exceeded by resources which leave developing countries; most are not productive investments in other countries but repayments, repatriated profits or illicit finance. Capital and interest repayments on loans totalled over USD 500 billion in 2011, while repatriated profits on FDI totalled USD 420 billion, equivalent to almost 90% of new investments in the same year. Illicit financial flows, often motivated by companies’ desires to reduce their tax bill, are large for many countries. These illicit flows are by nature difficult to quantify as they are deliberately mis- or un-recorded, but estimates suggest that they totalled over USD 630 billion in 2011\(^6\). In almost half of developing countries for whom estimates of illicit finance exist, these outflows are equivalent to 5% of GDP or more.

The distribution of ODA is very different to other flows, and it remains a very important resource for countries with the highest levels of poverty and the lowest levels of domestic resources. For almost three-quarters of countries with government spending of less than USD 500 per person, ODA is the largest international resource flow received. Aid performs very different functions to other resources and, given its unique mandate to directly target development, improved welfare and poverty reduction, it should have an important continued role to play in supporting many countries, as discussed in chapter 2.

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\(^5\) Based on estimates from Global Financial Integrity (Illicit Financial Flows from Developing Countries 2002-2011, December 2013) For 148 developing countries classified as eligible for ODA by the OECD, their figures suggest USD 633 billion in illicit financial outflows. This is the sum of ‘hot money (balance of payments)’ and ‘gross excluding reversals (non-normalised)’ estimates of illicit financial flows.
Lending is a major source of finance to developing countries, with net loan disbursements to developing countries totalling USD 340 billion in 2011, more than three-quarters to the private sector. Long-term loans from private sources totalled USD 518 billion in 2011, while repayments on capital totalled USD 358 billion (see figure 2 above). Net inflows of short-term loans, with a term length of less than one year, totalled USD 180 billion. The majority of loans go to more economically-developed countries. Brazil, Mexico and Turkey received the largest disbursements of long-term loans while China alone accounted for 72% of net short-term loans to developing countries in 2011. More than three-quarters of loans go to the private sector in developing countries. 78% of commercial loan disbursements went to the private sector in 2011 while 22%, or USD 113.4 billion, went to the public sector or were guaranteed by public institutions. However commercial loans to public borrowers are significant in some developing countries, such as Mexico, Brazil and China, where public or publicly guaranteed loans from commercial sources totalled USD 29.6 billion, USD 10.6 billion and USD 9.1 billion respectively.

High levels of lending place a considerable repayment burden on many developing countries, and short-term lending is extremely volatile. In addition to capital repayments, interest repayments on loans totalled USD 155 billion in 2011. Total debt repayments exceeded 5% of GDP in 26 developing countries.
countries in 2011, and in 10 countries exceeded 10% of GDP. Net short-term loan disbursements\(^9\) to developing countries have fluctuated wildly over the past decade. Total net inflows to developing countries totalled USD 157 billion in 2007 before the global crisis, dropped to USD 5 billion in 2008, rose to a record USD 272 billion in 2010, before dropping again to USD 180 billion in 2011.

1.3.2 Private investments (FDI + Portfolio Equity)

FDI is the largest net resource flow to developing countries, but there are very large outflows of profits made on FDI, and the figures should be treated with care as they do not necessarily represent external investment. FDI was the largest resource flow in aggregate and the largest flow to 40 countries individually in 2011. FDI in developing countries grew from USD 303 billion in 2000, to a peak of USD 539 billion in 2008 before the crisis, and totalled USD 472 billion in 2011 (see figure 2 above).\(^9\) Portfolio equity, shorter-term investments that do not entail a controlling interest in the enterprise in question, totalled USD 30.4 billion in 2011. Europe is an important investor in developing countries. FDI from EU member states\(^11\) accounted for 29% of total FDI in developing countries in 2011, some USD 135.7 billion. This ratio has risen from between 10% and 20% in the early and mid 2000s. International investments, both FDI and portfolio equity, can be highly volatile with sharp swings in investment levels and massive capital outflows during crises.

The outflow of profits on foreign investments from developing countries totalled USD 420 billion in 2011, equivalent to almost 90% of FDI in the same year. This ratio has risen steadily since the late 1990s and early 2000s when repatriated profits were equivalent to less than 50% of FDI each year. For many countries, such as Nigeria, Algeria, Kazakhstan and Malaysia, outflows of profits on FDI exceed new investments by a considerable margin. Information on which investor countries these profits flow to is unavailable, but the EU has been an important investor for some affected countries such as South Africa, Argentina and Venezuela.\(^12\) Profit outflows are a fundamental component of the investment package and are not necessarily detrimental to the host economy. The true value of foreign investments is determined by the types of investments made, the technology and ideas transferred, the goods, services and opportunities offered, and the impact on the local economy. Nevertheless, the sheer scale of profit outflows highlights the importance of the issue to the development finance debate. Outward FDI from developing countries totalled USD 160 billion in 2011, small in comparison to both inward FDI and the outflow of profits on foreign investment.

Information on inflows of FDI includes the reinvestment of earnings from within the ‘destination’ country, which are not an inflow, as well as mergers and acquisitions, which are not always an investment in additional productive capacity. Reinvested earnings accounted for over 60% of ‘outward’ FDI from developed countries in 2012. Mergers and acquisitions vary considerably by region, accounting for around one-fifth of FDI in East and South-East Asia, but were negative in Africa\(^7\).

Most FDI goes to more economically-developed countries, and there is little investment in countries with high poverty rates or low domestic resources, except where natural resources are present. Foreign

\(^9\) Net disbursements = new loan disbursements – repayments of capital on existing debt. Data on lending and repayments on debt are calculated from the World Bank’s International Debt Statistics and the IMF’s World Economic Outlook.

\(^10\) Note that data on total FDI in developing countries is taken from UNCTAD, while data on FDI from the EU in developing countries is from the OECD.

\(^11\) Based on data on 21 European Union countries (excluding Bulgaria, Cyprus, Latvia, Lithuania, Malta and Romania, as well as Croatia which was not an EU member in 2011) from the OECD’s FDI by Partner database.

\(^12\) Over 2000–2010 FDI from EU member states accounted for more than 40% of total FDI in these countries.
investment in developing countries is highly concentrated; 70% of FDI in developing countries\textsuperscript{13} in 2011 went to just 10 countries\textsuperscript{14}. China alone accounts for over a quarter of total FDI to developing countries. The next largest recipients are Brazil, India, Mexico and Indonesia. Only a small proportion of overall FDI goes to countries with the lowest levels of domestic resources or the highest poverty rates, and most of this goes to countries that have natural resources.

Developing countries with lower domestic resources tend to receive more ODA and less foreign investment from Europe. European countries follow a similar pattern of engagement with developing countries to other donors. Interactions with developing countries with the lowest levels of domestic resources are dominated by ODA, while more economically developed countries are both more attractive to foreign investors and are lower priorities for European aid agencies.

FDI is heterogeneous in nature and different investments in different contexts may have diverse impacts. The effective incorporation and monitoring of private resources into the post-2015 agenda will require substantial improvements in the available information about investment and other private resources. Available data shows a high degree of concentration in export-motivated extractive sectors in many countries, particularly in low-income and least developed countries. This type of investment can exacerbate a dependence on primary exports, is associated with the risks of economic non-diversification, is often funded by private sector debt and may be associated with high capital outflows. There is little comprehensive and comparable information about the sectors that are being invested in, the motivation, financing, or length of investments, or even who is investing where.

