5 Innovations in Financing Development

Until recently, the only financing for government permitted to LDCs was official development assistance. The prospects for aggregate ODA are not encouraging: unprecedented fiscal pressures in OECD countries are reducing aid budgets. There is a need both to sharpen the focus of ODA onto LDCs, and to look to alternatives.

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Sharpening the focus of ODA on LDCs

Given that the prospects for total aid are discouraging, a sensible strategy for the governments of LDCs is to focus attention on its allocation. While the ostensible rationale for aid is to address poverty, most aid goes to countries that are not LDCs. Indeed, large aid flows are going to middle-income countries that are already growing rapidly. If aid were focused on LDCs it would permit a major expansion in the aid flow to LDCs without requiring any increase in OECD aid budgets. As the category of emerging market economy expands, it is important that these countries cease to be aid recipients so that aid can be concentrated on those countries that really need it. In making the case for reallocating aid, three rationales for providing aid to middle-income countries must be countered.

One rationale, seldom admitted by OECD governments, is that the emerging market economies are important markets for OECD products and so aid is useful in maintaining good relations with their governments. This is, of course, an abuse of aid. Were other, more legitimate sounding concerns of OECD governments properly addressed, this illegitimate rationale could be exposed and faced down. While recognising that it is a motive for aid, it is therefore important to attend to any rationales for providing aid to middle-income

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countries that appear superficially to be more legitimate. There are two such reasons why OECD donors do not allocate more of their aid to the LDCs.

One rationale for OECD aid to middle-income countries is that even middle-income countries have many poor people in them. This argument is spurious because a middle-income country is in a position to address such poverty from its own national income. If the government of a middle-income country chooses not to redistribute national income it should not expect other societies to address the poverty of its people with their own income. In contrast, in an LDC poverty cannot be solved through redistribution: there is not enough national income to redistribute.

The second, and more potent, rationale is that aid is better-used in middle-income countries because policies and institutions are better than in LDCs. The quality of policies and institutions is measured annually by the World Bank and published in its highly influential *Country Policy and Institutional Assessment* (CPIA). The CPIA formally determines the aid allocations of the World Bank and influences the allocations of many other donors. It is time that this approach to aid allocation was challenged. By linking the volume of aid to a country to its CPIA, LDCs almost inevitably end up with smaller aid allocations than middle-income countries. In particular, they get little of the fully discretionary funding that they need, such as is provided by budget support. In the donor perception there is a tension between the need for aid and the ability of governments to use it. This then faces donors with an impossible choice: provide aid to needy environments where it will be badly used, or provide it to environments where it will be better used but where it is not really needed.

The governments of LDCs need first to recognise that while donors feel that this is the choice with which they are

faced, most major donors will tend to favour aid to middle-income countries. This is because their fiduciary responsibility to their own taxpayers leads them to be fearful of contexts in which aid can be shown to have been used badly. Looming fiscal pressures in OECD countries can only intensify such concerns and threaten to undermine provision of budget support. Having recognised the nature of the problem, governments of LDCs need then to do something about it. There are two approaches, potentially complementary.

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One approach is to encourage independent assessment of the capacity of the government to spend aid honestly and effectively, such as is necessary for a donor to be confident that budget support will be properly used. The most appropriate agency would probably be the IMF, which already undertakes public financial management performance reports. However, currently these do not include an overall assessment as to whether a system is fit for budget support. *Were the IMF to certify systems as fit for budget support it would enormously strengthen the case for donors to provide it.* Indeed, it might even give the US Congress the evidence it claims is lacking to justify American provision of budget support. Evidently, not all LDCs are currently at a level of government capacity at which certification would be assured. Hence, it would be important to combine a certification process with transitional arrangements, including support for capacity building followed by re-assessment for those countries currently below the standard necessary for certification.

Another approach, which can potentially be complementary to certification, is for LDC governments to encourage routes by which aid can still be received by public agencies even if donors are unwilling to provide budget support directly into the budget. While from the perspective of government this may be inferior to budget support, it is evidently better than the government not receiving the aid at all.

At present, the main alternative modalities to budget support are project aid, the provision of aid directly to local governments (as with World Bank aid to Ethiopia) and completely bypassing government through direct donor funding of non-governmental organisations (NGOs). None of these are satisfactory. In particular, the NGO bypass undermines the capacity and authority of government.

