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Financing the 2030 Agenda for Sustainable Development

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Chapter 11

Financing the Post-2015 Sustainable Development Agenda

11

Financing the Post-2015 Sustainable Development Agenda

Tancrède Voituriez, Kanako Morita, Thierry Giordano, Noura Bakkour, and Noriko Shimizu

In March 2002, the Monterrey Conference on Financing for Development called for greater mobilization of private finance to support poverty reduction through economic growth and job creation (UNGA 2002). In September of that same year, at the Johannesburg Summit on Sustainable Development, the UN Secretary-General launched what was supposed to boost private-sector involvement in developing countries: the so-called “Type II outcomes” or “partnerships,” consisting of a series of commitments and action-oriented coalitions. The follow-up, however, has been quite disappointing (Ramstein 2012). Although evidence of such mobilization has so far been scarce, the Addis Ababa Action Agenda of the Third International Conference on Financing for Development strongly emphasizes the need to mobilize domestic and international private finance for sustainable development (UNGA 2015). In this chapter, we explain why crowding in private finance is now an unavoidable component when designing financing for global development agreements. After looking at investment needs (section 1), new blending finance facilities (section 2), and public-private partnerships (section 3), we highlight the need and opportunities for financial partners to bend their learning curve, particularly with respect to successfully mobilizing private sector investment (section 4). We then examine policy implications and look at possible donor interventions that could help narrow the gap between the high expectations placed on public-

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private partnerships and what they actually achieve (section 5). We conclude with our key messages.

Unprecedented Investment Needs

It is hardly surprising that integrating the Millennium Development Goals, launched in 2000, into a new and broader set of Sustainable Development Goals will push up the overall cost of achieving these. The Sustainable Development Goals cover many more topics than the Millennium Development Goals, and they are more ambitious—targeting, for example, “zero poverty” and “zero hunger”—and placed within a universal perspective.

This widening of the development agenda raises specific questions on implementation, particularly in the area of funding. The UN Intergovernmental Committee of Experts on Sustainable Development Financing examined this issue and drew up an inventory of funding needs and sources (UNGA 2014a). This review of the investment needed to tackle climate change and broader sustainable development issues was fine-tuned by the Sustainable Development Solutions Network a few months ahead of the Third International Conference on Financing for Development in Addis Ababa (SDSN 2014).

The UN Intergovernmental Committee of Experts on Sustainable Development Financing has evaluated the financing needs at US\$35–195 billion per year to eradicate extreme poverty, and US\$5–7 trillion to cover investment needs in infrastructure, with an additional US\$2.5–3.5 trillion to develop small and medium enterprises (UNGA 2014a, 10). In the energy sector, the International Energy Agency estimates that US\$48 trillion global investment is required to meet projected energy demand between now and 2035. In the low-carbon 2-degree scenario, total investment needs of the energy sector are projected to be US\$53 trillion, which is 10% up on the business-as-usual scenario. Across the economy, the

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Global Commission on Economy and Climate estimates that in a low-carbon scenario, infrastructure requirements would be around US\$90 trillion between 2015 and 2030 (New Climate Economy 2014). Interestingly, this is “only” US\$4 trillion more than investment needs under the business-as-usual scenario, partly due to spillovers in cost savings across sectors and technologies. While the exact numbers will depend on GDP and population growth rates as well as technological developments, both estimates suggest that investment shifts will need to be substantially larger than incremental investments.

Estimates of the order of magnitude given in the literature and compiled by the Intergovernmental Committee of Experts on Sustainable Development Financing show that the annual requirements are at least 20 times higher than the annual official development assistance, which reached a record level in 2013 of around US\$134 billion. This official development assistance will grow only slightly—due to present and future burdens on donor country public finances—and will never match the financing needs in the broadest sense. It is possible that the announcement of the new Sustainable Development Goals will kick-start mobilization—as was the case between 2000 and 2005 following the launch of the Millennium Development Goals and the implementation of the Heavily Indebted Poor Countries initiative—but it seems unlikely to incite a bifurcation or sea change in the long-term trend of net official development assistance, which follows a very steady trajectory.