1.3.3 Remittances

Remittances – private transfers by migrant workers overseas – totalled USD 343.4 billion in 2011, but are highly concentrated in countries with the largest diasporas. 10 countries received 70% of all flows to developing countries.\textsuperscript{15} Remittances are the second largest flow to developing countries overall (see figure 2 above), and are the largest flow for 31 developing countries. They are less volatile than other private international resources and can be counter-cyclical in nature. Remittances are closely linked to patterns of migration and countries with a large diaspora - such as India, China, Mexico and the Philippines - receive the largest volumes. While remittances are an important transfer for some countries, there are also costs to emigration. Emigrants are often among the most educated and entrepreneurial people in a population, so there is a loss of their talents to offset against the income they send home.

Internationally comparable information about remittances is limited. Data on remittances are generally regarded to significantly underestimate true volumes, due to informal money-sending channels that are not captured by the data. Between 25 and 49% of remittance senders responding to a Gallup World Poll reported sending remittances via people rather than official channels\textsuperscript{8}. Available evidence suggests that a high proportion of remittances are for consumption rather than productive investment.\textsuperscript{9} However there is little comprehensive information on the use of remittances.

\textsuperscript{13} Note that the author used the OECD’s list of ODA recipients as the definition of developing countries throughout.

\textsuperscript{14} These ten countries are: China, Brazil, India, Mexico, Indonesia, Chile, Turkey, Colombia, Kazakhstan and Malaysia.

\textsuperscript{15} The ten countries that receive the majority of remittances to developing countries are: India, China, Mexico, Philippines, Nigeria, Pakistan, Bangladesh, Vietnam, Lebanon and Morocco. Source: Investments to End Poverty, pp 145, Development Initiatives, 2013
1.4 **Current policy debates at the EU and UN**

While the post-2015 debate has taken shape in the last six months, financing discussions are a long way from being resolved. UN processes have not yet addressed the type of goals or targets on financing that could be included in the post-2015 framework. There is acknowledgement that MDG8 lacked strong mechanisms to monitor the contributions of development actors, and the MDGs as a whole failed to include any commitments from developed countries. However, the shape of mechanisms to monitor a much wider and more diverse set of actors in the post-2015 framework have not been discussed in detail. There has been much discussion about opportunities for collaboration between public and private resources, but the UN processes have not yet examined the strengths and weaknesses of particular mechanisms in detail. The debate will progress throughout 2014 and the completion of the open working group and expert committee processes, which are due to culminate in the publication of reports in August 2014.

Through its 2013 Communication and its 2012 predecessor\(^{16}\), the European Commission proposes a future financing framework for development that reinforces the linkages between public and private finance, and domestic and international resources. In July 2013, the EC released a communication on *Beyond 2015: towards a comprehensive and integrated approach to financing poverty eradication and sustainable development*. This is not a suggested position for EU negotiations on the post-2015 financing framework, as the EC notes that ‘the Communication does not propose new actions or commitments for the EU.’ A further communication is expected in 2014 that will move this agenda further forward.

The Communication argues that private finance is the ‘key driver of growth’ and that countries should ‘use public resources to invest in areas that leverage private investments towards policy priorities.’ This explicit linking of the use of public resources to leverage private investment is not a new theme for the Commission, being a major feature of its *Agenda for change* policy position. In the Communication, the EC argues that the ‘blending of grants with loans and equity, as well as guarantee and risk-sharing mechanisms can catalyse private and public investments, and the EU is actively pursuing this.’ While the vast majority of existing blending has been to support the public sector, the EC’s plans for the future include a significant scale up of private sector blending.\(^{10}\)

This contrasts with the more cautious, evidence-based approach promoted by the European Parliament whose June 2013 resolution on financing for development called ‘on the EU to properly evaluate the mechanism of blending loans and grants – particularly in terms of development and financial additionality, transparency and accountability, local ownership and debt risk - before continuing to develop blending loans and grants’. The Communication also recognises the importance of public resources, particularly domestic public resources, while recognising the role of ODA in low-income countries. However, it contains no discussion of whether public resources may have a different role to play from private resources, and its promotion of using public resources to leverage private finance suggests a belief that the two are interchangeable. This would be a controversial assumption, which this report will examine in detail.

\(^{16}\) The 2012 Communication: “Improving EU Support to Developing Countries in mobilising Financing for Development”
2. FRAMEWORK: THE ROLES OF PUBLIC AND PRIVATE FINANCE

This chapter introduces the concepts of public and private finance, and discusses in further detail the significant finance gaps in developing countries. The chapter concludes that global public finance is predictable and plays a unique role in protecting and providing public goods. ODA in particular remains an important source of finance for many countries and contributes to providing essential public services such as health, education and sanitation in many more. International private finance faces a number of difficulties when used as a source of development finance. It tends to focus on higher income countries and bypass lower income ones, has a limited potential to support micro, small and medium enterprises (MSMEs) in developing countries, and requires public support in the form of regulation and catalytic public investments – for example in infrastructure - in order to realise its full potential.

2.1 Global public finance: still vitally important

The following types of global public finance flows are especially relevant from a development perspective:

- **Official development assistance (ODA or “aid”)** as highlighted above.
- **Debt cancellation or debt relief.** Existing literature has found a positive correlation between debt cancellation and increases in economic output, public investment and domestic revenues.\(^{11}\) Though there has been significant debt cancellation there is currently no process for orderly restructuring of developing country debt, as the Highly Indebted Poor Countries (HIPC) Initiative is about to expire.
- **Global public lending, largely from the World Bank and IMF.**
- **Innovative finance** - a number of different initiatives or proposals to raise additional public finance for developing countries. Most are in a proposal or early implementation stage, so the overall benefits to development have not been comprehensively assessed, though UNDESA has produced a very useful summary of what is already known.\(^{12}\) Unfortunately, there has been a recent clouding of the meaning of the term to include mechanisms to use public finance to incentivise or leverage private finance. In the table below, we stick to the traditional meaning, and consider these other public-private mechanisms in section 3.

