Deutsches Institut für Entwicklungspolitik
German Development Institute
d·i·e

Briefing Paper 22/2013

Post 2015: Why the Development Finance Debate Needs to Make the Move from Quantity to Quality

Summary

The implementation of a future global development agenda with a broader set of goals replacing the Millennium Development Goals (MDGs) after 2015 will require greater and more efficient financing. The failure to establish a sound financial foundation risks jeopardising the success of any new development agenda right from the start. Although an intergovernmental Expert Committee on Sustainable Development Financing has been established, more high-level political dialogue on the means to implement the post-2015 agenda is needed. If the international community does not succeed in advancing this discourse properly, there is a risk of having "too little finance, too late".

In the current environment of fiscal constraints in donor countries, it is unlikely that additional financial resources can be mobilised solely through aid. Hence, other sources of financing and new financing mechanisms will have to be brought in to bridge the funding gap. Whether private or public, domestic or foreign, each financing source and funding mechanism has unique characteristics that have to be carefully adapted to local contexts. This briefing paper looks at specific examples – taxes, South-South cooperation, aid and innovative financing mechanisms – to explore ways to move beyond quantity, in order to focus on improving the quality of financing.

Increasing the level of domestic resources through taxation is a case in point for illustrating the strengths, limitations and specific conditions of financial resources in the post-2015 debate. More efficient and effective tax systems in developing countries can have positive effects on governance and accountability. At the same time, financial resources that can be collected through taxation will still be limited because tax bases are narrow and the political commitment is lacking. Further, the scope of taxation in developing countries is also affected by international tax regimes, which still fail to curb illicit financial flows and provide windows for tax evasion.

The post-2015 agenda can address such challenges at several levels to make more efficient and effective use of the different resources available. This will require country leaders working together to establish the right policy environment at the national and international levels. For the implementation of a future development agenda, the political and financial processes need to go hand in hand. The international community should consider three important aspects:

1) Using the right tool for the right job: Increasing the efficiency and effectiveness of individual financial flows and financing mechanisms requires careful consideration of respective potentials, limitations and country contexts.

2) Tackling global framework conditions: The post-2015 agenda has the great potential to contribute towards a more stable and equitable financial system, and to improve the coordination of international development cooperation.

3) Putting policies first: Improving the developmental impacts of financial flows requires good policies. A debate on the "means of implementation" for a post-2015 agenda is at least as important as the debate on the content of a future agenda.

Mind the gap: the challenge of increasing development finance in the future

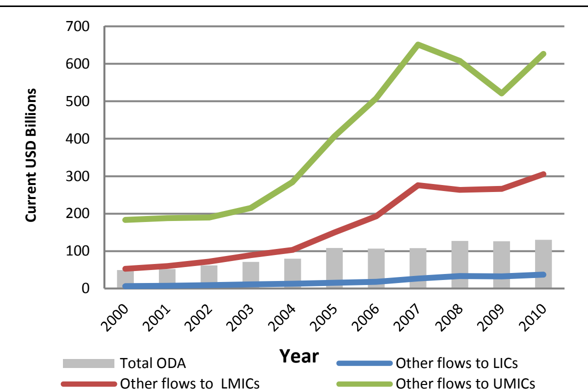
Debates on a future development agenda are increasingly focusing on financing because the needs of development finance beyond 2015 will be substantial. The MDG framework has been facing considerable financing gaps. The Organisation for Economic Cooperation and Development (OECD) estimated in 2012 that around US$ 120 billion would be needed each year until 2015 to reach just the poverty-, education- and health-related MDGs. The post-2015 agenda will combine sustainable development goals with human development goals. Putting more emphasis on issues such as environmental sustainability, productive sector development or the persisting income inequality in developing countries will inevitably be more costly. The World Bank, for example, estimates that until 2050 around US$ 70 to 100 billion a year will be needed just for climate change adaptation in developing countries. In comparison, Official Development Assistance (ODA) in 2012 was only about US$ 126 billion.

