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Financial Innovation for Global Solidarity

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Introduction

Two different, yet interrelated debates are currently taking place in international arenas. One is about the provision of global public goods, most notably climate change mitigation, under the auspices of the UNFCCC. The other relates to the adoption of the new post-2015 development agenda to succeed the MDGs, under the auspices of the UNGA. Both sets of debates pertain to the notion of 'global solidarity', defined as the collaborative pursuit of a global community of interests. This notion includes a 'within' dimension related to development challenges – such as poverty eradication, income distribution, education and health – and a 'global commons' dimension that calls for global collective action.

This chapter deals with innovative financing for global solidarity, and therefore cuts across both agendas. Much work has already been conducted on this issue in multilateral, regional and bilateral development institutions, as well as by various United Nations bodies and working groups.[1] Such work has been important in advancing understanding of the issue, and beyond the usual general statements about the need for a stable and well-regulated global financial system and a more coherent international financial architecture, it has converged around a few important ways to organise thinking as well as principles (UN System Task Team, 2013).

These include:

- increasing mobilisation and improving the allocation of (public and private, domestic and international) resources for sustainable development while providing a more effective framework for development cooperation;
- recognising that 'more than just money' is needed, notably through a toolkit of policy options, regulations, institutions, and (public and market-based) instruments to achieve better development outcomes; and
- reducing risk and lowering the cost of capital for investors within proper regulatory and institutional frameworks – in a nutshell, aligning private incentives with public goals (ICESDF, 2014).

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1 See, for example, ICESDF (2014).

We do not repeat this analysis, on which we largely agree, in this chapter. Instead, we raise three issues that may not have received adequate attention and will be crucial elements of a dynamic approach to financing global solidarity.

First, we argue that global solidarity itself is dynamic and evolving as a result of an inherent tension between the traditional development agenda (poverty, education, health, etc.) and the global public goods agenda (climate change, environment, etc.) This tension arises due to the different perceptions among countries about priorities, and different views about the tradeoffs involved. The global solidarity agenda is therefore in constant evolution and rests on ongoing social interactions that take place in various ways in different parts of the world.

One proposal on the table summarises this agenda through 17 goals and 169 targets (Open Working Group, 2014), which shows how difficult it is to reach a global consensus on the concrete meaning of global solidarity. This suggests that what drives collective action is subject to a constant interaction between knowledge, evidence, advocacy, ideology, negotiation, discussion, tensions, and learning. This implies that the goal of financing global solidarity cannot be reduced to a list of items to finance, as it is in constant evolution and rests on the political economy of priority and agenda setting. For example, the goals and targets proposed by the Open Working Group may provide a collective framework for action, but priorities in implementing its recommendations will most likely be specific to nation states.

The second issue is about the very notion of 'financing', which should be thought of as a process of production in which financial resources are an input to produce 'global solidarity', but the 'production function' involves other inputs that are partly substitutable to finance and partly complementary, and the 'production technology' matters. In other words, 'financing' is not only, and not even fundamentally, about 'money'. Rather than 'how much', which of course cannot be ignored, the question of 'how' is much more important and should be at the core of the debate. However, the often inconclusive debate on the amount of financial resources that can be put on the table relegates the more fundamental debate on how to move ahead with action to a status of assumptions based on wishful thinking.

The third issue has already received much attention through the notion of 'blending'. We argue here that instead of being relegated to a sort of 'cherry on the cake' that opens new frontiers (and often finds itself an 'add-on' to the discussion on finance), 'blending', or new innovative approaches to finance that bring together public and private actors, is absolutely central to the pursuit of both individual as well as collective interests. We see it as a very powerful approach to the question of 'how' mentioned above, because it has the potential to reset incentives for the various actors.

1. Tension between the traditional development challenges and the global public goods agenda

The relationship between the traditional development agenda (poverty eradication, education, health, etc.) and the agenda related to the provision of global public goods (most notably with regards to climate change) is a complex one. Some argue that the two are intrinsically aligned, and others believe they are not always compatible. This debate has strong political overtones that colour individual positions. To the extent that the provision of global public goods requires efforts and resources and that, in many instances, it amounts to taking corrective measures to mitigate the impact of the actions of rich countries, many developing countries make their participation in the collective exercise conditional on both actions by developed countries and financial compensation.

