Innovative Finance for Development

A Commonwealth Toolkit

Nils Bhinda, Samantha Attridge and Sheena Sumaria

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Foreword

New and additional resources have to be found if the development financing requirements of developing countries post-2015 are to be met. The relevance and impact of the new 'Sustainable Development Goals' will depend upon the ability to finance them. Even if the international community meets existing official development assistance (ODA) commitments, the needs significantly exceed the resources available. The financing gap is large and increasing. The necessity of finding ways to deliver traditional sources of finance more effectively, and for innovative finance for development (IFD), is therefore central to consideration of post-2015 development. ODA will continue to be vital, but will account for a reduced proportion of development financing overall. There will be greater reliance on mobilising finance from a combination of public and private sources in both developed and developing countries. The establishment of a stable and well regulated international financial system will also be important.

Addressing these pressing and contemporary concerns is a high priority for the Commonwealth. This publication is intended to facilitate consideration of how IFD can help overcome the immense challenges facing our poorest, smallest, and most vulnerable member countries. We hope it will assist policy-makers by serving as a tool that enables IFD options to be assessed against a range of criteria and considered according to principles appropriate to specific development goals. Draft Commonwealth principles for IFD are offered, which have been designed in consultation with specialists from Commonwealth developing country and other international experts. These take into account the principles established by the Paris Declaration on aid effectiveness but also consider issues of whether the funds are predictable and sustainable, benefit the poorest, can be disbursed quickly and are additional to ODA. This is a work in progress and is by no means a final or definitive framework. Rather it is intended to provide practical guidance and to stimulate constructive discussion globally. Working together, these principles can be refined and a more substantive and rigorous basis developed for assessing IFD. The goal, originally conceived by the Commonwealth, is to build resilience and overcome vulnerability so that in all our member countries – and more widely – sustainable prosperity can take hold with more equitable social and economic inclusion.

Kamalesh Sharma
Commonwealth Secretary-General

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Abbreviations and acronyms

AAL	average annual loss
ADB	Asian Development Bank
AF	Adaptation Fund
AfDB	African Development Bank
AFD	Agence Française de Développement
AMC	Advanced Market Commitment
AMF	Ascending Markets Financial Guarantee Corporation
AMFm	Affordable Medicines Facility-malaria
ARC	African Risk Capacity
AU	African Union
BBC	British Broadcasting Corporation
CARICOM	Caribbean Community and Common Market
CCL	counter-cyclical loan
CCLND	Contingent Credit Line for Natural Disasters
CCM	Country Coordinating Mechanism (Global Fund)
CCRIF	Caribbean Catastrophe Risk Insurance Facility
CDB	Caribbean Development Bank
Cat DDO	Catastrophe Risk Deferred Drawdown Option
CDM	Clean Development Mechanism
CDP	Commonwealth Draft Principles
CER	Certified Emission Reduction Credits
CDPR	Centre for Development Policy and Research
CPMF	Temporary Contribution on Financial Transaction (Brazil)
CRA	Contingent Reserve Arrangement
CSO	civil society organisation
DAC	Development Assistance Committee (OECD)
DDO	deferred drawdown option
DFID	Department for International Development (UK)
DPL	development policy loan
DSL	Development Sustainability Contingent Credit Line
EBRD	European Bank for Reconstruction and Development
DIB	European Investment Bank
EMBI	Emerging Markets Bond Index (JP Morgan)
FAT	financial activities tax
Forex	foreign exchange
FT	Financial Times
FTT	financial transaction tax
GCF	Green Climate Fund
GDP	gross domestic product
GEF	Global Environment Facility
GFI	Global Financial Integrity
GHG	greenhouse gas

GNI	gross national income
HMRC	Her Majesty's Revenue and Customs
IADB	Inter-American Development Bank
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association (World Bank)
IDRM	Integrated Disaster Risk Management
IFAD	International Fund for Agricultural Development
IFC	International Finance Corporation
IFD	innovative financing for development
IFF	illicit financial flows
IFFIm	International Finance Facility for Immunisation
IFI	international finance institution
IMERS	International Maritime Emission Reduction Scheme
IMF	International Monetary Fund
IMO	International Maritime Organization
IOF	Financial Operations Tax (Brazil)
LDC	least developed country
LDCF	Least Developed Countries Fund
LIC	low-income country
MDG	Millennium Development Goal
MDTF	Multi-Donor Trust Fund (World Bank)
MFI	monetary financial institution
MIC	middle-income country
MIE	Multilateral Implementing Entities
MIGA	Multilateral Investment Guarantee Agency
MSME	micro, small and medium enterprise
NASFAM	National Smallholder Farmers' Association of Malawi
NDB	New Development Bank
NIE	National Implementing Entity
NREL	National Renewable Energy Laboratory
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
OIF	Organisation internationale de la Francophonie
OOF	other official flows
OTC	over-the-counter
NAPA	National Adaptation Programmes of Action
PBG	policy based guarantee
PBR	payment by results
PCG	partial credit guarantee
PIDG	Private Infrastructure Development Group
PPP	public–private partnership
PRG	partial risk guarantees
SA	South Africa
SCCF	Special Climate Change Fund

SDR	Special Drawing Right
SIB	social impact bond
SIDA	Swedish International Development Agency
SIDS	small island developing states
SME	small and medium enterprise
SRI	socially responsible investment
SSA	sub-Saharan Africa
STT	securities transaction tax
SWF	Sovereign wealth funds
TRP	Technical Review Panel (Global Fund)
UN	United Nations
UNDESA	United Nations Department of Economic and Social Affairs
UNDP	United Nations Development Programme
UNECA	United Nations Economic Commission for Africa
UNEP	United Nations Environment Programme
UNESCO	United Nations Educational, Scientific and Cultural Organization
UNFCCC	United Nations Framework Convention on Climate Change
UNICEF	United Nations Children's Fund
US SEC	US Securities and Exchange Commission
VAT	value added tax
WFP	World Food Programme
WHO	World Health Organization
WII	weather index-based insurance

Introduction and outline

This publication is intended to serve as a practical tool to enable understanding of how innovative finance for development (IFD) can help overcome the immense challenges facing developing countries, including the Commonwealth's poorest, smallest, and most vulnerable member countries.