The bulk of the additional funds required to cover the financing needs of the 2030 Agenda for Sustainable Development must therefore come from other sources of long-term financing—for example institutional investors such as pension funds, insurance companies, and sovereign wealth funds. The Intergovernmental Committee of Experts on Sustainable Development Financing has stated that public and private savings amount to US\$22 trillion, and financial assets US\$218 trillion. Reallocating some of these resources would theoretically

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cover all of the estimated needs (UNGA 2014a, 11). The United Nations estimates that institutional investors alone hold financial assets worth US\$75–85 trillion. Pension funds, life insurance companies, and sovereign wealth funds (together holding US\$60 trillion in assets) have financial tools (long-term liabilities) that are compatible with the long-term horizon required for some investments in the 2030 Agenda for Sustainable Development (UNGA 2014a). As highlighted in the UN report on the implementation of the Monterrey Consensus and the Doha Declaration (UNGA 2014b), these “long-term investors today do not invest enough in the long-term direct investment necessary for sustainable development, both in developing countries and rich countries—regardless of the institutional and regulatory framework” (UNGA 2014b, 7). Leveraging private investment with a limited amount of official development assistance—or “doing more with less”—is the core principle of blending, which we discuss next.

New Blending Facilities

The definitions of “blending” or “blended finance” differ across institutions (UNGA 2014a). One approach distinguishes between sources of financing on the basis of their institutional nature: blending thus corresponds to a mixture of public and private funding. This approach, however, is often misleading. Public funding is not channeled through grants alone. For instance, part of France’s official development assistance is financed through loans, which are themselves refinanced through private savings on capital markets. Equally, private financing does not always involve loans, as is the case of grants from the Bill and Melinda Gates Foundation, which have nonprofit goals and therefore differ little from official development assistance.

The second approach emphasizes the distinction between the different types of financing instruments: loans, grants, guarantees, and equity investments are combined within the same operation. This makes it possible to establish a blending typology and to identify emerging innovations more precisely, along with their scope and potential application.

In this respect, blending most traditionally involves combining a variety of instruments—basically loans and grants—from a single institution. This type of blending translates into subsidized loans and represents the core business of development finance institutions such as the European Investment Bank, the French Development Agency, and the German development bank KfW.

The second type of blending involves combining funding from financial and nonfinancial partners. This is the model used by the Global Environment Facility, as well as by the eight blending facilities launched by the European Commission in 2007. The EU approach to blending involves using targeted EU grants to mobilize nongrant funding under the lead of a European multilateral (for example, the European Investment Bank) or national finance institution (for example, the French Development Agency or the German KfW). EU blending comprises direct investment (41%); interest rate subsidy grants (19%); technical assistance (32%); risk capital (4%); and guarantees (3%). Average EU grant size lies in the range of €5–10 million. There are eight EU global facilities involving blending. The sectors covered are mostly energy (35%), transport (26%), water (20%), followed by support for small and medium enterprises (11%) and social (5%) and information and communication technologies (3%). Leveraged resources figures for the EU blending facilities since 2007 show that €1.6 billion of EU grants unlocked €42 billion of additional financing (grants, loans, and investments). Climate change windows in EU blending facilities were announced in 2010. They provide transparent tracking of all climate change–related projects in the EU

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regional blending facilities, as well as the opportunity to draw additional resources for climate change adaptation and mitigation projects. More than €700 million are targeted as “climate finance” in EU blending (European Commission 2013).

In its “Beyond 2015: Toward a Comprehensive and Integrated Approach to Financing Poverty Eradication and Sustainable Development,” released in July 2013, and in its 2012 communication (European Commission 2012), the European Commission proposed a future development financing framework that reinforces the links between public and private finance and domestic and international resources. 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” (European Commission 2013). This explicit linking of the use of public resources to leverage private investment is not a new theme for the commission, as it stands as a key feature of its Agenda for Change policy.

