financing for development

TRENDS AND OPPORTUNITIES

TRENDS IN FINANCING

Global financing for development has changed dramatically over the past two decades. The biggest shifts have been in the massive growth of private financial flows to middle-income countries and the growth and increasing diversity of official aid, which now includes several emerging markets and middle-income countries, some of which are still aid recipients. This shift has been accompanied by a growing trend toward a proliferation of aid channels as well as fragmentation and earmarking of aid.

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MICs and LICs—where from the funds? Changes to the level and composition of financial flows to developing countries have led to a dual financing architecture for development. In this architecture, middle-income countries (MICs) rely primarily on private flows, whereas low-income countries (LICs) count more on official flows, in particular official development assistance (ODA). As a result, MICs saw significant declines in net private capital flows in the wake of the financial crisis, while LICs were able to maintain financial flows thanks to a continued increase in official development aid.

Enter the BRICS. The 2000s saw several new entrants into the aid landscape. In particular, aid from Brazil, Russia, India, China, and South Africa (BRICS) grew rapidly during 2003-09, albeit from a low base. The BRICS' relatively low aid volumes do not capture their rapidly growing economic influence, which is significantly impacting the LICs' financing architecture, especially in Africa. In addition, private players have taken on a greater role in the aid landscape.

Existing global coordinating frameworks, such as the OECD-DAC, do not include many emerging players, which follow different approaches. For example, emerging donors typically deliver assistance in aid packages integrated with trade and investment and do not attach policy conditions to their assistance. However, almost all tie part of their project assistance to the purchase of domestically produced goods and services. These differences contribute to slow progress in coordination between traditional and non-traditional development partners.

A crowded aid scene. Over the last half century, the number of bilateral donors and international organizations, funds and programs has expanded significantly. Today, 24 countries have more than 40 active donors, and bilateral donors have grown from around 5-6 in the mid-1940s to at least 56 today.

In addition, large numbers of donors may provide relatively small amounts of funding or allocate funds for many different uses within a given country—contributing to "aid fragmentation." In fact, in 2009 the average volume of donor-funded activities in developing countries was about $1.3 million and the total number of interventions/activities reached almost 120,000.

Multiple aid channels can strain an already weak ability to implement projects in low-income countries, especially since different donors usually insist on using their own unique processes for initiating, implementing, and monitoring projects. Although the transactions costs associated with this type of fragmentation are not systematically quantified, there is ample anecdotal evidence pointing to increased costs, notably in time diverted from domestic priorities.

Earmarking on the rise. Evidence also points to an increasing trend in aid earmarking. This is the practice of designating or dedicating aid to the financing of specific themes, sectors, or countries.

There are several arguments for and against earmarking. The main case for earmarking is that it helps raise funding to address specific development issues, protects high-priority programs from cuts, and helps ensure support of the general public for development aid. There are also significant challenges. Globally, earmarking can create systemic aid effectiveness challenges related to, for example, insufficient integration into country priorities, systems and processes.

While earmarked funds may fill important gaps in the global financing architecture—playing a complementary role to non-earmarked multilateral ODA—recent trends point to the need to consolidate and increase their strategic alignment, selectivity, or impact.

OPPORTUNITIES OUT OF COMPLEXITY

Today's resource-constrained environment provides the imperative to look for opportunities amid these trends.

Make better use of existing channels. While there are ongoing intiatives to mitigate the impact of the fragmented aid architecture, including by enhancing the division of labor among DAC donors, the root causes remain on the supply side. There is even more need now for donors to consolidate funding mechanisms and make greater and better use of non-earmarked multilateral channels, which can mitigate the adverse impact of the complex aid system.

Limit creation of new global funds. The earmarking of aid through global funds and programs poses several challenges. The principle agreed in Accra of "thinking twice" should translate into a commitment to limiting the creation of new global funds to those addressing "real" global public goods coupled with clear implementation principles that ensure country ownership and the sustainability of global initiatives.

Improve transparency and data reporting. Improved transparency and data reporting is needed to facilitate more systematic and comparable assessment of overall aid resources. The BRICS are beginning to make important inroads in this direction, though more needs to be done to establish common methodologies and more regular reporting. Similarly, the available information on private aid does not allow for a complete understanding of its actual magnitude, purpose, and geographic orientation.

Coordinate. Improved coordination among all aid resources is needed to ensure the sustainability of development results. LICs, particularly those with increased "borrowing space" in the wake of the Multilateral Debt Relief Initiative, might find it easier to borrow on non-concessional terms, which may not be consistent with their long-term debt sustainability. LICs may also have increased opportunities to access aid without having to address necessary policy reforms. And finally, if good practices in project appraisal are not followed, increased aid could translate into more unproductive and/or unsustainable capital projects.

Revisit terms of ODA. The donor community may need to revisit the terms of ODA in order to maximize the impact of scarce aid resources. A more differentiated approach to allocating concessional funding may be warranted based on aid recipients' economic and financial status, whereby grant financing would be focused on the poorest countries.

Reference: Adugna, A., Castro, R., Gamarra, B., and Migliorisi, S.. *Finance for Development: Trends and Opportunities in a Changing Landscape,* World Bank: Concessional Finance & Global Partnerships, Working Paper No. 8, 2011

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