Rather than merely oppose such approaches (which simply results in less aid), governments of LDCs can build new designs of public organisations which give donors sufficient confidence to provide finance, while retaining government control. One such approach is the public service agency (PSA) (Collier, 2009). A PSA is a government body which finances, but does not directly provide, public services such as health and education. It contracts with NGOs, local communities or local governments (according to what the government considers appropriate). As with an independent central bank, the government sets the rules and guidelines by which the PSA allocates the money received from donors. The PSA then finances the service providers (such as NGOs) on terms which it sets, and monitors their performance. Donors have representation in the management and oversight of the PSA (although the government retains overall control). However, since a core function of the PSA is to monitor the performance of the service providers, donors receive a continuous flow of information as to the cost-effectiveness of their aid. This gives them the confidence to provide enhanced funding.

PSAs need not be temporary arrangements. In many LDC contexts they may well turn out to be more cost-effective ways of providing public services than the conventional OECD model of direct government provision inherited by LDC governments at independence, which has often proved to be ill-suited to local conditions.

As with independent certification for budget support, the principle underlying public service agencies is for the governments of LDCs to recognise why for the past two decades they have been getting such a small share of global aid, and to address the problem by meeting the reasonable concerns of OECD governments.

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Sharpening the focus of aid to LDCs on growth

The predominant original rationale for the millennium development goals (MDGs) was to strengthen the case for aid in OECD societies. In this they have been rather successful. However, their subsidiary rationale of shifting the priorities of LDC governments onto MDG-monitored outcomes, can potentially be counterproductive. In some LDC contexts the MDGs are manifestly not the most pressing priorities. For example, in post-conflict situations it is often important to generate jobs for young men as quickly as possible, yet employment is not an MDG.

More fundamentally, the MDGs are outcomes, rather than a strategy for achieving those outcomes. Inadvertently, the focus on the MDGs can create the impression than these desirable social outcomes, such as universal primary education, are simply purchased by aid. Yet the only sustainable way of achieving the MDGs and the myriad of other goals that a society aspires to, is through growth of the economy. Aid can potentially be helpful in financing the costs of growth, such as the necessary economic infrastructure. Yet the emphasis upon social goals risks diverting aid from such fundamental economic priorities to purposes which are more instantly appealing to voters in OECD countries. Over the past 15 years this has clearly occurred: funding for infrastructure has declined, while funding for social objectives has increased. As an example of uses of aid for enhanced growth, in Chapter 2 the case was made for aid to be used to finance

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prospecting for natural resources. An LDC where such a use of aid might be useful is Yemen, which is almost entirely dependent upon revenues from natural resources, but where proven reserves are near to exhaustion. There is a reasonable case for permitting the Government of Yemen to use some of its aid to finance exploration so that these revenues become more sustainable.

The international community is now starting to think beyond the time horizon of the MDGs. Hence, *it is timely for the governments of LDCs to insist on a refocusing of aid on a growth agenda.*

Rethinking debt sustainability

LDCs with IMF programmes were explicitly required not to borrow commercially. However, the IMF is now rethinking what determines debt sustainability and this is opening up the options for financing.

The model used by the IMF in its debt sustainability analysis implicitly assumed that public investment was completely unproductive. This followed from the lack of a link in the model from public investment to subsequent growth of the economy. Hence, by assumption, borrowing to finance extra public investment necessarily reduced the sustainability of debt: liabilities were incurred without any corresponding increase in productive assets.

These assumptions were clearly unreasonable. For example, the Growth Commission, led by Nobel Laureate Michael Spence, analysed all the countries that had transformed themselves from being low income and on the basis of its analysis urged LDCs to raise their rates of public investment. To its credit, the IMF is now revisiting its assumptions. In an important new working paper, 'Public Capital and Growth' by Arslanalp *et al.* (2010), the Fiscal Affairs Department of the IMF analyses the relationship between public investment

and growth both in developing countries and in the OECD (where emerging debt crises raise the same issues that LDCs have grappled with for decades). The paper finds that public capital is productive but subject to diminishing returns. Beyond a certain level of the public capital stock further investment is unproductive and indeed can have net negative effects once the disincentive effects of the taxes needed to pay for it are taken into account.

Borrowing for economic infrastructure is therefore the main candidate for expansion financed by borrowing.