There is currently a large shortfall in development financing. While there are no generally accepted estimates of sustainable development financing needs, it is largely agreed that even if the international community meets its existing official development assistance (ODA) commitments, financing needs significantly exceed the finance available. Thus there is an urgent need to tap into new sources of finance and to find ways of delivering traditional sources of finance more effectively. It is critical, therefore, for IFD to be a central feature of the post-2015 financing for development discussions, including the forthcoming third International Conference on Financing for Development in July 2015.

International dialogue on IFD should focus on: seeking agreement that sources of innovative finance should be used primarily for development and climate change; restating the need for an agreement on a core set of principles that should underpin IFD; discussing and agreeing to pursue specific public sources of IFD by identifying a menu of priority IFD options for international focus; and establishing a mechanism to monitor progress in scaling up aggregate IFD and its implementation, which would include agreement on a definition of IFD. Such discussions can also benefit significantly from sharing knowledge and experience, identifying national and regional best practice and examining how best to scale up and broaden successful examples of IFD to other countries, regions and sectors. It is with this latter point in mind that the Commonwealth has developed this toolkit.

This publication consists of four sections:

Section 1. Understanding Innovative Financing for Development presents the context. It considers the current shortfall in development financing and the consequent large financing gaps which need to be filled to meet development and environmental challenges. It looks briefly at *traditional* sources of finance and considers the potential of innovative financing for development to meet the shortfall in financing.

Section 2. Commonwealth IFD Draft Principles and Instrument Selection outlines the draft methodology for assessing IFD instruments. It defines a set of Commonwealth draft principles for

IFD, which take into account the aid effectiveness principles but also consider issues of whether the funds are predictable and sustainable, benefit the poorest, can be disbursed quickly and are additional to ODA. As a foundation for the detailed assessments in Section 3, it identifies the instruments and mechanisms to be assessed.

Section 3. Assessment of IFD Instruments and Mechanisms presents the detailed assessments of the selected instruments using the methodology described in Section 2. The instruments and mechanisms covered fall into five categories. These are: bonds, loans and guarantees, public revenue, insurance, and vertical funds. The assessments are preceded by a brief description of the instrument, discussion on first considerations (e.g. eligibility) and operational aspects.

Section 4. New and Potential Developments raises a series of questions relating to the applicability, feasibility and operation of potential developments in IFD. Targeted at decision makers and technical officials in the smallest, poorest and most vulnerable countries, this section is divided into four parts. It looks at: the adaption of existing instruments covered in Section 3; mechanisms that are still being developed; impact investing; and pooled approaches to development challenges. There are a number of proposals in the international arena which have the potential to significantly fill the development financing gap should there be the political will. Some of these are briefly outlined in this section with the intention of stimulating debate rather than recommending a particular option.

This toolkit is the first of its kind where sources of innovative finance are documented in one place according to a set criteria and then assessed against a set of effective finance principles to help policy-makers navigate the landscape and begin to match mechanisms and sources of finance to fund particular development goals. Initiatives such as this toolkit serve as a platform to facilitate a coming together of minds across the Commonwealth to consider how IFD may be used to address the most pressing development challenges of the day. The true test of this toolkit's utility will be the regularity with which it is consulted and the extent to which it stimulates thinking about new solutions to development challenges. Comments from users of the toolkit are welcomed, and will help to develop the pilot assessment methodology further, and maximising its use among decision makers in Commonwealth developing countries.

How to use the toolkit

This toolkit is intended primarily to be a practical tool that helps decision makers in Commonwealth developing countries to identify, assess and target IFD instruments and mechanisms. Readers may therefore 'quick-start' by heading directly to Sections 2 and 3. However, as the toolkit also aims to raise awareness and stimulate thinking, readers are advised also to review the context in Section 1, and to take time later to consider the new developments and questions raised in Section 4. The pull-out flap on the back cover contains easy-access descriptions of the draft principles.


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Section 1

Understanding Innovative Financing for Development

Overview

This section opens by considering the current shortfall in development financing, and the resultant large financing gaps that must be filled in order to meet the Millennium Development Goals (MDGs) and their successor goals (Chapter 1). It briefly considers traditional sources of finance, including official development assistance (ODA), other official flows (OOFs), assistance from actors outside the Organisation for Economic Co-operation and Development's Development Assistance Committee (OECD DAC), foreign private capital flows, remittances, philanthropy and domestic resource mobilisation. In light of the financing gaps, Chapter 2 seeks to define 'innovative financing for development' (IFD) and finds that there is no internationally agreed definition. This raises challenges for determining how much IFD instruments and mechanisms are generating. The section then makes use of selected analyses to consider the current and potential scale of IFD.

Chapter 1

Overview of Traditional Development Financing

1.1 The context: the development finance gap

Development finance comes from many sources, as shown in Figure 1.1. Each flow has very different features, and some have a higher development component than others. A large proportion of development finance comes from donor governments. However, in recent years, many of the countries that have traditionally been sources or catalysts of development finance have been affected by the global crisis and suffered consequent fiscal challenges. This has translated into a reduction in their contributions to development finance, and Commonwealth developing countries are consequently facing increasing difficulties in accessing funds.