Clearly, the estimates on future costs are methodologically problematic because they assume a simplistic link between inputs and development outcomes and neglect, for instance issues such as limited absorption capacities in developing countries, decreasing returns on aid and spillovers between goals. Nevertheless, the above figures present an important message: financial resources are in short supply and financing requirements in the future will be substantial. This raises the question of what to do to collect the necessary financial resources for a new development agenda post 2015.

Looking at the development of external financial flows to developing countries in the past decade shows that external flows increased and became more diversified. But the global financial crisis has created a difficult political and economic environment to mobilise additional resources for development. Foreign Direct Investment (FDI) and portfolio investment benefiting primarily the private sector, for example, increased over the past decade but slumped during the global financial crisis (see Figure 1). This hit Upper-Middle-Income Countries (UMICs) especially hard, since they have been attracting comparatively more investment than Lower-Middle-Income Countries (LMICs) and Low-Income Countries (LICs). The latter are generally struggling to attract investment and, to a large extent, rely on aid financing. Remittances to developing countries have also risen since 2000. Again, UMICs and LMICs have seen much higher inflows than LICs, which are only slowly picking up. Following the crisis dip, however, FDI, portfolio investment and remittances had quickly recovered and reached their pre-crisis levels again by 2010.

For ODA, on the other hand, the trends and predictions are different. Whereas ODA to LMICs and LICs has risen steadily since 2000, ODA to UMICs has remained almost constant. The year 2010, however, marked a turning point. In 2011, ODA disbursements dropped by around 2.7 per cent in real terms – the first time in 15 years that ODA had decreased. Due to the growing fiscal constraints in many donor countries, it is likely that ODA will continue to decrease.

Figure 1: External financial flows (2000–2010)



Source: The authors, based on World Bank (2012). Other external flows include FDI, portfolio investment and remittances.

Comparing the absolute volumes of public and private external flows since 2000, the trends suggest that private external flows such as FDI and remittances are likely to play an important role in financing development beyond 2015. These flows had already surpassed ODA right from the start of the MDG agenda. However, their volatility and lack of predictability and commitment may limit their contribution towards financing development. Moreover, many LICs receive only low levels of investment finance, meaning that ODA will continue to play an important role in these countries.

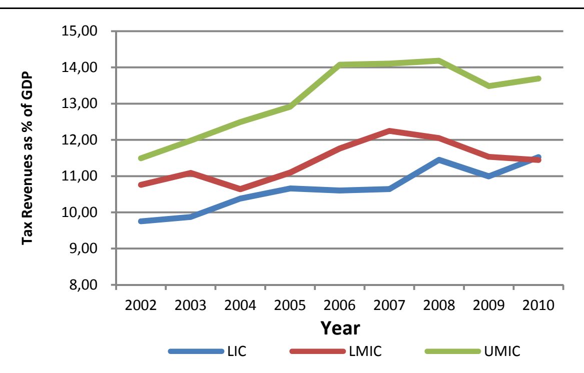
Nevertheless, it seems that ODA offers only limited potential for funding a new development agenda. In drafting a new development agenda, international leaders therefore have to think about innovative means to increase development finance. At the same time, there also needs to be more discourse on how to make more efficient and effective use of available resources.

Looking inside: mobilising domestic resources through taxation

In recent policy discussions about post-2015 financing, taxation has featured prominently in the debate for two main reasons: first, equitable tax systems underpin national development and may have positive effects on governance. Second, taxation provides substantial policy space (i.e. the room for national decision-making) for developing countries. By using tax revenues instead of external sources of finance, countries are becoming less dependent on the interests of external contributors, be they donors or investors.

Both governance effects and policy space may positively affect the effectiveness with which tax revenues are used. However, the volume of revenues that can be collected is limited in many countries, despite the overall increase in the past decade (see Figure 2). Particularly in many LICs and LMICs, the tax base is still low and they have limited potential to collect additional taxes because of their structural characteristics.