Given the low level of public investment in LDCs in recent decades, many of them are likely to be within the range at which, on the IMF analysis, public investment is productive. As the paper notes, this has important implications for rethinking debt sustainability. Whereas in the old framework, borrowing for public investment necessarily worsened debt sustainability, once it is accepted that public investment can be productive, the effect of borrowing to finance it becomes contingent on what particular investments are being increased.

The critical issues become the rate of return on particular public investments, and whether sufficient of these returns can be captured through the tax system to enable the government to service the debt. While warranting some borrowing for public investment, the new perspective is not a licence to spend on whatever public capital is thought desirable. In particular, even though investments in social sectors, such as hospitals, may raise wellbeing, they may not sufficiently raise taxable income to be self-financing. Indeed, on the contrary, they may indirectly increase claims on public expenditure, most evidently through the recurrent costs necessary to operate the new capital. Borrowing for economic infrastructure is therefore the main candidate for expansion financed by borrowing.

What is needed to guard against debt becoming unsustainable is to base investment decisions on unbiased estimates of

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the likely economic returns on marginal public investments. Both technically and politically this is difficult. Technically, the best that economics can offer is cost-benefit analysis, but this tends to be biased against large projects. Currently there are moves in some OECD countries towards setting up independent bureaux for budgetary assessment, and LDC governments may wish to build similar domestic institutions.

The new analysis is timely because the world is awash with liquidity. The rate of interest is at a historically low level, and the OECD countries are no longer seen automatically as safe havens. Further, as a result of the Jubilee campaign for debt forgiveness, most LDCs have very low levels of debt. Hence, there has seldom been a more propitious time for LDCs to increase the stock of public capital by borrowing commercially. Nevertheless, lending to LDCs is perceived as being high risk. It is therefore sensible to consider whether innovations in borrowing instruments can reduce the perceived risk of default.

Reducing the cost of commercial borrowing

One approach might be for the World Bank to *create an International Bank for Reconstruction and Development (IBRD)-like club of borrowers designed for LDCs*. When the IBRD was created, it was designed for countries that were not so different from LDCs today. Over the years, the IBRD club has, in effect, collectively moved up; in the process its members have become less risky and so are now able individually to borrow commercially. The IBRD club is not so necessary, other than at times of financial crisis. To contain risks, eligibility for membership of the IBRD-like club might be confined to those LDCs that were in conformity with an IMF programme or some such reassurance mechanism. The rationale for LDCs would be the same as that for the formation of the IBRD – by reducing perceived risk, it reduces the

cost of borrowing. The IBRD carries a guarantee from OECD countries which has never been called. Unlike the International Development Association (IDA) it has therefore come at no fiscal cost. In the present environment of fiscal tightness in the OECD this is important. For example, it explains why at the March 2009 meeting of the G20, vast new resources were found for the IMF, while only negligible new money was found for the World Bank. Hence, a substantial expansion of financing for LDCs is more likely if it can use strategies which do not make explicit fiscal calls on the OECD.

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A second approach, which might well be combined with the above, is for the rate of return on the bonds issued by LDCs to be linked to some aspect related to their ability to repay. That is, *it is better for objective risks to be shared explicitly rather than be left lurking as an offstage risk of default*. One performance measure is the rate of growth of GDP. This is a further advantage of a collective borrowing instrument such as an IBRD-like club, since the rate of interest on the bonds issued could be linked to the average growth rate of the LDC club. This would virtually eliminate the 'moral hazard' which would be associated with each individual government linking the rate of interest to the rate of growth of its own economy.

Another possible link is to the prices of commodity exports and imports. Potentially, the risks of commodity exporters can now be hedged. However, it would be unwise for LDC governments directly to engage in such transactions. Even the international investment banks have periodically proved incapable of adequately supervising their employees engaged in these transactions and have found themselves inadvertently exposed to massive losses. It is therefore preferable to have these risk transactions managed by a third party with expertise but no commercial interest, such as the World Bank. The Bank would undertake hedging operations on

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behalf of LDC governments aimed at reducing the volatility of the revenues generated by rapid changes in the prices of commodity exports. While it is not realistic to aim at stabilising such revenues, it should be possible to slow the rates of change, softening periods of declining revenues by accepting a slower pace of price increase at times of rapid increases in world prices.

While hedging can be costly, the World Bank is in a position to do some of it purely through internal matched transactions which would effectively be cost free. For example, it could match portfolios of loans to oil exporters (whether or not these were LDCs) with loans to oil-importing LDCs. When oil prices were rising, debt service on the loans of oil-importers would be reduced and those of oil exporters correspondingly increased, and vice versa when oil prices fell.