The reduction in development finance from traditional sources falls at a time when achieving sustainable development is becoming increasingly difficult, and when the scale of required financing is growing rapidly. While there is no generally accepted estimate of the financing needed for sustainable development, it is widely agreed that the financing gap is large, as estimates in Table 1.1 demonstrate. The shortfall in development finance thus requires immediate and sustained action in all sectors of development including health, education, food security and the environment.

Figure 1.1 Traditional sources of development finance

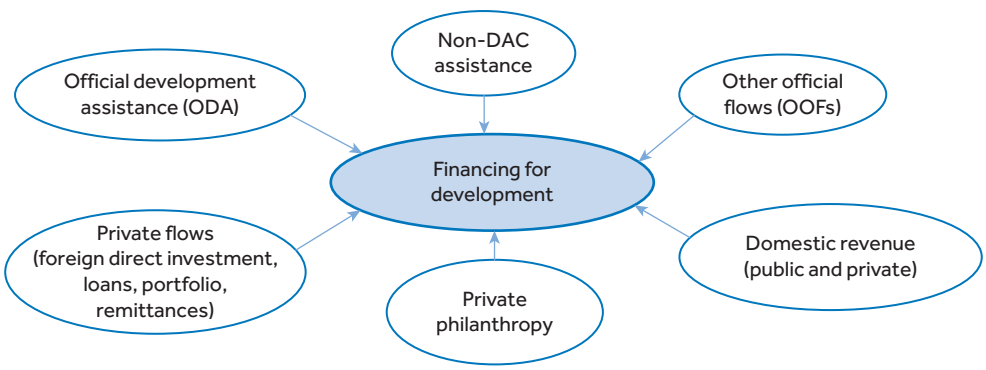


Table 1.1 Additional financing required to fill the development finance gap

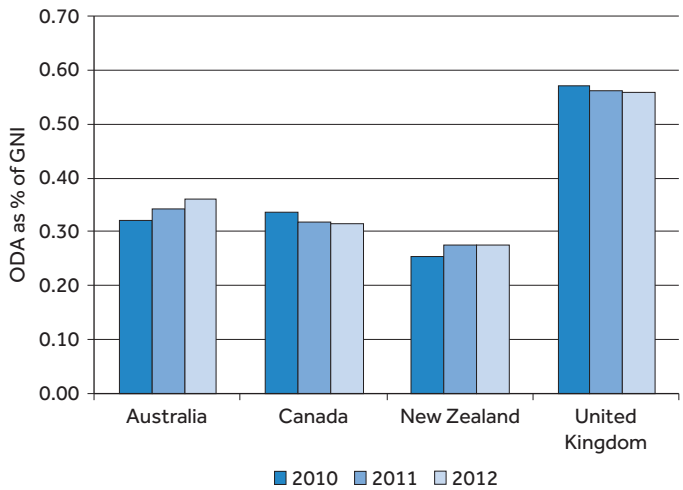
Development sector or objective	Additional cost required per year
Eradication of extreme poverty	An additional US$66 billion per year is needed to provide every person in the world with a minimum income of US$1.25 per day, guaranteeing them the right not to live in absolute poverty (Brookings Institution 2011: 13).
Education	US$42 billion dollars is required per year to achieve universal education – US$29 billion for primary and US$13 billion for lower secondary. Given that donors are currently spending only US$5.8 billion annually on these areas, the financing gap is estimated to be US$38 billion per year (UNESCO 2013).
Health	The financing gap to address communicable diseases alone will increase to US$37 billion per year by 2015. Financing needs for universal access to healthcare will be much larger given that this estimate deals with only a limited range of diseases (WHO 2010).
Water and sanitation	The combined cost of water supply (US$203 billion) and sanitation (US$332 billion) is US$535 billion. Distributed over the period 2010 to 2030 to assist effective absorption of this spending, additional investments of US$27 billion per year would be required (WHO 2012c).
Nutrition	In the period to 2025, an additional US$50 billion per year is required to eliminate hunger (Schmidhuber and Bruinsma 2011).
MDGs 1–6	A further US$121 billion each year is required to meet MDGs 1–6 for health, education and poverty reduction worldwide (OECD 2011a).
Combatting climate change	The needs of developing countries to adapt to the effects of climate change are estimated to total an additional US$75–100 billion per year (World Bank 2009).

Source: Commonwealth 2013c (adapted)

1.2 The shortfall in official development assistance

Since the creation of the MDGs, the international community has made concerted efforts to mobilise financial resources for their attainment. However, a shortfall in MDG funding remains, and the Gleneagles targets for the delivery of ODA set for 2012 have been missed.[1] This is in part because fiscal consolidation in many donor countries, as a result of the global recession, has taken a toll on ODA (OECD 2012a). While ODA reached record levels of US$129 billion in 2010, it has since fallen by 6 per cent in real terms to US$127 billion in 2012 (OECD 2013). The average country effort (measured as the ratio of ODA to gross national income [GNI]) fell from 0.43 in 2010 to 0.40 in 2012, which represents a step back from the United Nations (UN) target of 0.7 per cent of GNI. The country effort among Commonwealth donors improved in Australia (from 0.32 to 0.36) and New Zealand (from 0.26 to 0.28), but deteriorated in Canada (from 0.34 to 0.32) and the UK (from 0.57 to 0.56) (Figure 1.2).