Over the long term, and in a world with perfect knowledge, there is little doubt that the two agendas are logically and inherently consistent. It would not make sense to promote 'unsustainable' development, to finance development programmes that neither take climate change into account nor facilitate adaptation, or to continue deteriorating global commons. Conversely, the provision of global public goods is hardly compatible with the persistence of extreme poverty. In practice, however, the agendas do not appear to be aligned for at least two reasons.

First, there is scientific and practical uncertainty over the global public goods and sustainability agendas. There are many things we still don't know, whether about climate change (such as the detailed nature and distribution of its impacts, or the cost-effectiveness of various mitigation and adaptation interventions) or other global public goods. Such uncertainty does not imply that we should not feature them highly on the policy agenda, but it does mean that building a consensus for action is problematic, as the evidence will always tend to be contested. It is difficult to align the two agendas given these uncertainties. The global agenda, therefore, evolves out of advocacy and lobbying between various views, convictions and interest groups, each of which may claim to represent the common interest. As a result of this uncertainty, action often takes place when actual and perceived damages have made it clear that a current situation is unsustainable – rather than acting for sustainability, it is easier to react to unsustainability. Unfortunately, the perception of unsustainability is stronger after, rather than before, crises and catastrophes. Shifting the global public goods and sustainability agendas from a crisis management approach to a prevention approach is thus at the core of current debates. What this implies is that, *de facto*, these agendas cannot be pre-set in any deterministic way, but must evolve in a dynamic action-reaction framework. Current actions produce unsustainable outcomes such as catastrophes and other crises that call for reaction, and the process goes on. Some will argue that this model of *ex post* reaction eventually works, but there are two major drawbacks: crises may be very costly, and irreversible changes may take place that cannot be corrected.

Second, from a political economy perspective, the time horizons of the two agendas differ. For example, developing countries may want to prioritise the

traditional development goals (which emphasise immediate 'material' gains through economic growth, poverty eradication, and the provision of education and healthcare) over global public goods like sustainability and climate change mitigation (which many refer to as 'post-materialist' concerns).[2] Any proposed change in the production and distribution of material gains as a result of the provision of global public goods could well be interpreted as an (unaffordable) net cost unless it directly or visibly contributes to greater immediate effectiveness or higher real income (through energy savings, for example).

The two agendas therefore do not naturally converge and the broader post-2015 agenda, which comprises both the traditional development agenda and the global public goods agenda, is constantly evolving, with varying sets of priorities. This is also one of the reasons why the United Nations' Open Working Group (2014) needed 17 goals and 169 targets to reach an agreement. Financing global solidarity therefore intrinsically implies addressing some of the tensions that affect individual as well as collective action, which suggests that the amount of money available cannot be the only determinant.

2. Finance is much more than just 'money'

Substantial analytical work has also been conducted on financing the sustainable development agenda. This work, which we will not review here, is a useful guide to identifying concrete actions and thinking about how they can be financed. Our contention is that there is a need to address more deeply the question of 'how': How are the actions that have been identified going to be undertaken? Costing exercises assume that (i) there is a clearly identified unique set of actions, and (ii) the actions can be implemented successfully. Under these assumptions, they provide information about the amount of financial resources needed to achieve their objectives. But these assumptions may not always hold.

First, even if the costs of different desired actions could be adequately estimated and even if the proper funding commitments could be gathered, it does not necessarily follow that the desired actions will take place. They may be inhibited by several other (non-financial) obstacles – some of which we discuss below – as well as political economy considerations that go far deeper than technical costing and funding exercises. The availability of financial resources may indeed act as a facilitator, but most of the time will be insufficient to address the obstacles, and may even be dependent on how these obstacles can be addressed. Our contention is thus that the availability of needed financial resources is as much the result of a set of policy decisions as an engine for proper decision-making.

Second, costs depend on behaviours and policies. It thus may not be possible to properly estimate the costs of reaching a particular objective. A simple example illustrates this: suppose that an industrial company pollutes a river with chemical waste. One option may be to restore 'sustainability' by cleaning the river regularly (assuming there is a technical solution for this), and to estimate the recurrent costs of doing so at given intervals. Another option, which many

2 Pritchett (2014).

would deem superior, is to change the incentives facing the polluting firm (through tax or regulation, or through pressure from civil society organisations) so that it 'internalises' the cost of polluting and decides to change its production technology to limit pollution. There will be a cost to the firm, and a broader social cost of implementing the tax or regulation. The true costing will depend on which option is chosen.

Hence, we argue that the very notion of 'financing' should be thought of as a process of production in which financial resources are one input, but the 'production function' involves other inputs that are partly substitutable with finance and partly complementary, and where the production technology matters.