A final link between returns and performance is to move the focus from the national level to the project level. Public–private partnerships provide security to investors by earmarking specified public assets collateral, while sharing the risk by linking debt service to certain verifiable aspects of the performance of the project. The recent Greek fiscal crisis has demonstrated how public–private partnerships can be abused. If the state merely shifts existing public assets into 'partnerships', it undermines the collateral for general public debt, increasing the risk of default. The legitimate rationales for public–private partnerships are either to finance new capital or to bring in superior management. In the former case, the new capital can indeed be used as collateral without undermining the collateral for existing debt. In the latter case, the right structure is either a management contract in which the private firm receives a specified return for improvements in performance while the state retains full ownership of the capital, or an outright sale of public assets (privatisation) rather than a partnership.

Increasing absorptive capacity for investment

While the IMF analysis on the returns on public capital is encouraging, it also finds that in developing countries public investment can become unproductive at surprisingly low levels of the public capital stock. This is support for the conventional IMF concern about constraints upon 'absorptive capacity'. If borrowing to finance public investment is to be viable on any scale, it is therefore essential to break this capacity constraint. Three approaches are complementary in raising the capacity to absorb public investment.

One approach is for government itself to improve its capacity to select and implement investments efficiently. As part of this it may be useful to establish an independent public institution for the scrutiny of proposed public investment projects. While cost-benefit analysis is technically the best way of selecting projects, it may require more capacity than many LDCs can reasonably muster, and it does not address issues of implementation. An alternative or supplement to cost-benefit analysis is to learn from the success of countries that two decades ago were themselves LDCs but which, through rapid growth, have transformed themselves. The government of an LDC could decide to follow the scale and sequence of public investment projects that had been carried out by a country that two decades ago was similar, but which has grown rapidly. For example, such a peer-matching exercise may reveal that heavy investment in rural areas is less important than investment in urban infrastructure: after two decades of rapid growth, cities are where the population and the economy are predominantly located. *Formalising opportunities for such learning from former peer countries would be helpful to the governments of LDCs.*

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The second approach is to adopt policies that are conducive to private investment. Public and private investments are complementary, implying that the return on public

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investment depends in part upon the level of private investment. There are already various international ratings of investment policies which can be helpful to the governments of LDCs in guiding policy reform. For example, Rwanda has recently risen dramatically in these ratings.

The third approach is to focus on policies which reduce the cost of capital goods, both structures and equipment. Both types of capital good tend to be more expensive in LDCs than in other countries, so that an expenditure on investment buys less capital. Bringing down the cost of structures is a matter of targeting construction costs. These can be excessive for many different reasons: legal impediments on the acquisition of urban land, bottlenecks in the supply of cement or shortages of skilled labour. Each of these problems can be addressed by appropriate policies. Bringing down the cost of equipment depends upon trade policy, because in LDCs equipment is imported. If the market in imported equipment is merely national, in an LDC it will inevitably be small. Small markets are unlikely to support enough importers to be competitive. Instead, they will be characterised by cartels and prices set above world levels (Collier and Venables, 2010b). A good way around this problem is to encourage markets in equipment to be organised regionally rather than nationally; this in turn depends upon the removal of trade barriers within the region. Collectively, these three approaches to increasing absorptive capacity are an agenda for 'investing-in-investing'.

Innovations in financing private investment

In many LDCs the ratio of private capital to public capital is lower than in more developed economies. Public and private investments are seldom substitutes: usually they are complementary. Private investment finances activities that are not well suited to be managed by government. Hence, many

LDCs are even more lacking in private investment than they are in public investment. Much of the finance for private investment in LDCs will need to be foreign, and so the challenge is to attract it in various forms. Some forms are better than others. Short-term foreign private lending to commercial banks has proved to be fickle and therefore dangerous. At the other end of the spectrum of private financing, foreign direct investment is not readily reversible and also brings skills and networks. The third main form of private finance is the purchase of equity in domestic firms. This is attractive because it is risk bearing, so that LDCs can share some of the risks they face.

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Foreign investment in the private sector in LDCs is perceived as risky and this is an important deterrent. There are various ways in which these perceived risks can be reduced.