<table>
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<th>Table 1: Innovative financing mechanisms</th>
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<td><strong>Mechanism</strong></td>
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<td>Financial transaction tax</td>
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<td>World Bank Green Bonds</td>
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<td>Product (RED)</td>
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### Mechanism | Type | Description | Revenue | Status
---|---|---|---|---
**Carbon tax on aviation and bunker fuels** | Tax/charge | A global tax per ton of CO\(2\) emitted when using these fuels | USD 22 billion a year with a tax of USD 25 per tonne | Proposal

**Billionaire tax** | Tax/charge | A tax of 1% on individual wealth holdings of USD 1 billion or more | USD 40-50 billion | Proposal

**New SDR issuance** | Monetary resource creation | Annual allocation to developing countries – similar to ‘global quantitative easing’ | USD 160-270 a year | Proposal

Source\(^{13}\)

#### 2.1.1 The unique role of global public finance and ODA

ODA remains a key source of finance for many developing countries, and pays for an important share of public services in many countries. In 2011, ODA accounted for 9.1% of the gross national income (GNI) of low-income countries (LICs).\(^4\) However, the relevance of ODA can be best measured when compared to the level of government expenditure. Although data on government expenditure is not available for all countries, in 2011 aid accounted for 71% of the central government expenditure of the 13 LICs for which information is available.\(^5\) In these countries, ODA supports an important share of the government’s spending on essential services such as health and education. For example, over 40% of the health budget in Mozambique and Uganda depends on aid funds.\(^6\) The importance of aid to support government spending is also important in several lower-middle-income countries (LMICS) – 47.5% in Nicaragua, 42.5% in Laos, 21.5% in Ghana, 16.8% in Georgia – and upper-middle-income countries (UMICs) – 11.5% in Jordan, 8.8% in Bosnia Herzegovina and 7.9% in Serbia.\(^7\)

Global public finance is a more flexible and predictable source of finance compared to international private flows. Though ODA flows are more volatile than domestic tax revenues, globally they have proved less volatile than external private finance. Overall, however, global public finance is more likely to remain stable than external private finance in case of external shocks or a global systemic crisis such as the one that started in 2008. It is also important to remember that ODA and charitable donations provide emergency assistance during humanitarian crises.

Global public finance also plays an important role in providing and protecting public goods. Some examples include the prevention of climate change, protecting biodiversity, funding international organisations such as the UN and the International Criminal Court, and the efforts made in developing countries to prevent and treat communicable diseases. Though providing and protecting global public goods can sometimes lack a direct local connection, as is the case for scientific research on communicable diseases, the results can have an important impact at the national or local levels.

Despite efforts to improve the effectiveness of ODA, its real value to developing countries is reduced by poor donor practices. According to a recent study, better quality aid would prevent the loss of 10-20% of country programmable aid.\(^8\) A number of civil society organisations have highlighted that some aid expenditures do not entail a real transfer of resources to developing countries and that concessional loans reported as aid artificially inflate aid figures. The European NGO Confederation for Relief and Development (CONCORD) has estimated that European bilateral aid was inflated by EUR 5.6 billion in 2012, while a similar report by ActionAid looking at the aid flows recorded by the OECD, including multilateral assistance, suggests that only 55% of all aid contributes effectively to poverty reduction.\(^9\) The case of tied aid, which independent estimates suggest increases the cost of aid by 14-40%, shows...
that donors face pressures to use their aid to support companies from their own countries, even though they know that this reduces its value to recipients. This experience should be borne in mind when considering the use of aid to support private sector interventions.\textsuperscript{21}

The aid and development effectiveness agenda remain a crucial reference framework also when working with the private sector. The principles agreed in Paris, Accra and Busan do not only play a role in ensuring effective aid flows. The Busan Partnership for Effective Development Co-Operation has put the principles of ownership, transparency, development results and accountability at the core of all development activities.\textsuperscript{22} Publicly supported private finance should not be an exception insofar donors are pursuing development objectives. As a signatory and a champion of this agenda, the EU should contribute to mainstream this agenda in international processes, such as the post-2015 framework, by continuing to pursue the aid and development effectiveness commitments, monitoring their implementation, and supporting the Global Partnership for Effective Development Cooperation (GPEDC).

2.1.2 Financing gaps

Global public finance is currently insufficient to meet all development needs, and the development finance gap - the difference between the available resources and the needs - is highest in LICs and LMICs. In 2012, the OECD estimated the finance gap of reaching the MDGs by 2015 at USD 120 billion a year,\textsuperscript{23} an amount similar to current ODA levels. If future goals are to encompass the full range of sustainable development needs, then the required amounts will be many times this. For example, the cost of addressing the climate needs of developing countries alone is in the range of USD 0.5-1 trillion a year.\textsuperscript{24} The poorest countries simply do not have the domestic public resources to finance the investments that only public expenditure will provide, in health, education and other services. The OECD estimates that improving and strengthening tax collection systems without increasing tax pressure in LICs and LMICs would generate an additional USD 5 billion a year.\textsuperscript{25} This does not include gains that could be made if global action were taken to prevent the tax avoidance and evasion that is a major problem for developing countries, as discussed in chapter 4. Strengthening tax systems in developing countries remains important, but it will only raise a small fraction of the finance that is needed.

Filling the public financing gap will require sustained efforts to meet ODA commitments, raise genuinely additional innovative finance, and support developing country efforts to raise domestic revenues. ODA has been falling in recent years, but several European countries have met the 0.7 % target,\textsuperscript{17} and others are making progress towards it. It remains as relevant as ever, as does implementing commitments to make aid more effective. Plans for raising additional revenues through the innovative financing mechanisms highlighted above also need to be pushed ahead, particularly given the increased expenditure that will be needed to mitigate and adapt to climate change. Perhaps the most significant way that European countries can support domestic resource mobilisation is to help tackle the enormous problem of illicit financial outflows highlighted in chapter 1, the majority of which are caused by companies' attempts to avoid taxation. We explore this further in chapter 4.

Investing public resources in essential services is an important redistributive tool that helps fight poverty and inequality. Health, education and other public services such as social protection and water and sanitation are important contributors to economic and human development.\textsuperscript{26} Only public

\textsuperscript{17} According to the OECD 2012 data, these countries are: Denmark, Luxembourg, Sweden and the Netherlands.
resources can make these services accessible to all, including the poorest and most marginalised, allowing previously excluded people to improve their own lives, and helping to reduce inequality and exclusion in the long term. Many developing countries have insufficient domestic resources to spend on the provision of public services. In 2011, health expenditure per capita in LICs and LMICs was USD 31 and USD 79 respectively. In comparison, UMICs spent USD 418 per capita, still far from the approximately USD 4,607 spent by high-income economies. To put these figures into perspective, in 2009, the WHO estimated that LICs would require spending of USD 60 per person by 2015 to provide basic health care coverage.

Public resources can also have an important role to play in catalysing the development of key economic sectors. For example, public investments in infrastructure can help to increase access to markets or lower production costs, making the private sector more competitive. Public finance also plays a direct role in creating and sustaining a regulatory and institutional environment that supports growth, including business and labour regulations, and access to financial services.

2.2 Private finance: recognising limitations

In the context of this report we define private finance as finance that is seeking commercial returns. This would include:

- Reinvestment of profits made by the domestic private sector and individuals.
- External FDI (ownership of at least 10% of voting shares) and portfolio investments (less than 10%).
- Lending by financial institutions, both domestic and international.

We do not examine in detail remittance transfers, though they are significant, as they are a function of migration policy. The exact amount of remittances that goes to support private sector investments is unknown, but there is an important body of literature that suggest that the main destination is consumption rather than investment. Technically remittances do not include transfers made with the objective of investing in or creating a business or acquiring property such as a house or land, although this is very difficult to measure in practice. There is evidence from Mexico that remittances can be an important source of finance for start-up and micro-enterprises. Reducing costs, for example to the G20 target of 5%, will be important, as will examining other ways of helping remittances support investment.