Figure 2: Tax revenues as percentage of GDP (2002–2010)



Source: The authors, based on World Bank (2012)

The success of collecting revenues through taxation also depends on local politics and the commitment of political leaders to promote productive investment in order to widen the tax base and to develop equitable and transparent fiscal systems, even when this means challenging powerful political interests.

Furthermore, the international context also plays a crucial role. For example, the absence of an effective international tax regime, among other things, permits ongoing tax evasion by local elites in developing countries and Multinational Corporations (MNCs), thereby limiting the availability of domestic resources for development.

Therefore, to promote domestic resource mobilisation and make more efficient and effective use of the available resources, donor countries should continue to assist the revenue authorities in developing countries to improve their tax capacities. In line with the Policy Coherence for Development (PCD) agenda, it is also necessary to enhance international collaboration to reduce illicit financial flows and limit tax evasion by MNCs and wealthy individuals (von Haldenwang / Kerkow 2013).

Looking outside: developments in external financing

A promising development is the increase in South-South Cooperation (SSC). Rough estimates suggest that emerging economies currently provide about US$ 15 billion in aid each year. But this figure may potentially rise to more than US$ 50 billion by 2025 and thus become a larger source of development finance. Clear estimates are difficult to obtain because aid is only one component of SSC, which often combines loans, grants, investments, trade and technical cooperation.

Despite concerns by traditional donors about weak social, environmental and/or governance standards of individual SSC projects, developing countries show a high demand for SSC. Following the principle of "non-interference", SSC tends to be unconditional on the adoption of policies regarding governance, or economic and institutional reform. Many developing countries appreciate SSC for its investments in infrastructure and productive sector development because it complements the activities of traditional donors, who, since the adoption of the MDGs, have tended to concentrate on social sectors such as health and education.

With the growing importance of SSC, emerging economies are also under pressure to become more active in the international debate on aid coordination and transparency. However, this will also require flexibility from the traditional donors to devise mutually acceptable definitions and approaches to exploit synergies in recording financial flows.

Furthermore, there is scope to increase the impact of ODA leveraging other forms of development finance. Donors are already using innovative financing sources and mechanisms. For example, special purpose bonds and blended finance mechanisms are used to tap capital markets based on donors' strategic use of financial commitments. Their use has increased remarkably in recent years. Both mechanisms have, for instance, been promoted as vehicles for financing renewable energy in developing countries, and are thus expected to contribute to sustainable development in the future.

Yet, like other innovative financing instruments, special purpose bonds and blended finance mechanisms face two important challenges: first, the developmental impact of these mechanisms depends on the country context, and thus on domestic economic and political factors. For instance, the provision of loans – as opposed to grants, as in the case of blending – might be less appropriate in LICs than in MICs. The capacity to repay loans in hard currency is higher in MICs than in LICs, where foreign exchange earnings tend to be limited. Moreover, the quality of governance may affect the potential of aid to promote development, with ODA being more effective in environments with good governance. Second, the purposes for which any one mechanism can be used are limited. For instance, special purpose bonds are best suited for projects requiring a large initial investment with long maturity; blending is suited to projects yielding economic and social benefits and generating a financial return, which, however, is not sufficient to attract non-concessional finance.

The individual features of innovative financing mechanisms suggest that, in the future, a range of these mechanisms will have to be adopted for different purposes as part of a comprehensive financing strategy for a new development agenda.

Bridging the gap: international cooperation in development finance

Globalisation has increased the impacts of international policies on developing countries. Therefore, development cooperation post 2015 should not only focus on raising the level of development finance but, more importantly, also concentrate on reforming international policies in order to improve the policy environment in – and for – developing countries.