This is recognised in existing reports. ICESDF (2014), for example, notes that while the needs are huge and challenges enormous, they are surmountable because global public and private savings are sufficient. But it also notes that current patterns of finance are not adapted to these needs and challenges – most notably because expected returns on investments associated with sustainable development are not as attractive as other opportunities, especially in the near term – and that there are many competing demands on public resources, which confirms that the availability of resources cannot be a sufficient condition to move forward.

Having said all of this, there are, in our view, a series of 'no-regret' financial investments the international community must consider.

The first is significantly increasing the resources devoted to scientific research on (environmental and social) sustainability issues. This would not only promote the generation of scientific knowledge, but also generate new incentives to work on sustainability. The examples of global scientific initiatives in the past – such as the CGIAR model in agriculture, which led to the first Green Revolution, and the Intergovernmental Panel on Climate Change – demonstrate to us that this is doable and a worthwhile investment.

The second is identifying, documenting and promoting 'win-win' opportunities – for example, investments in energy efficiency that reduce costs and promote sustainability at the same time. But, as some free-marketers would argue, if these 'win-win' opportunities are not being exploited on their own, why must they be catalysed through conscious facilitative investments and actions? There are several reasons why such win-win situations may exist but are ignored. First, there may be an information problem, which could be related to a lack of technical knowledge, or a lack of information on market opportunities in certain parts of the world. Second, there may be a risk problem that holds back private investors from committing financial resources. Third, there may be a policy or regulatory problem, with local policies either creating barriers to investments or trade that impede potential profitability, or providing subsidies that prevent innovation by sustaining current practices and distorting markets (for example, fossil fuel subsidies). More research is needed within developing countries to identify such 'win-win' opportunities and to disseminate them.

The third 'no-regret' investment is in evidence-based advocacy campaigns to raise citizens' awareness and sense of responsibility towards future generations,

and sustainability issues in particular. It is thanks to sustained mobilisation of citizens over the last two decades (partly facilitated by increased financial resources to support advocacy) that the sustainable development debate has now entered the highest political arenas as one of the top international priorities. A concrete example of this is the Post-2015 Consensus Project launched by the Copenhagen Consensus Center,[3] which is undertaking a cost-benefit analysis of the various proposed targets in the post-2015 agenda through a peer-review process and disseminating the findings to governments and the general public. Many such initiatives are underway and must be invested in.

Even more is needed in terms of knowledge creation and dissemination. The next steps might be to relate as much as possible the available evidence to the analysis of costs to society. On social issues, while there is a global consensus on fighting poverty and reducing inequality, or on promoting 'inclusive growth', the identification of concrete actions to undertake is constrained by the limited knowledge of people's livelihoods across the world. More locally based knowledge generation is therefore critical.[4] Financial resources should be further mobilised to promote concrete and empirical research into how global public good concerns interact with local citizen's welfare and livelihoods.

3. Putting blended finance at the core of financial innovation

Our main message from the previous sections is that the crucial question to answer is not actually 'what' to finance or 'how much' resources to provide, but 'how' to use scarce financial resources to change incentives. This important question brings to centre-stage financial instruments and financial innovation, as opposed to the quantity of financial resources that can be made available. By 'innovation' we do not necessarily mean sophisticated technical innovations such as those that have characterised financial markets in the recent decades. Instead, we mainly mean simple combinations of standard financial instruments, such as loans, grants and guarantees that are appropriately structured and targeted to development finance.

Our central argument is that 'blended finance' (defined as the deliberate and organised pooling of public and private resources and expertise) is fundamental to the finance agenda. The reason for this conviction is that the other more 'traditional' types of finance emphasised in the ICESDF (2014) report – namely, the mobilisation of public and private, domestic and international resources – do not adequately address the central political economy problem of sustainable development. Through the traditional channels, we may in theory raise billions of dollars, but may still be unable to invest them appropriately. Any discussion on traditional channels is mainly centred on the quantity of finance available, not the incentive structure (or production function) that transforms finance into

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3 For information on the project, see http://www.copenhagenconsensus.com/post-2015-consensus/background.

4 Promoting locally generated academic knowledge, which can be mobilised for such purposes, is the major *raison d'être* of the Global Development Network (GDN).

action and results. Moreover, the mobilisation of resources itself depends on that incentive structure.

We therefore suggest that blended finance should be far more central to the finance discussions, and indeed should be the starting point for many discussions. And this is where the main potential of 'innovative finance' lies. In that sense, the sustainable development agenda is indeed one of financial innovation.