Policy makers seeking to maximise the role that private finance can play in development must recognise three key limitations, the first being that it predominantly flows towards higher income countries. In chapter 1, we saw that this is true for external private finance, but it is also the case for private domestic investment, which is the main source of private sector investment in developing countries. The chart below indicates the extremely low levels of domestic private investment in the poorest countries – which is in most countries the largest portion of the measure of ‘gross capital formation’. In 2011, per capita gross capital formation not including FDI, was USD 120 in LICs, compared to USD 2,280 in UMICs.
The second is that, in developing countries, the private sector is dominated by micro, small and medium enterprises (MSMEs), yet they find it particularly difficult to access external private financing sources. MSMEs account for approximately 70% of employment and 60% of the GDP in LICs and 95% of the employment and 70% of the GDP in MICs. The remaining share of the economic output and employment in developing countries is mostly due to the public sector. There is also evidence that smaller firms tend to be the most dynamic and innovative and important drivers of economic diversification, which makes countries more resilient to external and internal shocks. However, close to 80% operate in the informal economy, which not only reduces the government’s tax base and can impact decent working practices, but is also a major obstacle for both enterprises’ and workers’ access to finance, insurance, social safety nets and formal commercial opportunities. They also often face regulation that is biased in favour of large companies.

The third is that the for-profit nature of private finance means it cannot deal with some development constraints, including some of the barriers to private sector growth, without public sector involvement. Private finance’s incentives to invest in the protection and provision of public goods is limited because by definition they are non-rival and non-excludable. The World Bank estimates that, over the last decade, 80–85% of all investments in infrastructure in developing counties have been publically funded. The enactment and enforcement of regulations to deal with externalities (for example to prevent pollution), or public sector support to provide public goods (for example in subsidising anti-retroviral drugs to prevent HIV transmission), are therefore necessary. As developing countries get richer, the economy and employment tend to become more diversified and economic activity moves towards higher added value sectors such as manufacturing or financial services and away from the production of primary commodities. The process of diversification is driven by innovation, but innovation is very limited in the absence of industrial policies and public investment in the form of subsidies for new and non-traditional activities, and investments in infrastructure such as irrigation, electricity grids or transportation that reduce the cost of innovation.
The remainder of this paper therefore focusses on the interaction between public agencies and private investment, tackling two key questions for policy makers:

- Chapter 4 Can public institutions and public finance be used to incentivise and subsidise private finance?
- Chapter 5: How could European policies and regulations be improved to support better private investment in developing countries?
3. INCENTIVISING AND SUBSIDISING PRIVATE FINANCE

This chapter focuses on publicly supported private finance or how public finance can be used to leverage private investments for development. It introduces the main actors and instruments and evaluates the risks and challenges that this approach presents from a development perspective. The chapter shows that the nature of the instruments used to leverage private finance make it difficult to target MSMEs. It also discusses weaknesses and inconsistencies in the estimation of leverage ratios and the existing narrative about ‘additionality’ that are key for the appraisal of publicly supported private finance. In addition, the governance structures and the standards and monitoring and evaluation mechanisms put in place by European DFIs are insufficient to guarantee that publicly leveraged private finance is consistent with development effectiveness principles. The penultimate section notes potential increased debt burdens in developing countries and problems with pro-cyclical flows which should be taken into account when assessing the use of public funds to leverage private investments for development. The final section concludes that there is very little evidence to assess the development impact of these interventions.

3.1 Instruments and institutions

There are a large number of public institutions engaged in efforts to mobilise private finance for development, including:

- **Multilateral development Banks (MDBs)**, including the World Bank Group (WBG), the European Investment Bank, the Asian Development Bank (ADB), the African Development Bank (AfDB) and other regional development banks. In general, there are specialised branches or units within MDBs responsible for the private sector, such as the WBG’s International Finance Corporation (IFC).

- **Bilateral development finance institutions owned by developed countries**. Some European examples include France’s Proparco, Germany’s DEG, and the Netherlands’ FMO. These, and another 11 European bilateral DFIs, are members of the Association of European Development Finance Institutions (EDFI).

- **Dedicated funds and facilities** such as the EU blending facilities or the Clean Technology Fund. In general they have their own decision making bodies, but they are dependent on the procedures of MDBs or bilateral DFIs for implementation. It is important to note that almost all existing EC blending has been to support public institutions. Therefore the desire to use these mechanisms to support the private sector is an aspiration the EC sets out in its Communication, which is so far unsupported by practical experience.

- **Export credit agencies** include both multilateral institutions such as the World Bank’s Multilateral Investment Guarantee Agency or certain units within regional multilateral development banks, as well as national export credit agencies. The primary mandate of national export credit agencies is to promote national exports. ECAs are highly influential players in global trade. According to the Berne Union – an organisation representing 49 members, most of them national export credit agencies – ECAs insured or supported USD 1.8 trillion in exports in 2012.

- **National development banks and funds**. Many developing countries have created national banks and funds with a development mandate, or a mandate to support investments in key economic sectors. The importance of these institutions is shown by the fact that while MDBs and bilateral DFIs contributed approximately USD 37.8 billion in development finance in 2011, national development banks and funds have total reported assets in excess of USD 2 trillion and the real figure is much larger as this does not include Chinese development banks. However, due to the large number of institutions, the
variability in terms of mandate, size and scope, and the lack of good comparative data and analysis, this report will not focus on them.

These institutions use five major kinds of instrument to support or leverage private sectors investments in developing countries:

- **Grants**: to subsidise private investments in developing countries. For example, the concept of blending involves a grant combined with a loan. At the EU level, blending has been used primarily to subsidise public sector investments, but there are plans to expand support to the private sector in the future.\(^5^2\)
- **Debt instruments**: predominantly in the form of loans for which a repayment is required. Loans represented 46% of the total portfolio of the 15 EDFI members.\(^5^3\)
- **Equity instruments**: that involve the ownership of shares in a company are the second most common tool, representing 28% of IFC disbursements in 2011, for example.
- **Quasi-equity instruments**: a complex form of business finance, which combines elements of ‘equity’ and ‘debt’. Some examples include loans in which share options are given as collateral or ‘subordinated loans’ in which the issuer has a lower repayment priority in case of bankruptcy compared to traditional lenders.\(^6^4\)
- **Guarantees**: instruments designed to tackle the risks of investing abroad. They can protect investors directly, or a third party involved in a project (e.g. a lender), or both. When applied to loans, guarantees work by ensuring creditors receive the repayment of all or part of the loan. Guarantees, only represent 2% of the portfolio of EDFI members\(^5^5\) and are predominately provided by export credit agencies.