In recent years, most blending operations have provided subsidized loans to the public sector (some 90% of recipient projects target public investment) in developing countries. For the EU 2014–2020 budgetary period, the intention is much more explicitly to use EU aid to subsidize or incentivize private-sector loans—which is tantamount to an admission that this was not previously the case. In the 2013 communication, the European Commission thus argued that the “blending of grants with loans and equity, as well as guarantee and risk-sharing mechanisms can catalyze private and public investments, and the European Union is actively pursuing this” (European Commission 2013). While the vast majority of existing blending operations have been in support of the public sector, the European Commission’s plans for the future include a significant scale-up of blended finance for the private sector.

According to the European Commission, the €1.2 billion grant contribution from the EU budget, the European Development Fund, and member governments have leveraged loans of development finance institutions worth €32 billion, unlocking project financing of at least €45 billion, in line with EU policy objectives (European Commission 2013). Two points should be underlined here. Even though development finance institutions borrow on international capital markets to finance their loan, the loan-grant blending facility is a public-public partnership. Secondly, as Bilal and Krätke observe, “estimates on the amount of funding invested in and leveraged through blending facilities vary considerably. The European Investment Bank has noted leverage ratios of eight times the EU budget contribution, whereas the European Commission has noted leverage ratios of up to 31 times. Measures of leverage are also unclear, notably confusing the grant-to-loan-component ratio with the grant-to-total-cost ratio” (Bilal and Krätke 2013, 2).

The European Commission’s position on blending contrasts with the more cautious, evidence-based approach promoted by the European Parliament, whose June 2013 Resolution on Financing for Development called on the European Union “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” (European Commission 2013). In their study “Financing for Development Post-2015: Improving the Contribution of Private Finance,” commissioned by the European Parliament’s Committee on Development, Griffiths, Martin, Pereira, and Strawson stress that “policy makers seeking to maximise the role that private finance can play in development must recognise three key limitations” (2014).

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First, the authors write, private finance flows predominantly toward middle- and high-income countries—a point flagged already in 1990 by Lucas (1990). Second, in developing countries the private sector is dominated by micro, small, and medium enterprises that find it particularly difficult to access external private financing sources. Close to 80% of these operate in the informal economy, which not only reduces the government's tax base and impacts decent working practices, but also constitutes a major obstacle for both enterprises and individuals to access finance, insurance, social safety nets, and formal-sector business opportunities. Finally, the incentives for the private sector to invest in the protection and provision of public goods are limited, since these are by definition non-rivalrous and non-excludable. The World Bank estimates that over the last decade 80–85% of all infrastructure investments in developing countries have been funded by the public sector (World Bank 2014).

Revisiting the Case of Public-Private Partnerships

Public-private partnerships might be a solution in this situation. A public-private partnership is a contract drawn up between public and private entities to mitigate the level of risk-taking for all parties and create a win-win situation: The public entity can trigger the most needed investments despite an eventual lack of funding; the private entity can expand its business by building and operating the required infrastructure while benefiting from more effective risk-sharing. It could be tempting to replicate these public-private partnerships in poor countries for the obvious reason that public finance, although scarce, remains the main source of funding and that it would be more efficient to use these funds to leverage private finance instead of replacing it. Yet is this really a viable option, given that most investment in poor

countries is characterized by its lumpiness, on the one hand, and the long maturity and low liquidity of most assets on the other?

A first strand of the literature attempts to craft the main features of public-private partnerships into a feasible mechanism for developing countries. Yet, so far, project evaluations show that successes have been few and far between, both in terms of the amount of private funding raised and the projects' impacts on growth, employment, and poverty alleviation (Griffiths, Martin, Pereira, and Strawson 2014). These findings have opened avenues to explore new or unconventional public-private partnerships in very different economic and social sectors (Chattopadhyay and Batista 2014; Hossain and Ahmed 2014). However, these more innovative public-private partnerships do not seem as yet to attain the scale and role played by public-private partnerships in developed or emerging countries.