Figure 1.2 Commonwealth donor ODA contributions as a percentage of GNI

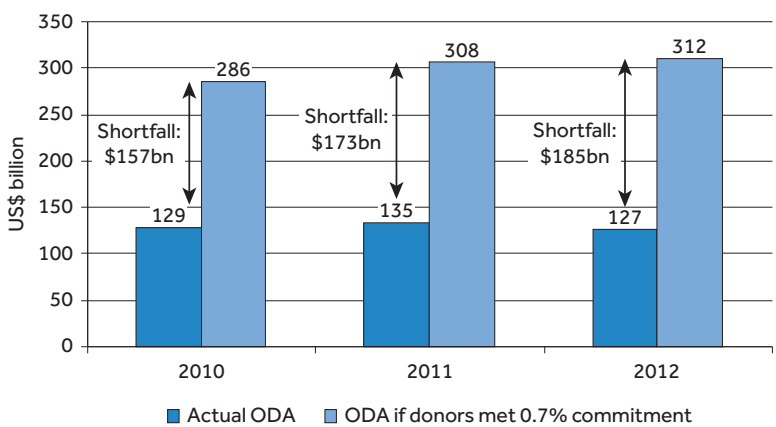


Source: OECD DAC database 2013

Since 2011 only 5 out of 27 DAC members (Denmark, Luxembourg, the Netherlands, Norway and Sweden) have met or exceeded their 0.7 per cent target (OECD 2013).

Figure 1.3 shows that if all DAC countries had collectively met the 0.7 per cent target, they would have raised a further US$515 billion between 2010 and 2012. The shortfall is expected to increase further over time. It is clear that even if existing commitments

Figure 1.3 The ODA shortfall



Source: Based on GNI and ODA figures from the OECD DAC database 2013

are met by DAC countries, ODA will remain insufficient to finance key development challenges, and new and additional resources will be needed.

1.3 Other official flows

Other official flows (OOFs) include transactions by the official sector with countries on the DAC List of ODA Recipients. The OECD does not classify such flows as ODA either because they are not primarily aimed at development or because they have a grant element of less than 25 per cent. The main items in OOF are export credits, official sector equity and portfolio investment, and debt reorganisation. These flows have been much less significant than ODA in recent years, and have been highly volatile, fluctuating from –US$10 billion in 2006 to +US$6 billion in 2008 and +US$10 billion in 2012 (OECD DAC Database 2013). They are therefore not elaborated upon here, beyond noting their limited development impact.

1.4 Non-DAC assistance

Non-DAC assistance refers to the aid contributions from OECD countries that are not members of the DAC, and several non-OECD donor countries.

Non-DAC assistance is currently modest, but is increasing and expected to accelerate. Non-DAC OECD donors contributed US$2.9 billion in aid in 2012, and non-OECD donors reporting to the OECD contributed US$3.6 billion (OECD DAC Database 2013). The total estimated aid contributed by countries not reporting to the OECD was US$5.1 billion in 2012 (OECD 2014). Non-DAC donors are diverse, and as such their objectives and methods of delivery vary among themselves as well as to those of the DAC. Many of them do not use the MDGs as their guiding framework. They fall into the following three broad categories, each with a distinct view on using the MDGs as a guiding framework (ODI 2012: 12–13, 18):

1.4.1 Emerging donors

Emerging donors such as Turkey and Israel are most similar to DAC countries in terms of characteristics, but they are smaller. In 2012, Turkey was the largest contributor of aid among OECD non-DAC countries, with net disbursements of US$2.5 billion (OECD 2014).

1.4.2 Providers of South–South co-operation

Donors in this group, including China, India and Brazil, are guided on the basis of solidarity, mutual benefit, reciprocity and non-interference more than poverty reduction per se. They provide both financial and technical assistance, and their support may be given through commercial packages or loans. In 2012, China contributed US$2.8 billion, India US$0.8 billion and South Africa US$152 million (OECD 2014).

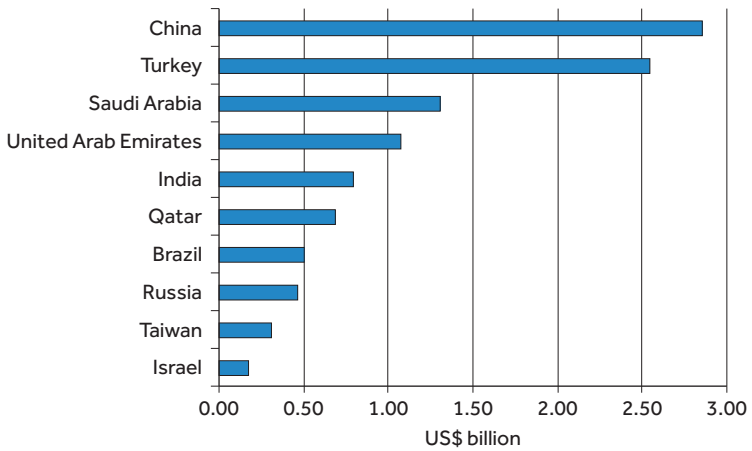
1.4.3 Arab donors

Arab donors such as Saudi Arabia, Kuwait and the United Arab Emirates have a track record as primarily bilateral donors, and take different approaches to the DAC. For example, they may be motivated by solidarity among Arab countries and take religious activities as guiding principles. In 2012, Saudi Arabia and the United Arab Emirates contributed US$1.3 billion and US$1.1 billion respectively in ODA-like flows (OECD 2014).

1.5 Foreign private capital flows

Private capital inflows from non-resident investors and creditors have been volatile, eroding the ability to build resilient growth. Furthermore, foreign direct investment (FDI), non-publicly guaranteed private sector external debt and portfolio flows have tended to be pro-cyclical (decreasing during economic downturns in recipient countries). Remittances were until recently considered to be counter-cyclical (increasing during economic downturns in recipient countries), but because the effects of the recent global financial and economic crisis were so wide ranging, even remittances were hit during the downturn. For example, the contraction in US construction led to redundancies and reduced incomes for workers of Latin American origin, which led to a fall in remittances to countries in Latin America that were also being hit by the crisis. Private philanthropy may also be pro-cyclical, and these flows are small, but they are expected to increase. It should also be noted that different types of private flows have very different impacts on development – see Bhinda and Martin (2009) for a more detailed discussion.

