Innovation... and effectiveness?

Challenges, risks and opportunities for blended finance

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As donors and multilateral institutions invest more official development assistance (ODA) in blended finance initiatives, there is growing need to define and agree shared principles for effective delivery of blended finance, through inclusive, open and honest debate. The Global Partnership for Effective Development Cooperation (GPEDC) provides a key venue for this debate to happen.

Financing the ambitious 2030 Agenda for Sustainable Development (Agenda 2030) and the Sustainable Development Goals (SDGs) will be an enormous undertaking, with a funding gap in developing countries estimated at between US$1.9 trillion and US$3.1 trillion each year between now and 2030. Substantial additional financial resources from both domestic and international sources need to be mobilised, and attention has turned to how to make this happen. ODA is clearly a valuable but limited resource in the context of the overall financing needs, and many developing countries, while seeing a massive growth in domestic resources, are still far short of the financing required if they are to achieve Agenda 2030.

The SDGs call for a combined effort by all actors, including national governments in developing countries, 'traditional' providers of development finance and, increasingly, the private sector. There is little disagreement that private investment in developing countries is needed to finance the SDGs. Developing countries also prioritise the mobilisation of private investments, both domestic and foreign, in their own national plans and discourse. An active, responsible and inclusive private sector is an essential provider of jobs, growth, products and services.

Why are providers of development cooperation engaging with the private sector?

In this context, donors, multilateral development banks and development finance institutions (DFIs) are increasingly promoting direct engagement with the private sector in development cooperation, for example through 'blended finance' – using ODA to invest in partnerships – as a means of:

- Leveraging additional private finance to meet public financing gaps ('financial additionality'). Donors believe this has the potential to provide at least part of the solution to the SDG financing gap, with some actors suggesting it could 'turn billions of dollars into trillions.[1]'
- Improving the development focus and outcomes of private investment, both domestic and multinational ('development additionality').
- Using market-based solutions to attempt to tackle development challenges in ways that are assumed to be effective, efficient, provide value for money and have long-term sustainability.
- Commercial interest: through blending activities in developing countries, some donors can secure commercial opportunities for their domestic firms and investors.

What is blending, and how does it work?

Blended finance aims to incentivise private finance to invest in developing countries, when purely commercial motives would have precluded this. Through blended finance, or the use of public funds to de-risk or 'leverage' private investments in development, the public actor inputs resources aimed at either *reducing risk* for the private actor, or increasing the ultimate profit in such a way as to *compensate* for their initial risk.

Blended finance is not just one type of 'flow': donors have been using several different instruments. For example, guaranteeing an investment; lending through 'mezzanine' loans, where the public actor takes the first 'hit' if there is a default; or making equity investments into companies in developing countries that may be perceived as more 'risky' (the perceived risks may not always be based on evidence of the actual risks). The financing arrangements used in blending can be quite complex and require specialist skills to set up, which is why donors generally partner with development finance institutions (DFIs), who in turn may use private equity funds to manage the donor money.

There is no one single accepted definition of blended finance. In this discussion, we focus mainly on the use of international public finance to attract additional investments from private sector actors ('private finance blending'). Even though some actors have been active in blending grants and loans solely from public sources for some time, this focus on the mobilisation of private sector investments reflects the international debate and policy orientations of key donors, such as the European Union.[2]

How much is there?

The amount of private investment mobilised through blending reached US$14.3 billion in 2014.[3] This is less than 1% of flows to developing countries – far less than is provided through other sources such as commercial debt, foreign direct investment (FDI), remittances and ODA. However, the use of blended finance is growing and there does appear to be potential for significant future growth. Private investments mobilised by blended finance grew by around 20% annually between 2012 and 2014; in contrast, net ODA grew by 3.5% per annum over that period. The scale of funds available to private sector banks and pension funds has led to speculation that the amount of finance that could potentially be mobilised could be huge. If the current annual growth rate continues, private capital mobilised through blended finance would total US$42 billion by 2020 and US$252 billion by 2030 – well short of what is required to meet the SDGs. We therefore need to ensure that blending is used sensibly within the portfolio of resources, not treated as a 'silver bullet'. It is also not clear that blending is the most effective or sustainable route for increasing the investments needed in developing countries. Unfortunately, due to the quality and availability of data, it is impossible to determine how much public resource, or ODA, was used by providers (donor agencies and DFIs) to stimulate the current levels of private investment.