Drawing lessons on past experiences, a second strand focuses on the conditions required to develop public-private partnerships and ensure they deliver their intended economic and social outcomes (Trebilcock and Rosenstock 2015). One drawback is that most past experiences are from emerging and developed countries. As a result, new outcome-based mechanisms have been developed to reinforce the social impacts of public-private partnerships and balance the risk/profit trade-offs for private investors (for example, development impact bonds). While very promising, these improvements are of little direct help to poor countries. Although they restore the development impact of public-private partnerships, they fail to reinforce their applicability to poor countries, given that the credit risk for the private sector is still excessively high.

A third strand of the literature points out the possibility of blending public and private finance in different ways, driven by the development of additional, innovative sources of finance. For example, over the past few years, many developing countries have accessed

international capital markets for the first time. Government debt thus constitutes a “new” source of public finance, offering the possibility of developing innovative blending mechanisms that combine government debt, donor facilities (grants or concessional loans), and private finance. The question is whether blended finance can have a strong enough impact on public and private risk- and responsibility-sharing to incentivize debt holders, equity holders, governments, and guarantee providers to agree on new modalities for doing business in poor countries.

In their analysis of how government intervention has evolved against the backdrop of the financial crisis and the related constraints on the supply of capital, [Hellowell, Vecchi, and Caselli \(2015, 74\)](#) identify five categories of state intervention recently used to stimulate public-private partnerships. Since developing countries face exactly the same constraints on a permanent basis, not only during crises, it would be useful to assess the extent to which blended finance actually matches these same solutions.

The first category relates to projects where the private operator’s revenue depends on user payments. The state entity commits to make scheduled debt repayments to lenders should the private operator default. This means that lenders bear only the construction risks. In poor countries, this kind of state guarantee is undermined by low levels of public resources, weak governance, and high political risks. As the state is ill-equipped to act as the insurer of last resort, this responsibility must necessarily be assumed by another actor.

On very similar lines, the second option also deals with the mitigation of credit risks, but instead of relying on a direct state guarantee, capital is set aside beforehand to provide an indirect credit guarantee through subordinated debt. This debt is only used by the private operator in the event that he has difficulty in paying off the senior debt. The state entity is endowed with sufficient capital to significantly improve credit quality. This mechanism aims

at crowding in long-term investors. However, state entities in many developing countries have been poorly managed, and their credit rating is no better than that of the state itself, which of course detracts from the reliability of this type of mechanism. This means that an external actor with a good credit rating will need to provide this subordinated debt in order to ensure credit quality.

A third category of intervention involves changing a project's capital structure. This requires the private operator to increase its equity share in the project so as to limit its debt exposure and strengthen its capacity to cope with cash-flow fluctuations. This option might be limited in poor countries, where raising equity capital is already a hugely difficult challenge. Alternatively, a higher share of government equity capital would lower the credit risk. Government equity is supposed to increase the transparency of the contract, but poor governance in most countries makes government equity unlikely to enhance contract transparency; quite the reverse.

A fourth option targets the refinancing of the loan at maturity. Providing a refinancing guarantee makes it possible to have shorter tenors. It makes the initial project more affordable, a serious advantage in developing countries where the capacity to pay is often rather low. However, the same cautiousness as before applies here, since a developing state can hardly act as a guarantor.

The last option involves a very different mechanism: substituting public debt capital for private finance through a public entity. This entity, most often a state infrastructure bank, becomes the lender to the private operator, with guarantees from insurers and banks. Rather than playing on loan terms and conditions, the purpose here is to overcome initial liquidity constraints to make sure that the project actually takes off. Financing is provided at market rates, as the state bank needs sufficient returns on investment to operate its business. In

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developing countries, this type of public entity would most likely benefit from state guarantees rather than insurance or bank guarantees, but this would deprive the mechanism of its risk-sharing advantage, as the state would be the sole risk-bearer.

The above options fit nicely into the context of developed economies, but replicating them in poor economies is difficult to envisage, chiefly because the state is required to play a central role in providing capital or guarantees. In either case, developing countries are too hard-pressed to assume such a role due to the lack, and sometimes misuse, of public funds. If public-private partnerships are to gain ground, other actors must take over.