Figure 1.4 Non-DAC assistance: largest ODA-like flows from non-DAC donors in 2012



Source: OECD 2014

1.5.1 Foreign direct investment

FDI has tended to concentrate in resource-rich exporting countries and a number of middle-income countries (MICs). Although FDI inflows have recovered in most developing regions, Africa continues to experience a decline (UNCTAD 2012), widening the gap between richer and poorer countries. While FDI can have positive development benefits, it is guided primarily by profit and not by the MDG principles, so cannot be relied upon exclusively to plug development finance gaps. The development benefits of FDI are in part determined by the sectors of economic activity they enter, the number and quality of jobs they generate and the development of local infrastructure. Although FDI is generally assumed to be long term and stable, it includes short-term components such as short-term loans from parent companies or affiliates and reinvested earnings that can be repatriated very quickly (for a discussion on FDI volatility, see UNCTAD 2011: 21–3). FDI has traditionally flowed from countries in the North to those in the South. However, this has been changing dramatically in recent years.

South–South FDI is expected to play an increasingly significant role for the least developed countries (LDCs) in the future. This has the potential to boost productivity and significantly affect development patterns. South–South FDI has been less volatile than FDI from developed countries, and has been more resilient during the recent global economic crisis, partly because it is less dependent on debt financing (UNCTAD 2011: 76).

1.5.2 Private sector external debt

Non-publicly guaranteed private sector external debt has also been a significant contributor to development assistance. Its development benefits again vary depending on the economic sector concerned, how the money is used and whether the debt is long or short term – the latter being potentially destabilising. The purpose of the debt is a key issue. It can be used, for example, to supplement the activities of business, and therefore support FDI. It can also be short term to cover day-to-day business costs, thus being potentially unstable. It can also be in the form of supplier credits, which are typically short term, but which oil the wheels of global economic activity (even the most traditional instruments were hit during the recent crisis). The cost of the debt is also a key determinant of its sustainability, as is its ratio relative to long-term equity.

1.5.3 Portfolio investment

Portfolio investment covers transactions in equity and debt securities. Portfolio investments provide a means for business to finance its activities, and if invested directly into the business, they can be long term and sustainable. However, they tend to be invested via fund managers, and are often highly speculative and short term, and hence have extremely destabilising effects. The UN reports that, in 2013, net

portfolio flows to developing countries experienced a sharp decline, turned negative in 2013 and remain extremely volatile (UNDESA 2014).

1.5.4 Remittances

A large share of remittances is used by households for subsistence purposes, and is therefore development related. It is estimated that remittances to the developing world in 2013 totalled US$414 billion, and are expected to continue growing strongly over the medium term. With an estimated average annual growth rate of 9 per cent, remittances should reach US$540 billion in 2016 (World Bank 2013b).While they are not new, much is still to be understood about the scale and impact of remittances, as large amounts pass through informal channels and are thus not represented in official statistics. Furthermore, the global dialogue tends to assume that anyone can benefit from migration and remittances, yet in reality even less is known of their distributional aspects. This is a question not just of the extent to which remittances are reaching the poorest countries, but also of the extent to which they are reaching the poorest households in the poorest countries.

A study of remittances in the Buduburam Refugee Settlement in Ghana found that recipients of remittances were invariably the offspring of the ruling ethnic elite in pre-war Liberia, many of whose wealthy members had long ago migrated to the USA and other rich countries (SOAS 2011). If these findings were to prove more widely applicable, this would suggest that the development impacts of remittances, while real, are unlikely to be as great as is currently assumed. It also highlights the need for more research into these distributional aspects with respect to the poorest households in particular. Research into the distributional impacts of remittances remains sparse.

In spite of these gaps in understanding, remittances have gained growing attention in recent years due to their rapid growth in absolute terms (dwarfing even FDI in some countries), and their significance relative to the size of the economies they enter.

The issue is also critical to Commonwealth developing countries. The top recipients of officially recorded remittances for 2013 included India (US$71 billion) and Nigeria (US$21 billion). Pakistan and Bangladesh (both Commonwealth countries) are also among the larger recipients. Although the amounts that they receive in absolute terms are much smaller, remittances to small states are arguably even more significant as their remittances are larger relative to the size of their economies. Relative to gross domestic product (GDP), Lesotho and Samoa were among the top recipients in 2011 at 27 per cent and 21 per cent respectively (World Bank 2013), and Tonga has experienced similarly high flows of over 20 per cent (Government of Australia 2011).

Innovation in the area of remittances relates in large part to market efficiency. Remitting, via official channels at least, can be very expensive, averaging around 9 per cent of the total amount sent (World Bank 2013b). This has resulted in a

very high number of remittances being sent via informal channels, which are difficult to measure.[2] In response, Commonwealth developed countries have in recent years been actively engaging in improving the efficiency and reducing the costs of remitting to developing countries. Some examples are outlined below, as remittances per se are not dealt with in the later chapters on innovative instruments and mechanisms.

In recognition of the sheer scale of remittances and the fact that half of global remittance flows are sent or received by G20 member countries, at its Cannes summit in 2011 the G20 prioritised action to maximise the positive impact of remittances by making them less costly to send and receive. At the summit, the G20 set a target of reducing the average transfer cost from 10 per cent to 5 per cent by 2014, which it is estimated will provide an additional US$15 billion per year to recipient families. The G20 has also committed to monitor progress on reducing the average cost through the World Bank, including actions that will be undertaken to reach the aforementioned quantitative target.