Blended finance: a challenge for effective development cooperation?

The four core principles of the Busan Partnership for Effective Development Cooperation (country ownership; a focus on results; transparency and accountability; and inclusive partnerships) are conceptually reflected to some degree in blended finance approaches, but there are limitations in delivering on the principles in current practice. Some reasons for this are:

- **Focusing on results** can be challenging in complex financing partnerships. This can be due to a lack of common language or dialogue opportunities between actors in blending and governments, and because public and private actors may have different objectives for the partnerships.
- **Country ownership** challenges can be due to different 'institutional models' of new actors, as well as different incentive systems and legal or regulatory frameworks (private actors are somewhat obliged to be profit-seeking as opposed to developmental in nature). For example, DFIs, the main delivery partners for donors in blending, often act more like banks than traditional donor agencies.
- **Tied aid** is also a potential risk. Blending creates incentives and opportunities for providers to use public funds to promote investments in companies from home.
- There are **institutional constraints** of different actors participating in blending that limit the delivery of the principles. For example, transparency and accountability are currently low in blending; many DFIs are subject to national legal frameworks that do not allow them to publish names of investee companies. However, some DFIs do better than others in publishing information and data.
- **Lack of consensus** on how to operationalise the principles; and no policy dialogue platform to agree how to achieve this. For example, all actors agree that better reporting and analysis of the results of projects financed through blending is a priority, but there is no appropriate space for dialogue to agree how to do this.

With all these challenges, there is a risk that some hard-won gains achieved by the development effectiveness community, such as progress on transparency, accountability, use of country results frameworks, and untied aid, could be lost unless improving the development effectiveness of blended finance becomes a high priority for all actors.

We also need to bear in mind broader developmental risks. For example, opportunity costs: donors using ODA for blending could mean less money available for other uses of ODA, such as financing public services. There is also a risk that blending, when it relies on external private finance, may crowd out the domestic financial sector in the host country, or could unnecessarily subsidise private investment in a way that causes long-term damage to domestic markets. There is the question of whether donor agencies or other blending actors are well situated, with enough local understanding and sufficient knowledge to 'pick winners' in other countries' economies – developing or bringing in that knowledge and understanding could be a potentially expensive undertaking. Finally, careful consideration needs to be given to the appropriate use of blending in poor and fragile countries. Though current evidence indicates that blending mainly incentivises private investments in lower and upper middle income countries, donors of the Organisation for Economic Co-operation and Development (OECD) Development Assistance Committee (DAC) are in the midst of changing the rules of ODA eligibility in a way that will incentivise the use of these financing instruments in poorer countries. This carries with it a new set of opportunities and risks.

Opportunities and proposed ways forward

Principles of effective development cooperation can and should apply to all forms of development cooperation, including blended finance. Actors could agree to:

1. **Develop economies**. Before scaling up blending, donors and their partners need to take a step back, review **evidence on the comparative advantages of blending versus other uses of aid to support developing** and reflect on the importance of public investment to leverage private sector growth. Aid is well suited for investments in the public sector, which in turn is crucial to private sector investment. A healthy, educated workforce is a key factor in where firms choose to invest, for example. The African constituency of the GPEDC has called for aid to be directed at 'productive sectors and economies' and for more focus on domestic resource mobilisation. Evidence should be produced on the most impactful uses of ODA in line with these needs and tailored to country level.
2. **Focus on generating better evidence on the results and impacts of blending on people and communities in poverty, as well as wider and linked development goals, such as climate change**. Donors and partner countries need to better understand the impacts of blending, and the comparative advantages for ending poverty of blending instruments in relation to traditional grants and loans. This is especially important in light of the ongoing modernisation of the definition of ODA, which could incentivise donors to scale up their use of blended finance instruments in some of the poorest and most fragile – including environmentally fragile – developing countries. Since data and evidence are currently insufficient to inform decision-making on these points, providers should be cautious in scaling up blending, until the quality of data and evidence is improved.
3. **Address barriers to delivering blended finance in line with development effectiveness principles**:
    - Establish dialogue platforms for reaching agreement on the appropriate role of blended finance for delivering sustainable development (including GPEDC, UN Development Cooperation Forum, Financing for Development). Help promote recognition of the principles of development effectiveness by blending actors.
    - Promote consensus between stakeholders on how the principles should be operationalised in blended finance, and address practical challenges in applying the principles. For example, agree best practice in publishing information on blended finance to the International Aid Transparency Initiative (IATI).
4. **Agree key governing principles for blending, building on development effectiveness principles.** (See diagram 1)

Diagram 1: Proposals for discussion

Actors could commit to ensure that blended finance...

Country ownership

- Is targeted to circumstances where it can help achieve clear sustainable development outcomes and reduce poverty, in support of national development strategies
- Prioritises investments in domestic companies and small and medium enterprises
- Prioritises investments in companies that are paying their fair share of taxes and reporting on this

Focus on results

- Demonstrates financial and development additionality
- Minimises risks for people and the environment, and is accompanied by sufficient social, labour, environmental and human rights safeguards
- Focuses on strengthening companies and sectors that benefit the poorest people (eg generic medicine producers)
- Is supported by regular monitoring and evaluation, with metrics that demonstrate blending activities ensure financial and development additionality, 'do no harm' and 'maximise positive benefits' (ie make a positive impact on sustainable development, including being environmental/climate sensitive, and make people in poverty better off as a result)
- Is only funded by ODA when traditional grants or loans would not be more appropriate, based on evidence-based assessment of needs

Inclusive partnerships

- Has in place robust policies addressing gender discrimination in labour markets
- Generates decent and sustainable employment opportunities
- Helps empower the citizens of partner countries to work together with their governments to develop common investment priorities for blending, including civil society organisations and trade unions
- Has clear grievance/feedback mechanisms for recipients, stakeholders and local communities

Transparency and accountability

- Introduces a common standard of reporting, established for all providers investing in and implementing blended finance activities (this could be based on IATI)
- Incorporates published and improved qualitative reporting on development objectives and outcomes
- Is regularly audited, and the performance of blending activities is evaluated and the results shared publicly

Recommended reading

- Development Initiatives (2016) Blended finance: Understanding its potential for Agenda 2030. http://devinit.org/#!/post/blended-finance-understanding-its-potential
- Development Initiatives (2016) Aligning blended finance with the Busan principles of development effectiveness. http://devinit.org/#!/post/aligning-blended-finance-to-busan-principles
- Oxfam International and Eurodad (forthcoming) Private finance blending for development, risks and opportunities for CSO work.
- UK Aid Network (2015) Leveraging Aid – A literature review on the additionality of using ODA to leverage private investments. http://www.ukan.org.uk/wordpress/wp-content/uploads/2015/03/UKAN-Leveraging-Aid-Literature-Review-03.15.pdf

Notes

1. Gavin Wilson, (18 July 2016) 'There's a $2.5 trillion development investment gap. Blended finance could plug it'. Blog on World Economic Forum website: https://www.weforum.org/agenda/2016/07/blended-finance-sustainable-development-goals/
2. The new EU External Investment Plan states the intention to scale up the use of blending to attract more private investments in development, particularly in Africa.
3. Development Initiatives (2016) *Blended finance: Understanding its potential for Agenda 2030.* http://devinit.org/#!/post/blended-finance-understanding-its-potential

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