ICESDF recognises the potential of blended finance. However, it comes at the end of their well-documented report as something to further explore, as opposed to being one of the central recommendations to act on. The report describes the major blended finance instruments, from direct financing of the private sector, to blended risk-based or performance-based instruments, to elaborate public-private partnerships (Table 1, p. 39). This is a useful framework and we now need to build on it.

We believe that 'blending' can help realign incentives in two major ways:

- it can help reconcile private interests with the pursuit of global and local public goods; and
- it can help bring much more focus on performance and results.

This is indeed a 'public-private partnership' agenda, not in the sense of any case-by-case contractual arrangement between a public entity and a private contractor, but more fundamentally as a way to engage private actors in the provision of public goods. Such engagement requires both a focus on the public goods dimensions and social impact of private investments (which may not come naturally to private investors) and due consideration to private profitability, thus gearing private investments towards producing public goods.

However, there are technical, legal and contractual, as well as cultural challenges to this agenda. Technical challenges are the simplest to address. Current innovations suggest that there is indeed a high potential for finding productive ways to blend public and private resources. A number of risk-sharing instruments are already in use through which public money is used to mitigate risks (beyond market risks) that the private sector will not be willing to take. Such risks may be due to lack of information, weather uncertainty, political instability or intrinsic vulnerability, for example. The risk-mitigation agenda does not stop at public-private partnerships, though. In many cases, it is interesting to combine risk-mitigation instruments with conventional public finance. For example, development loans might include more systematically provisions that protect the debtor in case of unfavourable evolution of the market environment.[5] 'Concessionality' may thus be increasingly developed as a 'blending' instrument. Instead of focusing on the degree of concessionality from a charity perspective, it would be advisable to ask what is obtained as an outcome of the concessionality. If the investment that is financed through the loan turns out to be profitable, there is no need for concessionality *ex ante*. However, if it turns out to be less profitable than the cost of the loan for reasons other than poor management, there is a case

5 The French Development Agency introduced in the mid-2000s a 'contra-cyclical concessional loan', which allowed the debtor country to suspend debt service in case of a negative shock.

for at least some form of risk-sharing and donor compensation. The notion of 'concessionality' may thus usefully evolve from a traditional view of a monetary 'subsidy' to that of a 'risk-sharing' mechanism through which a private investor can be compensated if certain types of risk arise during project execution. This debate is just starting and faces considerable ideological obstacles.

The deeper obstacles relate to the prejudice against private actors. Since they are pursuing private profitability, a common assumption is that private actors cannot promote the public interest. This 'private versus public' view is a major impediment to innovative thinking. Trust needs to be rebuilt here, as there are several examples of 'public-private partnerships' of various kinds failing in the past either due to poorly designed and enforced contracts, or for other reasons. This prejudice cannot be changed without the full cooperation of both sides: from the public side, a better understanding of the functioning of private companies; from the private side, a higher consideration for the ultimate social objectives of economic activity. It is encouraging that, through forums such as the World Economic Forum, the idea of a structured public-private approach and partnerships is gradually taking hold, with major private companies willing to take the lead.[6]

Notwithstanding these prejudices, interesting innovations are taking place in development finance.

In the 2000s, a first innovation came with the notion of outcome-based aid, namely, an aid instrument that is designed to disburse public money as a counterpart to actual results. Several instruments have since built on that notion.

The World Bank (2013), for example, talks of 'pull-based mechanisms' which provide *ex post* economic incentives to reward specific innovations that solve a well-defined development problem. By linking payments to the actual impact of an innovation, these mechanisms can help create a self-sustaining, competitive market for the relevant product. For example, in 'advance market commitments', instead of financing private research and development, public money is used to guarantee market demand once private R&D has produced a desired innovation. The World Bank (2013) refers to the AgResults Initiative, a new pull mechanism developed by Australia, Canada, the UK and the US – working in partnership with the Bill & Melinda Gates Foundation, the World Bank and Dalberg, a global development advisory firm – which uses public financing to reward agricultural innovation in developing countries and, in the process, build sustainable markets for agricultural inputs, products and services that benefit the poor, while pulling in private investment and technological innovation.