The comparison website www.fxcompared.com, initiated by the UK's Department for International Development (DFID), offers near-live rates freely to its users, in response to the high charges commanded by money transfer companies. Since its establishment in 2005, the website has broadened its scope to become global. It is now privately owned by FX Compared Ltd (PBI), and raises money from advertising. Similarly, a website established by the governments of Australia and New Zealand – www.sendmoneypacific.org – contributed to reducing the average cost of sending US$200 to Pacific island countries by US$6 (3 per cent) during the period from January 2009 to June 2011. The website allows remitters to freely compare the costs of sending money from Australia, New Zealand or the USA to Fiji, Kiribati, Papua New Guinea, Samoa, Solomon Islands, Tonga, Tuvalu or Vanuatu.

Australia has been promoting remittance flows in its region in collaboration with the G20 and the Pacific Islands Forum Economic Ministers' Meeting. It provided A$3.5 million from 2011 to 2013 to assist Commonwealth developing countries including those in the Pacific to set up their own mechanisms to reduce costs (and thus maximise amounts received by households to pay for education, healthcare and general subsistence), support the development of new technology such as mobile banking services and provide increased access to financial services for the poor (Australian Government Treasury 2011).

The trend of migration is also shifting from a predominantly South–North direction to a more South–South outlook, and there is therefore an urgent need to broaden the focus of intervention to ensure the maximisation of intra-regional remittances. Primary options could include encouraging regionalism, which would entail creating regional organisations such as banks, which would not charge a premium for sending money within the region.

1.5.5 Private philanthropy

Philanthropy from private corporations and from foundations such as Gates, Hewlett, Ford and Rockefeller reached US$25.3 billion in 2009, and whilst this amount is relatively small, it is expected to grow (Greenhill et al. 2013). The top 50 philanthropic donors in the USA gave over US$7.4 billion to non-profit organisations in 2012, US$3.1 billion of which was donated by Warren Buffett alone (Chronicle of Philanthropy 2013). This type of support may be closely aligned to the MDG framework, but may not be explicitly guided by it. In the case of Hewlett, this is explained by the small size of the organisation. The Gates Foundation feels it can influence international development issues without making specific reference to the MDGs (ODI 2012: 20–1).

1.6 Domestic public and private sector revenue mobilisation

1.6.1 Public sector

It has long been recognised (including in the 2002 Monterrey Consensus on Financing for Development) that domestically generated revenues should be the primary source of resources to support developing countries fund their economic and social development. Over the last decade Commonwealth developing countries have made important progress in relation to revenue generation, although the period since the global financial crisis has seen some reversal. The average Commonwealth developing country's revenues increased from 23.8 per cent of GDP in 2000 to 28.3 per cent in 2006, before falling to 25.9 per cent in 2011. This compares with revenue levels of 36–38 per cent that high-income countries achieved on average during the period 2006–11 (Commonwealth 2013d). However, the prospects for increasing domestic revenue mobilisation relative to GDP via the public sector remain very limited in the Commonwealth's poorest and smallest countries. MICs and resource-rich countries have the greatest scope to raise revenue through more efficient tax gathering efforts, but these countries are generally already on track to achieve the MDGs (OECD 2011a: 13). In contrast, the poorest countries must still look outside their borders for the bulk of development assistance. In all countries a number of challenges will need to be overcome to increase domestic revenue mobilisation further, including stemming revenue losses from illicit financial flows, broadening the tax base and building the capacity of tax administrations.

1.6.2 Private sector

Domestic revenue from the private sector includes domestic private investment. In the poorest countries, this tends to be from micro, small and medium-sized enterprises (MSMEs), which form the majority of the business community and are in many ways the backbone of the economy. Such enterprises have experienced a great deal of difficulty obtaining long-term financing from domestic banking sectors, and accessing international finance is generally not an option. There is also the risk

that such enterprises may to some extent be crowded out by foreign investment. However, larger domestic enterprises that may find it easier to tap finance from domestic and even international banks may in some cases enter into joint ventures with foreign direct investors to invest in MSMEs. Data on the domestic private sector remain limited, but this and the nexus with foreign investment and the contributions to development provide a fertile area for further research.

1.7 Innovative financing for development

With traditional sources failing to raise sufficient funds to meet the challenges of the poorest households and countries, development partners, as well as developing countries themselves, are seeking and finding innovative ways to raise additional development finance and use existing funds more effectively. A number of new initiatives have been launched at the global level, which have mainly been used to fund health sector programmes. These efforts are highly commendable and necessary and the majority of these mechanisms have been innovative in the way finance has been channelled. However, the financial resources for development that are currently classified as IFD are in fact ODA, and thus are not additional to net financial resources available to developing countries for their development. As a consequence of this blurring, it is particularly important to locate the debate on IFD in the context of the need to raise finance at the global level that is *additional* to present sources. In this sense, developing countries perceive innovation in itself as inadequate if funds raised through innovative means are subsumed within existing donor commitments.[3] In light of the above, Chapter 2 explores how IFD is currently understood, as well as its actual and potential gains for development.

Notes

1 At the Group of 8 Gleneagles Summit in 2005, donors promised to increase ODA by US$50 billion by 2010. The target was missed by US$24 billion (in 2010 dollars). Source: www.oecd.org/dac/stats

2 Irregular migration is also a significant aspect of informally channelled funds. Undocumented migrants resort to this method of migration to remain undetected. Irregular migration exacerbates the problem of the lack of data, which compromises informed decision-making.

3 For a more detailed discussion on additionality and the relationship between innovative finance for development mechanisms, see OECD 2011b, 2009.