### 3.2 Evaluation of risks and challenges

**Supporting MSMEs – more work needed**

The private sector mechanisms used by European DFIs are not always adequate for supporting the development of MSMEs in developing countries, especially in LICs and LMICs. Research on the EIB, Norfund, FMO (the Dutch DFI), and BIO (the Belgian DFI) shows that the majority of their funding for the private sector does not target SMEs, which represent respectively 34.3%, 25.0%, 34.1% and 52% of their portfolios respectively.\(^5^6\) In comparison, 40% of the beneficiaries are large companies listed in stock exchanges.\(^5^7\) The large majority of these investments are in middle-income countries with SMEs in LICs accounting for 0.4%, 5.2%, 2.9% and 4.2% of the portfolios of these four European DFIs.\(^5^8\) These figures suggest that bilateral DFIs are finding it difficult to support MSMEs, especially in the poorer countries. This is due to:

- **Better investment opportunities in higher income countries.** Far larger, more diversified private sectors provide greater investment opportunities, and as we have seen a far higher level of private investment, both domestic and foreign. In addition, they usually have a better and more stable business environment, which plays a critical role in the risk assessments made by European MDBs, Bilateral DFIs and Export Credit Agencies (ECAs). In the case of ECAs, low-income countries usually have worse risk ratings than higher income ones,\(^5^9\) which translate into higher risk premiums and more costly projects.
- **Lack of appropriate instruments.** Informality is one of the main constraints. Instruments such as equity and quasi-equity investments can only be used with formal companies. Direct loans and guarantees provided by European DFIs are also subject to strict risk assessment and financial requirements that make them inadequate for informal companies. In general, direct funding is only accessible for the largest MSMEs, which
given that definitions of MSMEs are usually based on western standards, can be very sizable in the context of developing countries.

- **European DFIs are generally too distant from the ground.** This makes them very difficult to access for most MSMEs in LICs and LMICs. European DFIs do not operate as commercial banks that have branches where the owner of an MSME can request information and apply for a loan. There are also very strict application procedures and language requirements that are a barrier for most owners of small businesses. To overcome this problem, it is possible to operate through local financial intermediaries. The problem is that those local financial intermediaries that fulfil the strict fiduciary standards and other criteria of European MDBs and bilateral DFIs are not very common in LICs and LMICs and, even when they exist, are not usually accessible for MSMEs. In addition, these intermediaries often tend to concentrate in urban areas. Financial intermediaries also make project oversight more difficult (see section on monitoring and evaluation below).

**Additionality – a lack of evidence**

To ensure that these instruments support, rather than replace private finance, it is necessary to prove ‘additionality’ – but existing evidence is very weak. In general, European MDBs and DFIs have a mandate that requires their investments to be additional to existing or potential private financial investment. ‘Additionality’, as this concept is known, is characterised by two main components:  

- **Financial additionality:** Would the private investment have happened anyway? This is the most common approach to defining additionality. Without financial additionality, instead of leveraging private finance, the public institution is simply subsidising private financiers and companies, or competing with them.
- **Operational and institutional additionality:** Is the resulting investment better aligned with the aims of the public institution backing it? Have there been improvements in, for example, the environmental or social performance of the investment as a result of the public institution’s involvement?

External evaluations of a number of international DFIs show that lack of additionality, both financial and operational/institutional is common among their private sector investments. A systematic review of additionality looking at several MDBs and DFIs, including 17 institutions based in Europe, found that 55% of the projects would have gone ahead without the public finance. Similar results were revealed by an audit of the Swedish DFI, Swedfund, which found that eight out of the 12 companies they interviewed stated that the investment would have gone ahead without public support. Research on the additionality of ECAs, especially the issue of credit guarantees, is much more diverse in its conclusions, but there is an extensive body of literature that suggests a significant share of the projects lack additionality.

The results of evaluations looking at operational and institutional additionality show worse results. The same review mentioned above found that ‘there is very little evidence that DFIs actively seek to influence project design or policy to improve direct poverty outcomes.’ An evaluation of IFC lending, undertaken by the World Bank’s own Independent Evaluation Group, found that ‘at least one form of operational or institutional additionality was identifiable in about one-third of the cases.’ A more recent report focusing on financial intermediaries concluded that around 30% of the projects did not show any improvements as a result of the IFC’s involvement and that figure increased to 60% in the case of sub-projects.
The measures of financial additionality used by European DFIs are varied, but inadequate. The EIB, for example, has an ‘additionality’ requirement that limits the amount of funds it can provide to 50% of the total finance when supporting SMEs, but it does not actually measure the amount of finance the investment has leveraged. An official evaluation of EIB lending to SMEs concluded that ‘The additionality requirement appears, in fact, to be more of a compliance check than an incentive for FIs to increase MLT [medium to long term] lending to SMEs. It is not equivalent to the additionality concept normally used in the economic literature.’ In general, European MDBs and bilateral DFIs rely on historical accounts, leverage ratios and portfolio distribution to claim financial additionality, but these measures do not provide an accurate account of their actual financial additionality. ECA additionality measures also rely on a number of different approaches, with most relying on surveys of ‘intention’ rather than actual financial data. No evidence has been found of systems or structures designed to systematically measure operational and institutional additionality.

In the case of DFI investments, additionality is usually considered as one of multiple criteria when projects are evaluated, rather than as a condition the private sector project must fulfill. This may help to explain the approval of projects that are not actually additional.

**Estimating leverage – who is leveraging who?**

One of the driving forces behind the idea of using public finance to support the private sector is the potential to leverage additional investment, but there are important weaknesses in the way the concept is measured and used. Leverage can be generally defined as the ability to use public money to mobilise other funds for investment in a specific project or activity. However, the measurement of this concept presents important challenges.

There is no common methodology to estimate leverage ratios and existing calculations usually fail to differentiate between public and private finance, leading to double counting. For example, when estimating the leverage ratio of the EU Blending facilities, the EIB has noted ratios of eight times the EU budget contribution, whereas the European Commission has estimated ratios of up to 31 times. Though, as noted above, this largely refers to public finance, it indicates the difference that different methodologies make. There is also evidence that some international DFIs fail to differentiate between private and public finance when there is more than one public institution involved. This means that both institutions can claim to have leveraged each other’s money, and results in the double counting of public finance.

Much policy debate usually implies that high leverage ratios are better, but this only holds true if the additionality of the project can be demonstrated. In reality, the influence of the public investor tends to be diluted as leverage ratios increase. For example, the leverage ratio of 1:31 mentioned above means approximately 97% of the finance for the project was already available. This has important implications because a 3% share of finance does not usually translate into significant influence over the project.

**Governance – ownership remains an issue**

In general, European DFIs and facilities do not have participatory governance structures in which governments and citizens from developing countries can contribute to the decisions being adopted and hold European donors to account. This can represent an obstacle to achieving the levels of ownership and accountability required by the Paris Declaration. Beneficiary countries do not participate in the governance structures of European MDBs, bilateral DFIs and ECAs, and European DFIs and facilities lack formal mechanisms to ensure that private sector projects in developing countries respond to national development strategies. This is also the case for the EU and EIB blending facilities, with the
exception of the Western Balkan Investment Framework, which requires all projects to have the approval of a national coordination office managed by the government. Major European MDBs and DFIs have some regional offices, which can potentially consult with governments in beneficiary countries, but they are relatively small, cover a relatively large number of countries have many other activities in addition to communicating with local partners. For example, the EIB only has nine offices covering the whole world.

Standards: to minimise harm and promote good

Environmental, social, and fiduciary standards, which set minimum conditions and methods of measuring performance, play a number of key roles.

- **Prevention**: minimum procedures and standards help to prevent and mitigate harm.
- **Decision**: a reference to compare projects and take funding decisions.
- **Steering**: standards help to ensure that projects respond to the mandate of the institution and help steer investments in a given direction. The better aligned a project is with the standards, the greater the chances are that it will be approved.
- **Monitoring and evaluation**: the basis for monitoring and evaluations systems.
- **Accountability**: to monitor compliance and to trigger sanctions in cases of non-compliance. In addition to internal accountability, standards also increase external accountability by providing stakeholders with complaint or grievance mechanisms.