Bending the Learning Curve

How can resources, then, be better mobilized to narrow the funding gap? While many potential new sources of capital and expertise remain untapped (insurers, pension funds, and so forth), innovative financing for the development market is still very conservative, with roughly two-thirds of initiatives based on conventional bonds and guarantees (Dalberg 2014). Should we be scaling and replicating these “tried and tested” instruments rather than designing bespoke pilot solutions? The cost of gathering on-the-ground results and historical performance data means that investors face uncertain and often complex risk profiles, and therefore demand high returns (Dalberg 2014). Here, the well-known effect of endogenous risk appears to kick in: The fewer the track records and metrics, the higher the perceived risk, which naturally discourages new initiatives and further reduces the number of available track records and metrics, and so on. Breaking out of this vicious circle necessarily means changing how the actors perceive the risks involved by deepening their understanding of how this risk can be shared or transferred to maximize economic and noneconomic returns—which all entails substantial transaction and research costs.

Donors, international financial institutions, development finance institutions, and philanthropists have all developed initiatives to entice private operators into working in poor countries where the needs are huge but business conditions uninviting.

Donors' interventions to support public-private partnerships can be clustered into three broad categories. The first relates to enhancing the public finance capacities of poor states, and indirectly to improving their business environment. A wide range of measures can be included in this category, all pertaining to conventional official development assistance operations. Some are crucial to enable private actors to operate: building and strengthening institutions; laws and regulations conducive to private initiative; supporting social (such as education, health, and sanitation) and economic (such as energy, transport, and banking) services provision; and incentivizing the development of a transparent, stable, and predictable investment climate. Unfortunately, the transformative effects of such measures are still too slow and weak to have had significant impact on private investment. As for foreign direct investment, this has indeed increased over recent decades, but with many disparities between sectors and countries. Some suggest that this "old official development assistance model" is dead and unable to deliver, calling on donors to change their modus operandi and focus instead on supporting public-private partnerships (Simon, Schellekens, and de Groot 2014).

A second set of measures targets public-private partnerships directly. It seeks to facilitate the intervention of private operators through the provision of guarantees and insurance. Despite many experiences in this field, the level of investment remains low and reveals the donors' lack of appetite for risk—even though this should be their core business—as more commitments would probably imply more risks and more failures. The third set of measures focuses on the outcomes of private interventions and on what boils down to development impact investment (Dalberg 2014).

The 2014 Dalberg report emphasizes that the focus of innovative financing (blending and public-private partnerships included) is shifting from the mobilization of resources through innovative fundraising approaches to the delivery of positive social and environmental outcomes through market-based instruments. It anticipates three primary drivers of growth in the innovative financing sector, which could all bend the learning curve and narrow the gap between expectations from blending and public-private partnerships and their achievements:

- i) Increased use of established financial instruments. These instruments, such as green bonds, which investors can evaluate through existing risk frameworks, will attract new participants, including pension funds and institutional investors. Channeling the proceeds of these instruments to productive development goals will require new standards that specify how funds can be used most effectively.
- ii) Expansion into new markets through growth of replicable products. Over the past 10 years, the international development community has experimented with new instruments, such as performance-based contracts. These instruments do not yet have the track record to attract institutional investors, but offer promising opportunities to improve development outcomes in new sectors.
- iii) Creation of new innovative financing products. We are seeing the emergence of new products that are promising on paper but have not yet demonstrated results. While these products will represent a small fraction of the market in the short term, Dalberg encourages donor governments and other funders to continue experimenting with them so they can mature into the next important asset class (Dalberg 2014).

As Dalberg (2014) contends, blending has brighter perspectives today than in the past and, as a result, may well enjoy fresh momentum. What still needs to be set up is a carefully

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designed public policy framework enabling blending and public-private partnerships to meet expectations and enhance the implementation of Sustainable Development Goals. We address this issue in the following section.

Policy Implications

Skeptics will doubtless point out that UN files are already crammed full of texts, treaties, and conventions that, if taken as a whole, cover the three dimensions of sustainable development—economic, social, and environmental. Indeed, it can be legitimately asked what added value the Sustainable Development Goals can bring to this maze of texts.