Chapter 2

The Innovative Financing Landscape

2.1 What is IFD and who are the actors involved?

The quest for innovative and additional sources of financing for development has a long lineage. Mobilising IFD was recognised as a key challenge and objective at the UN International Conference on Financing for Development in Monterrey in 2002 (UN 2002). Political-level discussion has since gathered pace in international and regional forums including the Commonwealth Finance Ministers Meeting in 2011 (Commonwealth Secretariat 2011a), the G8 in 2009 and the G20 in 2011. Political commitments have been supported by a growing body of technical work by international, regional and national organisations, private sector associations and foundations, and civil society organisations (CSOs) (Table 2.1).

Table 2.1 The main actors involved in IFD and their roles

Category of actor	Selected stakeholders included in category	Actual and potential roles
Multi-stakeholder forums	Leading Group on IFD	• Experience sharing • Research and advocacy
International and regional organisations	Asian Development Bank (ADB), African Development Bank (AfDB), The Commonwealth, G20, Inter-American Development Bank (IADB), International Monetary Fund (IMF), OECD, UN, World Bank	• Mechanism design / management • Financial and technical assistance • Research and advocacy
Vertical funds	Adaptation Fund; The GAVI Alliance; Global Fund to Fight AIDS, Tuberculosis and Malaria; Global Digital Solidarity Fund	• Mechanism design / management • Delivery of development-related services
Private sector networks and foundations	Global Impact Investing Network, Gates Foundation	• Research and advocacy • Financial assistance
Civil society	ONE, CIDSE, Save the Children, Global Action for Health, World Wildlife Foundation (WWF), Ubuntu Education Fund	• Research and advocacy

(continued)

Table 2.1 (Continued)

Category of actor	Selected stakeholders included in category	Actual and potential roles
Donor governments	Aid agencies, donor governments	• Financial assistance • Advocacy
Developing country governments	Ministries of finance, health, education, environment, agriculture and others	• Mechanism design / management/ implementation • Delivery of development-related services • Advocacy

However, while IFD is being included in the agendas of a wide range of development organisations, there remains no widely agreed definition of what constitutes IFD, as Table 2.2 shows.

Broadly speaking, IFD refers to innovations in the way funds are mobilised as well as ways in which they are spent. Thus, while mechanisms such as the voluntary airline levy, International Finance Facility for Immunisation (IFFIm) and green bonds are

Table 2.2 Criteria by which various organisations define IFD

	EU	Leading Group on Innovative Financing for Development	Open Society Institute	OECD*	United Nations Department of Economic and Social Affairs (UNDESA)	World Bank	WHO
Application of funds							
Development-related	✓	✓	✓	✓	✓	✓	✓
Major public sector element				✓	✓		
Includes smaller projects		✓	✓			✓	✓
Type of innovation							
Innovative mobilisation	✓	✓	✓		✓	✓	✓
Innovative delivery	✓		✓		✓	✓	✓
New use for existing source	✓		✓		✓	✓	✓

(continued)

Table 2.2 (Continued)

	EU	Leading Group on Innovative Financing for Development	Open Society Institute	OECD*	United Nations Department of Economic and Social Affairs (UNDESA)	World Bank	WHO
Source of finance							
Includes purely private flows	✓					✓	✓
Includes purely domestic flows			✓			✓	✓
Involves cross-border flows			✓	✓	✓		
Other qualities							
Additional to ODA	✓	✓	✓		✓	✓	✓
Predictable and stable		✓	✓				
Counter-cyclical		✓	✓				
Major concessional element				✓			
Ready to be implemented				✓			

*Based on a working definition, not an official OECD definition.

Sources: European Commission (EC) 2012: 37; Leading Group on Innovative Financing for Development; Open Society Institute 2010: 3; OECD 2011b; World Bank 2009; WHO 2010; UNDESA 2012a

innovative ways of fundraising, new types of public–private partnerships including vertical funds such as the GAVI Alliance, as well as official counter-cyclical loans, also represent innovative channels of delivery.

An important criterion that features in most definitions of IFD is that it should be additional to ODA and not substitute existing traditional development financing. Yet analysis in this toolkit shows that much of what is currently considered to be IFD is, according to the OECD, classifiable as ODA and therefore not additional. The addition of IFD to existing sources of development finance therefore needs to be measured rigorously.

At this juncture it should be noted that the OECD is currently undertaking a review to develop new ways of measuring and monitoring external development finance beyond ODA, which will underpin the post-2015 financing framework. This includes a review of the definition of ODA, which may have significant implications for

additionality, the degree to which the availability of concessional funds will increase in future years and hence the definition of IFD in a post-2015 context.

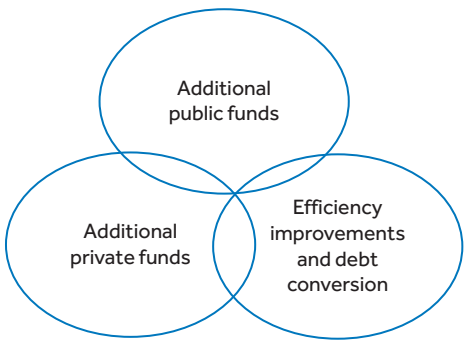
As Table 2.2 illustrates, different definitions of IFD also encompass private, official sector and domestic involvement to varying degrees. The World Bank, WHO and Open Society Institute consider mechanisms that are fully domestic.

The German Development Bank (KfW) categorises IFD into three broad, overlapping groups according to whether funds come from public sources, private sources or efficiency improvements. This definition includes additionality and efficiency aspects, and recognises a role for both public and private sectors, as shown in Figure 2.1.