Differences in the standards of European DFIs mean that the performance of projects supported is measured according to different criteria. Although efforts have been made to harmonise standards, there are still important differences in some standards. For example EDFI has promoted among its members the ‘Principles for Responsible Financing of the Association of European Development Finance Institutions (EDFI)’, a voluntary initiative, but many of its members continue to apply additional standards. Some European DFIs such as CDC (UK) and FMO (Netherlands) have also adopted IFC standards as a way of harmonisation.

In the case of ECAs, the OECD is the most important standard-setting body through its Working Party on Export Credits and Credit Guarantees. Social and environmental standards, as well as the monitoring and evaluation approaches, are summarised in its Common Approaches. Though the Common Approaches are fairly comprehensive in their scope, they are voluntary. Pressure for compliance is exerted on member ECAs through peer reviews.

Projects implemented under several EU blending facilities have different leading agencies and thus have to comply with different standards. This can make it difficult to compare projects, especially when it comes to measuring impacts.

Available evidence suggests that European DFIs providing publicly-supported private finance should improve their levels of transparency as well as existing monitoring and evaluations systems, especially when dealing with financial intermediaries. Current transparency levels and monitoring and evaluation systems are not up to the standards European governments have committed to in the aid effectiveness agenda and could sometimes limit the accountability to affected populations and beneficiary governments. Three European DFIs feature in the Aid Transparency Index compiled by Publish What

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18 Social standards must be understood in its wider sense and includes for example labour and development standards, which some literature sometimes address separately.
You Fund. One of them, Germany’s KFW, shows a fair level of transparency, but both the EIB and the EBRD are ranked as poor. More relevant to this report is the fact that all institutions working with the private sector tend to withhold information they deem sensitive from a business perspective, including contracts and all documents produced by the applicants such as impact evaluations.

Investments through financial intermediaries suffer from low transparency, poor monitoring and evaluation mechanisms, and implementation challenges. Information related to the operations of financial intermediaries is generally treated as the property of the intermediary and not disclosed by European MDBs and DFIs. For example it is not possible to know who are the clients of a local bank receiving support from a DFI, though this information can be accessed by the bank. An evaluation of the EIB found that internal evaluations are not conducted in all cases and that the quality of some of them could be improved. An external review of four bilateral DFIs also shows that independent evaluations of their performance are only common in two of the institutions they reviewed. In the case of ECAs, project evaluation is limited in its scope and publicity. Ex-post evaluations are only required for projects with large potential impacts (Category A projects) and, when conducted, reports are not required to be made publicly available and accessible to affected communities. It is also possible to approve projects that fail to meet international standards. In these cases justification is required, but the amount of information that is released can be limited on the grounds of business confidentiality.

The European Bank for Reconstruction and Development found that at least 25% of financial intermediaries did not implement the EBRD’s standards as expected. A more recent report from the EIB also finds important limitations in the monitoring of projects for SMEs channelled through financial intermediaries. An independent evaluation on the IFC’s lending through financial intermediaries found similar challenges.

Macroeconomic risks

All of these instruments involve increased debt levels for the private sector and potential liabilities for governments. Private debt has been the main driver of external debt accumulation in developing countries. Long-term private sector external debt stocks have tripled between 2005 and 2012 from USD 570 billion to USD 1.7 trillion. Private sector debt has often resulted in – or contributed to – debt crisis in developed and developing countries, including Mexico, Thailand, Korea, Malaysia and more recently Greece. These examples show how private sector debt can become a current liability for both developing and donor country governments through mechanisms such as financial sector bailouts or public guarantees for, for example, foreign investment and export credits.

Assessing the risks requires a deep knowledge of the debt situation and financial sector stability of the recipient country. The recent debt crises in Ireland and Greece not only illustrate the links between public and private debt, but also highlight the difficulties in assessing the stability and sustainability of external debt stocks. In general, and especially compared to European countries, the financial architecture of most developing countries is not well equipped for surveillance and control of private debt and in particular highly leveraged financial institutions, which makes them especially vulnerable to debt crisis. It seems therefore reasonable that the promotion of private investment should go hand in hand with institution and capacity building to monitor and regulate private investment and lending.

There are also risks that these instruments, if significantly scaled up, could exacerbate the pro-cyclical nature of private finance flows overall. Net lending to, and FDI and portfolio equity investments in developing countries, are generally pro-cyclical, with large inflows during periods of high growth and outflows during recessions. Cross-border, bank-intermediated private credit flows show a similar
behaviour. This means that investors and lenders restrict the availability of funds in times of crisis, increasing the effort required to implement counter-cyclical policies in developing countries.

Attention needs to be paid to the costs to developing country governments of mechanisms to leverage additional private investment, particularly public-private partnerships (PPPs). As the box below shows, PPPs are by far the most expensive way to fund projects. Equally important, the cost is often non-transparent and not accountable to auditors, parliaments or civil society groups. Similarly, debt sustainability assessments do not currently take account of this cost as these are treated as off-budget transactions, and PPPs have also tended to be very high risk financing.

Unproven development impact

The impact on development of instruments and programmes designed to leverage private finance is unproven. The first problem when measuring the development impact is that there is no common definition and understanding of what development impact means when supporting the private sector, which translates into the lack of a common methodology to measure it. In addition to the challenges of monitoring and evaluation frameworks discussed above, systematic reviews looking at the development impact of publicly supported private flows and public-private partnerships (PPPs; see box 1 for additional background information) have found that comprehensive evaluations are scarce and the methodology is often not robust enough. Existing evaluations tend to focus at the project level and measure aspects such as financial return, taxes paid and direct employment, but they do not generally measure outcome indicators such as income effects or benefits to consumers, nor do they measure impact at regional or national level. Thus, existing evaluations are generally not able to measure spill over effects or the aggregated impact of a certain instrument or a set of projects.

In recent years, initiatives have emerged to harmonize methodologies used to measure the impact of projects designed to support the private sector in developing countries. One of the most important ones is the Standard for Measuring Results Measurement developed by the Donor Committee for Enterprise Development’s (DCED). However, while this approach should contribute to improve the comparability of projects implemented by different institutions, it remains focused at the project level and fail to measure outcomes and spill over effects.

Box 1: Financing infrastructure investment through PPPs

There has been a growing focus on developing countries’ enormous infrastructure needs, estimated from USD 1.1 to 2.3 trillion a year. Despite increases in external public financing flows, and increased domestic borrowing, public financing for infrastructure is acknowledged to be woefully insufficient. As a result, developing countries have increasingly resorted to ‘public-private’ financing partnerships (PPPs) and private financing initiatives. These involve structured financing packages where the private sector is responsible for mobilising the financing for the project, and repays its financing costs either from the revenues created (for example airport landing and passenger fees, road tolls, a share of oil revenues for pipelines) or from future payments from the government (for example for the use of infrastructure provided such as new hospitals). The role of DFIs and donors is to provide guarantees or other facilities to mitigate risk, and to co-finance private funds. PPPs have often been praised as a key means of leveraging private financing to achieve public goals, as in the Commission communication (see section A.4). While PPPs account for only around 2% of non-infrastructure finance, they finance more than a third of infrastructure for International Development Association (IDA) eligible governments.