Investment standards

For FDI one approach is for governments of LDCs to commit to certain standards of conduct which protect the investor against uncompensated confiscation. Most governments now have investment codes. However, these provide only limited reassurance because as purely national standards they can readily be changed unilaterally by governments. This is an example of a problem which has become standard in economics, known as 'time-inconsistency'. Governments (or indeed firms) which lack the ability to make commitments which are fully credible to other parties find that they are unable to make some deals which would be mutually attractive and so lose out. The key insight of the 'time-consistency' analysis is that faced with such situations governments themselves gain from placing credible restraints on their own power. LDC governments face precisely this problem vis-à-vis FDI and so would gain from appropriate ways of placing restraints on their individual power to confiscate private

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investment. Agreed international standards of conduct can be useful for the governments of LDCs in providing such restraints, although they must be standards set and agreed by LDC governments themselves, rather than imposed on them externally. In the 1990s the OECD attempted to create an international investment code to which LDCs were supposed to subscribe. This was precisely the wrong way to address the problem. Inadvertently, it created the impression that the OECD was attempting to force LDCs to accept standards that they were unwilling to adopt themselves. The collapse of this initiative left LDCs in a worse position than they had been before: by opposing the OECD proposal they were made to appear as wanting to confiscate foreign investment. Since then there has been no new initiative. Sufficient time has passed since that mistaken attempt for a new approach to be worthwhile. *This time the initiative should come from LDC governments themselves. They should collectively propose a common standard for foreign investment to which they are willing to adhere.* The proposal should include arrangements for independent adjudication to settle disputes and enforcement procedures for decisions. A common, enforced standard has two advantages. One, as discussed above, is the greater credibility of an international standard than of purely national codes. The other is that a common standard guards against a race-to-the-bottom in which international firms attempt to play off competing LDC governments.

Attracting foreign equity

LDCs are high-risk environments and the main financial instrument for financing in the context of high risks is equity. Yet to date LDCs have attracted very little foreign equity into their firms. Various public vehicles for purchasing the equity of firms in developing countries exist, such as the CDC and the International Finance Corporation (IFC).

However, to date, they have shied away from investment in LDCs. The governments of LDCs could usefully lobby for an increased share of these portfolios. This would be timely, since World Bank President Robert Zoellick has proposed that sovereign wealth funds should set a target of investing 1 per cent of their portfolios in low-income Africa. An evident generalisation of this proposal would be for the target group to be defined as LDCs. Since SWFs are becoming major vehicles for saving by EMEs, it is important to establish some link between them and the finance of investment in the poorest countries. It would be politically advantageous to link these two desired portfolio shifts. The one, through instruments such as the IFC and CDC, is through entities which are predominantly OECD financed. The other, through SWFs, is predominantly EME financed. Linking them would gear up the benefits to each decision and so increase the chances of each being adopted.

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Innovations in remittances

Remittances are now a major source of finance for LDCs. However, they are almost entirely a flow of money to households to enable increases in the consumption of imports. To the extent that remittances come from long-term migrants they are unsustainable, liable to dwindle as links with the country of origin fade across generations and as immigration restrictions in OECD countries are tightened. They therefore carry the classic Dutch disease risk of temporarily appreciating the real exchange rate and thereby undermining the process of industrialisation.

To counter this adverse effect of remittances, one approach is for the government to capture some of them so that some of the flow can finance public investment instead of only private consumption. Some governments, such as Egypt and Pakistan, have adapted domestic financial insti-

tutions so as to encourage migrants to hold large balances domestically. The banks can then hold some of these in the form of government bonds. Potentially, governments could also attempt to tax remittances: technically this is becoming easier as remitters rely more and more upon electronic transfers.

Complementary to governments capturing some of the flow, would be a switch in the composition of migration from permanent to temporary (Mode 4). Temporary migration addresses the risk that remittances will dwindle as the ties with emigrants weaken and may also be politically acceptable to OECD societies. A potential deal with OECD governments is that LDC governments agree to accept back some of the stock of illegal migrants in return for a generous but controlled flow of legal temporary migration.

The really big potential gain would be to link the switch to temporary migration to the need for the government to capture revenue from migrants. Thus, if migration was both temporary and legally controlled, it would be administratively feasible to require migrants to make minimum tax payments to their own governments as a condition for continued rights of residence in host countries. An analogy is the tax that the Government of Eritrea successfully levied on emigrants living in OECD countries as a condition for passport renewal.