For developing countries to benefit from more diversified sources of development finance, it is particularly important that the international community becomes active in two areas:

1) International cooperation for a development-friendly international financial system. This includes in particular reforming the global financial system, with a view towards enhancing financial stability, reducing the volatility of external financial flows and continuing efforts to curb illicit financial flows to facilitate domestic resource mobilisation.

2) Reforming development cooperation by enhancing the coherence of aid and other policies. Advancing the international aid- and development-effectiveness agenda in a way that engages both traditional donors and the providers of SSC should be a priority. In addition, better international cooperation and coordination in the provision of global public goods is important. In the area of climate finance, for instance, enhanced coordination and cooperation between development and other external policies is crucial to ensure that any new climate finance architecture supports inclusive and sustainable development, and that climate finance complements – and does not replace – aid.

Moving beyond quantity

The sources of development finance have become more diversified, thereby providing promising avenues to increase the level of financial resources to finance a future development agenda. However, all financial sources have limitations. These limitations can partly be overcome through enhanced cooperation at the international level, that is, through better regulation of the international financial system and stronger political commitments to PCD, because the impact of any financial flow crucially depends on the global as well as the local policy environment.

While the international community is still debating the content of a future development agenda, it might be difficult to foresee the specific financing needs. At the same time, the success of any global development agenda depends on the financial foundations it is built on. Hence, the international community stands at a crossroad. If global leaders do not start thinking about how to finance the future development agenda more rigorously now, they run the risk of doing "too little, too late."

Thus, safeguarding the financial foundations of future development goals should be considered at an early stage, and not in hindsight. Member States of the United Nations should advocate the convening of a development financing conference ahead of the post-2015 summit in September 2015, when the new development agenda will be announced.

The success of a financing conference depends on the level of political participation. The landmark conference of Monterrey in 2002 was attended by more than 50 heads of state and the heads of the Bretton Woods Institution. At the follow-up conference in Doha in 2008, such high-level participation was missing and, as a consequence, the conference went largely unnoticed. Ensuring the participation of global leaders in a post-2015 financing conference will therefore be critical. Public attention and political pressure need to be generated at an early stage.

Most importantly, the post-2015 financing conference should not only discuss how to increase the level of development finance but also address the quality of development finance, as the policy context plays a crucial role in ensuring an effective and efficient use of financial resources.

This briefing paper is part of the DIE series "Post-2015". See our homepage for previous issues (www.die-gdi.de)

Literature

European Report on Development (2013): Post 2015 : global action for an inclusive and sustainable future, DIE, ECDPM, ODI, Brussels: EU

OECD (Organisation for Economic Cooperation and Development) (2012): Can we still achieve the Millennium Development Goals? From costs to policies, Paris: OECD Publishing (Development Centre Studies)

Von Haldenwang, C. / U. Kerkow (2013): Post 2015 : the international battle against tax fraud and evasion, Bonn: DIE (Briefing Paper 16/2013)

World Bank (2012): Global economic prospects : uncertainties and vulnerabilities, Washington, DC: World Bank

Florence Dafe
Researcher
Department V „World Economy and Development Financing"
German Development Institute / Deutsches Institut für Entwicklungspolitik (DIE)

Renate Hartwig
Researcher
Chair of Development Economics
University of Passau / Universität Passau

Heiner Janus
Researcher
Department I "Bi- and Multilateral Development Cooperation"
German Development Institute / Deutsches Institut für Entwicklungspolitik (DIE)

© German Development Institute / Deutsches Institut für Entwicklungspolitik (DIE)
Tulpenfeld 6 · 53113 Bonn · Germany · Tel.: +49 (0)228 94927-0 · Fax: +49 (0)228 94927-130
E-mail: die@die-gdi.de · URL: www.die-gdi.de
ISSN 1615-5483

The DIE is a multidisciplinary research, consultancy and training institute for Germany's bilateral and for multilateral development co-operation. On the basis of independent research, it acts as consultant to public institutions in Germany and abroad on current issues of co-operation between developed and developing countries.