However, there is rapidly growing evidence that this has proved a very expensive method of financing, and has significantly increased the cost to the public purse. The chart below shows that
PPPs are by far the most expensive way to fund projects, due to, for example, demands from equity funders and other lenders for 20–25% annual returns on even the most bankable projects, costs of up to 10% for arranging the financing. In addition, project costs are often much higher due to limited competition or poor procurement by the private sector.

Equally important, this cost is often non-transparent and not accountable to auditors, parliaments or civil societies. Similarly, debt sustainability assessments do not currently take account of this cost as these are treated as off-budget transactions, thus perversely encouraging countries to use them in order to circumvent national or IMF agreed debt limits.

PPPs have also tended to be very high risk financing. Evidence from developed countries is that 25–35% of such projects fail to deliver projects as planned due to cost overruns, implementation delays or poor work specifications and bankruptcy or failure to repay financing. In developing countries with lower negotiation/management capacity, failure rates have been even higher. For these reasons and other concerns, LIC governments have expressed strong preferences for types of infrastructure financing other than public-private partnerships (OIF 2013).
4. **EUROPEAN POLICY REFORM TO IMPROVE PRIVATE INVESTMENT**

This chapter highlights the key role that policy reform at European level can have in improving developing countries’ ability to increase, improve and direct development finance. Critical issues include improving investment treaties, which have imposed significant costs on developing countries, tackling illicit financial flows, tax evasion and tax avoidance and promoting responsible financing standards.

International frameworks and treaties considerably affect the ability of developing countries to make the most of private investment. In 2012 there were 3,196 investment treaties globally, many of them affecting developing countries. There are also important investment chapters in free trade agreements. While these treaties and agreements are supposed to both protect foreign investors and benefit recipient countries, the growing number of investment disputes and ‘persistent concerns about the [investment arbitration] regime’s systemic deficiencies’ indicate that the balance may be tilted against developing countries. 2012 saw the highest number of international claims filed against states by foreign companies, with 66% filed against developing countries.

As the inter-governmental thinktank, the South Centre, has noted, the treaties often suffer from a number of problems that discriminate against developing country governments, including vague definitions of key terms such as ‘investment’ and ‘fair and equitable treatment’ that can make it impossible to make investors comply with domestic laws. In practice, these treaties and agreements can make it harder for developing countries to maximise the benefits of the FDI, for example by restricting their ability to require technology transfer or employment of local staff. They may also restrict the ability of governments to prevent ‘hot money’ outflows from destabilising their economies. As the EU moves increasingly towards a regional model for negotiating investment treaties, it will be crucial to strengthen both the development dimension of the EU’s policy towards investment treaties, and also developing countries’ negotiating capacity. As a recent study commissioned by the UK government has highlighted, treaties can have costs and benefits, and the evidence assessing these is so far very limited.

European policies and laws have significant global impacts, for example in terms of helping tackle tax avoidance and evasion by private companies. Given the scale of losses to developing countries through illicit financial flows noted in chapter 1, the EC communication on financing for development rightly notes that it will be crucial to ‘require transparency of the financial sector and multinational enterprises in key sectors […] through rules on illicit flows, country-by-country reporting, increased fiscal transparency and exchange of information.’ This transparency is a vital first step in preventing tax evasion and reducing tax avoidance, which also have considerable costs for the EU.

However, implementation in these areas in the EU still lags behind the commitments made in international forums such as the G8 and G20 and in Europe. For example, although country-by-country reporting has been legislated for the banking sector, plans to implement it across all sectors were pushed back by the Council at the end of last year, leaving hopes resting with the new Commission and Parliament after this year’s elections. Efforts to ensure public registries of the real or ‘beneficial’ owner of all European companies have been supported by the European Parliament as part of the review of the anti-money laundering directive. Discussions on automatic exchange of tax information are progressing within the EU but without taking into consideration specific requirements for developing countries.

Given the scale of external lending to developing countries, the poor debt situation in several, and the continued fragility of the global financial system, the time is ripe to make substantive progress on
developing fair and independent debt workout mechanisms. We have seen that short-term and long-term debt, taken together, are the largest inflow into developing countries, and that 26 face debt repayments of over 5% of GDP. Perhaps the main positive modern experience of debt workout was the 1953 London Debt Agreement, which dealt with Germany’s debts. This helped set the German economy on a new path towards economic transformation, by stipulating that debt repayments would be linked to the existence of German trade surpluses, allowing for recourse to arbitration, and being comprehensive, including most types of claims on the German economy.109 Unfortunately, recent debt reduction schemes such as the Heavily Indebted Poor Countries initiative have not been so positive, as they have been creditor led without sufficient space for debtors to negotiate as equals. This has meant that they have often taken a long time to resolve – prolonging crises – and have not always resulted in a sustainable debt situation at the end.110 No mechanisms currently exist for dealing with unsustainable debt levels in developing countries. The best recent alternatives have so far been limited to one country. On the creditor side, Norway took co-responsibility for failed development projects and unilaterally cancelled USD 80 million of debts owed by Egypt, Ecuador, Peru, Jamaica and Sierra Leone in 2007.111 On the debtor side, Ecuador set up an independent commission to audit its debt.112 However such unilateral moves are potentially risky in the absence of any collective framework.

The problem is potentially far more serious than the debt levels of individual countries, given that debt problems in developed countries – both public and private sector – can have significant impacts for developing countries and the stability of the global economy. A recent US court ruling in favour of two vulture funds led the IMF to note that this ‘litigation against Argentina could have pervasive implications for future sovereign debt restructurings by increasing leverage of holdout creditors’.

The UN has recently formed an expert group on debt workout mechanisms,113 which should be supported, and proposals for creating such a mechanism fast-tracked to the top of the international agenda. Such mechanisms should be: staffed by independent arbitrators and housed in a neutral institution independent of creditors; allow both borrowers and lenders to initiate proceedings, including in cases of illegitimate debt; be transparent and allow the participation of all stakeholders; and have strong enforcement mechanisms.

Debt audits provide a practical means to determine whether debts are in fact illegitimate and should be cancelled. For example, the Norwegian government commissioned Deloitte to closely examined 33 concessional trade credit agreements from 1970–2000 in order to assess whether they were in compliance with national guidelines and the newly established United Nations Conference on Trade and Development (UNCTAD) Principles to Promote Responsible Sovereign Lending and Borrowing.114

The domestic policy framework in developing countries is critical to improving the quantity and quality of private investment, and international institutions over which the EU has considerable influence can significantly affect developing country decision making in this area. In the case of FDI, in 2012 Unctad launched an ‘FDI contribution index’, which shows that the value of FDI varies considerably across countries. Emerging market countries such as Argentina, Brazil, China, Indonesia and South Africa do particularly well, and Unctad notes that, ‘In some cases this may be due to active investment policymaking; for example, channelling investment to specific higher-impact industries.’ However, this kind of active, pro-investment policy making has been frowned upon in recent decades by the IMF and World Bank who exert significant policy influence in developing countries, particularly during times of crisis. One key example is the World Bank’s Doing Business report which ranks countries according to the ‘ease’ of doing business, defined as having lower levels of regulation. While many of the indicators in the report are important, the notion that reducing regulatory red tape is automatically good for
business was shown to be problematic when the World Bank was forced to withdraw its employing workers indicator, which favoured lowering employment rights for workers. The paying taxes indicator has also been criticised for automatically favouring lower taxes. A more sensible approach to supporting private business investment would be to heed the results of a recent IMF study which found that ‘taxation is not a significant driver for the location of foreign firms in SSA [sub-Saharan Africa], while other investment climate factors, such as infrastructure, human capital, and institutions, are.’ This confirms the perspective that supporting sustainable investment in infrastructure and public services would be a far better focus for international institutions than trying to develop blueprints for domestic policy reform.