Carbon markets, through cap-and-trade schemes, provide another source of innovative finance. Recently, 73 countries and 11 states and provinces – together responsible for 54% of global GHG emissions and 52% of GDP – joined 11 cities and over 1,000 businesses and investors in signalling their support for

6 A one-day workshop took place in New York on 24 July 2014, organised by the World Economic Forum at the request of the United Nations, to discuss the role of the private sector in the sustainable development agenda.

carbon pricing, which suggests that this instrument might be at the cusp of a major take-off.[7]

Similarly, some countries have experimented with the concept of 'resource for infrastructure deals' (mainly in fragile states), whereby mineral extraction rights are exchanged for turnkey infrastructure development to overcome obstacles related to limited domestic capital markets and implementation capacity (although this mechanism has its own challenges in implementation).[8]

Concepts like 'results-based financing' are also gathering great momentum. In 2012, the World Bank has pioneered an instrument called Program-for-Results (PforR) Financing[9] that directly finances development activities, disbursing against achievement of programme results rather than against inputs. Started in 2012, the initial results have been promising and the Bank is keen to scale up the programme. The Japanese International Cooperation Agency (JICA) has also been making results-based loans to countries such as Nigeria and Pakistan for health projects, incorporating an innovative 'loan conversion' mechanism through which the Bill & Melinda Gates Foundation will pay back the debt service to JICA in place of the national governments if the project successfully achieves the performance trigger indicators during implementation.[10] Social impact bonds aim to do the same for service delivery – here, private investors pay the upfront costs for providing social services and government agencies repay the investors with a return, but only if a third-party evaluator determines that the services achieve agreed-upon outcomes.[11]

These are promising approaches in that they can create powerful incentives to manage projects properly and improve governance. One might also design market-based instruments (loans) in which there is an element of subsidisation in case of a negative shock, as briefly discussed above.

All this points to the agenda of reforming official development assistance (ODA). Unfortunately, the debate remains politically mired in a quantitative approach (reaching the mythical 0.7% of GDP), which does make much sense given the arbitrary measurement of what is referred to as ODA. We probably do need quantitative targets, but the current definition of ODA hardly captures what is needed. The only quantitative notion that really makes sense (and is much simpler than the complex calculations based on hypothetical discount rates that characterise the current statistical definition of aid) is the actual budgetary effort made by donor governments for development assistance. One of the keys to financial innovation is to disconnect the public grant element from the actual financing of development. Instead of talking about concessional loans,

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7 See the recent announcement at http://www.worldbank.org/en/news/feature/2014/09/22/governments-businesses-support-carbon-pricing.

8 World Bank (2013).

9 For a review of the PforR approach, see http://web.worldbank.org/WBSITE/EXTERNAL/PROJECTS/0,,contentMDK:23215867~pagePK:41367~piPK:51533~theSitePK:40941,00.html.

10 Read more at http://www.jica.go.jp/usa/english/office/others/newsletter/2014/1405_06_03.html and here: http://www.gatesfoundation.org/Media-Center/Press-Releases/2011/08/JICA-and-the-Foundation-Announce-Partnership-on-Polio-Eradication.

11 These have not really taken off at scale in developing countries yet.

for example, and being obsessed by the degree of concessionality, it is more productive to ask why a given development project could not be financed through a market loan and to consider that any subsidy element should be designed to address these reasons, which might range from the insufficient immediate profitability of social investments, to various kinds of risks, to a lack of solvency of targeted markets. Public subsidies can thus be blended into many kinds of financial instruments, such as loans, equity, full grants and guarantees. Each of these may benefit from some elements of subsidisation. The calculation of the 'degree of concessionality', which still animates the statistical collection of ODA, is a waste of time and energy and harms the political debate, because it focuses on a vision of 'generosity' that is misplaced. What matters is why the instrument is subsidised and to what end. Is it to mitigate risks, to incentivise results and proper management, or to mobilise other resources, perhaps? This is a very promising agenda for ODA and it is encouraging that, even though the focus remains on concessionality and the overall quantitative commitment, the donor community now recognises the need to think of ODA more as a catalyst than as a stand-alone financing scheme.[12]

4. Concluding remarks

Our main message in this chapter is that the sustainable development agenda is a problem of collective action, and the success of global solidarity rests in the alignment of the objectives and interests of the various stakeholders. It is our view that blended finance and financial innovation, as defined above, can play a central role in achieving this alignment, particularly in analysing how public and private resources and expertise can best be blended. This agenda is just starting off and deserves a major boost. It should be recognised as a defining element of the post-2015 agenda, should be the subject of much more attention and debate, and should be a major area of experimentation and evaluation.

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12 As suggested by the final report of the Expert Reference Group on Development Finance convened by the OECD Development Assistance Committee (OECD, 2014).

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