“If we are serious about implementation, then the bulk of the work will have to be done back at home,” comments Csaba Kőrösi, the vice-chair of the Open Working Group on Sustainable Development Goals. He further adds:

Even though the General Assembly has adopted the Open Working Group’s report with its goals and targets, ensuring that it will become a vital part of future negotiations, this in itself will not generate a movement of capital and knowledge. Only national and local plans and projects can achieve this redirection of funds. Banks and institutions will not finance the Sustainable Development Goals; finances and other implementation means will be targeted at actual, tangible projects. On this aspect, there is still much work to be done. Sustainable Development Goals are in place, but most countries do not have national plans and there is certainly a lack of projects (Kőrösi 2015).

Between global talks at UN headquarters and direct online consultations of world citizens, as in the MyWorld initiative, there is a missing middle: country-level initiatives and appropriation.

One way to foster this national appropriation and bridge the sustainable development implementation gap would be to develop different forward-looking scenarios of potential development paths for 2030 at national and regional levels. These forward-looking exercises are ongoing in some countries with respect to climate change and energy and agriculture.¹ They could be generalized to other Sustainable Development Goals² and lead to the formalization of what would be equivalent to intended nationally determined contributions applied to a dashboard of country-relevant Sustainable Development Goals.

On the funding side, what will make (sustainable) development finance transformative? Talks on development and climate financing strongly emphasize the need to mobilize new or additional resources to bridge the gaps in the estimated trillion-dollar figures required to attain the Sustainable Development Goals. It is implicitly assumed that the transformation will stem from “more” money to start with, to be raised by leveraging private finance through public funding through blending and public-private partnership mechanisms. There seems to be a consensus among practitioners that if co-benefits and trade-offs between climate and development priorities are managed together, the effectiveness of both climate and development finance would improve, and the trade-offs would fall into line with the transformative ambition of the Sustainable Development Goals. One possible storyline would be that development finance and the blending and public-private partnership mechanisms discussed in this chapter should be simultaneously climate-proofed and scaled up. Certainly, a critical step forward would be to design national investment plans as an equivalent of the intended nationally determined contributions, as they are known from climate governance.

Lastly, it is very likely that Sustainable Development Goals and countries will not receive their fair share of the capital available worldwide. Hence the need to place greater emphasis on the access to and dynamics of financing, and particularly on the question of who

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is the final payer: the taxpayer or the consumer? The taxpayer from the North or the South? Is it the rich consumer or the poor consumer? Funding for Sustainable Development Goals in the long term is comparable to the issuance of a debt for which the underwriters and the schedule must be defined at the outset. Otherwise, the financing package will not be *sustainable*, neither environmentally nor financially.

Conclusion

Financing for development and climate financing negotiations place great emphasis on the mobilization of new and additional resources to bridge the gaps with the trillion-dollar estimated needs to achieve the Sustainable Development Goals. We have tried to explain in this chapter why blending and public-private partnerships continue to have a high profile among development finance institutions in spite of their limited track records. First, the magnitude of the financing needs for Sustainable Development Goals calls into question the role of official development assistance and requires unprecedented financing flows. Second, development finance institutions have been exploring new blending facilities over the last eight years, switching their focus from new financing instruments to risk sharing among new partners. The diversity of financing needs for Sustainable Development Goals questions the metrics and value of perceived risk and calls for further experimentation—which blending and public-private partnerships can offer. Last, bending the learning curve with scalable multi-partner pilot projects paves the way to more blending and public-private partnerships. It is worth recalling, however, that Sustainable Development Goals and countries will not receive fair shares of the capital available worldwide. Evidence suggests that blending and public-private partnerships could increase the inequality of global capital allocation across countries and sectors if historical trends and risk-sharing practices continue unchanged. Our

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suggestion that countries should establish intended nationally determined contributions would provide a way of reducing risk for private investors and bringing more fairness into the allocation of blended public and private flows.

Notes

1. See the Deep Decarbonization Pathways Project at <http://unsdsn.org/what-we-do/deep-decarbonization-pathways/>.
2. See <http://unsdsn.org/news/2015/03/13/the-world-in-2050-pathways-towards-a-sustainable-future/>.

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