Responsible financing frameworks provide an elegant solution to how to maximise the value of European investment overseas, but more work is needed, particularly in implementation. The main international initiatives and proposed frameworks are summarised in the table below, though most of them refer to only some of the issues covered in this report, and several are weak in their specifics. In addition they all suffer from a significant implementation gap – with no effective enforcement mechanisms and weak incentives for compliance. There are also often weaknesses in monitoring implementation. This is an area where the EU could exercise global leadership by developing and adopting a clear framework that draws together the existing standards, including those listed below for EU companies operating overseas, identifies and fills in gaps, and strengthens the mechanisms and incentives for compliance.

### Table 2: Responsible Finance standards: main existing instruments and proposals

<table>
<thead>
<tr>
<th>Institution - Instrument</th>
<th>Year</th>
<th>Scope</th>
</tr>
</thead>
<tbody>
<tr>
<td>UNEP – Principles for Responsible Investment (PRI)</td>
<td>2006</td>
<td>Developed by institutional investors. ‘Voluntary and aspirational’.</td>
</tr>
<tr>
<td>OECD Guidelines for Multinational Enterprises</td>
<td>2011</td>
<td>Voluntary guidelines. Cover ‘employment and industrial relations, human rights, environment, information disclosure, combating bribery, consumer interests, science and technology, competition, and taxation.’</td>
</tr>
<tr>
<td>Eurodad Responsible Finance Charter</td>
<td>2011</td>
<td>Covers: technical and legal terms, protection of human rights and environment, development effectiveness, taxation, procurement, consent and transparency and disputes settlement.</td>
</tr>
<tr>
<td>UNCTAD Investment policy framework for sustainable development</td>
<td>2012</td>
<td>11 ‘core principles’ to guide investment policy making.</td>
</tr>
<tr>
<td>UNCTAD Principles on Responsible Sovereign Lending and Borrowing</td>
<td>2012</td>
<td>Covers only borrowing by governments – part of this will be from private sector.</td>
</tr>
<tr>
<td>G20/OECD High level principles of long-term investment financing by institutional investors</td>
<td>2013</td>
<td>Guidance for governments and international institutions on promoting long term investment.</td>
</tr>
<tr>
<td>IFC – Equator principles</td>
<td>2013</td>
<td>Banks, based on IFC performance standards. ‘Do no harm’ approach.</td>
</tr>
</tbody>
</table>
5. CONCLUSIONS AND RECOMMENDATIONS

A comprehensive examination of all development financing sources shows the critical role that domestic resources, particularly government spending, play in developing countries. Unfortunately, developing country efforts to mobilise resources are undermined by significant outflows, particularly debt repayments and illicit financial flows. Private resources are important, but the data on them is poor, and FDI figures greatly overstate the real inflows associated. ODA remains a crucial resource in the poorest countries.

The European Commission’s promotion of using public resources to leverage private finance does not recognise the key roles played by public finance that cannot easily be substituted by private finance. These include ensuring universal access to public services, protecting global public goods, responding to crises and targeting the poorest countries. Policy makers seeking to maximise the role that external private finance can play in development must recognise that it predominantly flows towards higher income countries, suffers from problems of volatility and pro-cyclicality, and has proved difficult to target to MSMEs.

Efforts to incentivise or subsidise increased private investment in developing countries have confirmed some of these concerns and identified a number of additional problems, including: difficulties in targeting MSMEs; a lack of proven additionality and leverage; poor transparency and accountability; little developing country ownership; and increased debt risks.

Therefore it would be more sensible for post-2015 discussions to focus on how international public flows can help reduce the barriers to private sector investment, through investing in essential services, such as health and education, and infrastructure. The issue of how public regulation, incentives and subsidies can be used to direct, increase and improve private investment would be better resolved at the national level, rather than by focussing on the limited role of development finance institutions, or promoting greater use of blending mechanisms to leverage private finance.

A far better contribution for the EU, and other developed economies, would be to alter their policies and practices that can hinder domestic investment in developing countries, including by having a strong development dimension to investment treaties, tackling illicit financial flows, supporting debt workout mechanisms and debt audits and showing leadership on responsible financing standards.

Both public and private finance have a vital role to play in post-2015 efforts to end global poverty. The EU can make the greatest contribution by recognising the different roles each can play, and changing European policies that can hinder developing countries’ efforts to increase, direct and improve development financing.

Therefore, we recommend the following concrete steps for the EU, which the Parliament can support:

- **Focus efforts to support private investment in developing countries on changing the EU policies that hinder this.** The acid test will be whether commitments to tackle tax evasion and avoidance – and hence maximise corporate tax payments in developing countries, which are the sources of resources and profits – will be honoured. For example, the Council should support the European Parliament’s proposal for public registries of beneficial owners of companies, trusts and other legal mechanisms.
Support systemic reforms to make the global financial system work better for development, including fair and transparent debt workout mechanisms. The EU, currently facing its own debt crisis has a vested interest in such reforms, which would benefit all countries. The European Parliament could lead the way through a parliamentary initiative that produces its own proposals for how to take this agenda forward, liaising with UNCTAD’s expert group on this issue.

Provide more international public finance for development including by meeting the 0.7% ODA target, while radically improving the effectiveness of EU aid. In addition to implementing existing aid and development effectiveness commitments and supporting the GPEDC, one key mechanism to do this is through tightening the definition of ODA to exclude items such as in-donor refugee and education costs, and by ending formally and informally tied aid. This is currently being discussed at the OECD DAC, but without sufficient input from developing country governments and stakeholders, or from parliaments. This paper has not covered innovative financing mechanisms in detail, but it is worth noting that one key test will be for the 11 European countries currently defining a financial transactions tax to ensure that it is introduced as soon as possible, has the broadest possible scope in terms of transactions covered, and that the maximum possible share of its revenues are allocated to supporting international development.

Ensure EU aid flows for the private sector are country owned and predominantly directed at reducing the barriers to private sector investment, through investing in essential services rather than promoting greater use of blending mechanisms to leverage private finance. Investments in health, education and infrastructure remain important barriers to private sector growth in developing countries. The issue of how public regulation, incentives and subsidies can be used to direct, increase and improve private investment are best resolved at the national level. This means that the Parliament should continue to question the Commission’s desire to use large quantities of ODA to support private blending, and demand that no further action is taken without significantly improved evidence of the positive development impact of private blending. It should also insist on a full assessment of the impacts on traditional aid priorities of the diversion of funds to these modalities.
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For more information, see: or more information see: [http://www.wbif.eu/Project+application+and+selection](http://www.wbif.eu/Project+application+and+selection)


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