While there is some overlap in how different agencies define IFD, definitions are shaped by the mandates and constituencies of the agencies concerned, and therefore do not agree fully. Several other agencies interviewed for this publication indicated that they do not have an official definition, although their literature refers to the concept.

This lack of precision means that absolute concepts have often become mixed with relative or spatial ones: some instruments, or applications of instruments, are genuinely new, while others may have existed somewhere before but are new to a particular region, country or even organisation. The definitions also do not address the question of shelf life: they do not specify when an instrument or mechanism ceases to be innovative and enters into the traditional mainstream. Should this, for example, be judged according to time, adoption or other considerations, and what thresholds should be set to decide this? For example, diaspora bonds have been used by India since 1991 but at what point they cease to be considered as innovative would depend on how the above questions are answered. Answering these questions is not of purely academic value. Clarity on them is needed in order to fully assess the scale of the financing gap and IFD's contribution to filling it.

Figure 2.1 The relationship between innovative financial instruments



Source: KfW 2012: 1

2.2 Current and potential use of IFD

2.2.1 Current IFD generated

Amount generated by IFD

It is difficult to ascertain how much IFD is generating and where it is going, owing to a lack of clarity in the definition of IFD.

Based on data compiled by the UN (2011b), the OECD estimates that, during the period 2002–2010, US$36.5 billion was generated for development assistance by innovative financing mechanisms, US$31 billion of which was channelled to environmental concerns and the remainder to health. However, the OECD classifies most of this as ODA. While many of these mechanisms may have been effective, because the majority of IFD has not been additional to ODA, development financing gaps remain substantially unfilled, and this is a major source of concern.

The World Bank estimates that IFD generated during the period 2002 to 2008 was a higher US$57 billion. This originates from a very wide range of sources, comprising predominantly official sources (based on data compiled by the UN [2011b]), including US$41 billion from domestic currency bonds issued by multilateral development banks and US$10 billion in aid from new donors. The inclusion of domestic currency bonds as IFD may be questioned in itself, as these flows may be seen as an effective way of managing debt to reduce currency mismatch rather than a source of development finance.

The Leading Group on Innovative Financing for Development (2014) estimated that its members had raised US$6 billion between 2006 and 2012 through the use of taxes on air transport, state guarantee mechanisms, the auctioning of CO_2 emission quotas, debt-for-nature SWAPs, lotteries and donations via participatory funding systems (Leading Group 2014: 10).

How and where IFD is being used

The majority of what is considered to be IFD has to date been channelled towards the health sector, administered via high-profile vertical funds to tackle communicable diseases in particular, such as HIV/AIDS, tuberculosis and malaria. Tackling environmental challenges has also been a significant recipient of IFD, with the main targets primarily being climate change mitigation and adaptation. As discussed in Section 11 of this toolkit, there are no technical obstacles to rolling out many of these instruments to other development sectors, such as education. The main challenges at present may relate more to the fiscal and revenue pressures being experienced by donor governments and the private sector.

Regarding geographic spread of the IFD, an assessment of the Caribbean and Latin American experience in the 2000s has found that some IFD reached the region, but the amounts were very small relative to national savings, government revenue and GDP.

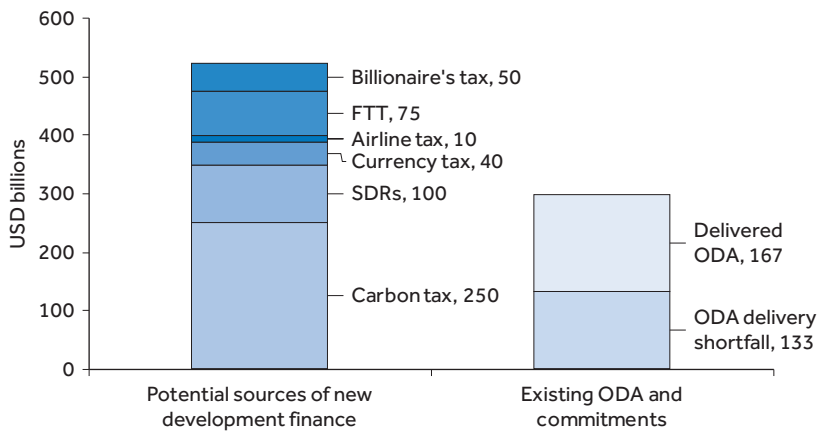
Funds originated mostly from vertical health and climate funds. Health funds have been more important in some small countries such as Haiti, while climate funds have tended to finance larger Latin American countries, with much less allocated to Caribbean countries, which are thought to be more vulnerable to the effects of climate change. While these funds have had some positive impact on health and climate, they have been too small to have a significant macro impact, and, as most were channelled through separate mechanisms, have not added to fiscal space. Remittances to the region therefore continue to play a relatively more important role in raising consumption and investment and in reducing poverty (Gottschalk 2012: 24–5).

2.2.2 The potential of IFD

Section 2.2.1 showed that, for all the attention it has received, IFD remains a small contributor to development finance. Nonetheless, UNDESA estimates that proposed instruments and mechanisms have the potential to contribute several times the current ODA levels.

As shown in Figure 2.2, potential IFD mechanisms and the amounts they could generate include the proposed internationally concerted carbon tax on the use of fossil fuels and other products contributing to CO_2 emissions (US$250 billion); the proposal to leverage idle special drawing rights (SDRs) holdings of reserve-rich countries for investment in development (US$100 billion, in addition to the US$150–270 billion which could be freed up for development through the proposed annual SDR issuance in favour of developing countries); a financial transaction tax (FTT) (US$15–75 billion); a tax on major foreign currency exchange transactions

Figure 2.2 Potential contributions of IFD instruments versus ODA (US$ billions /year)



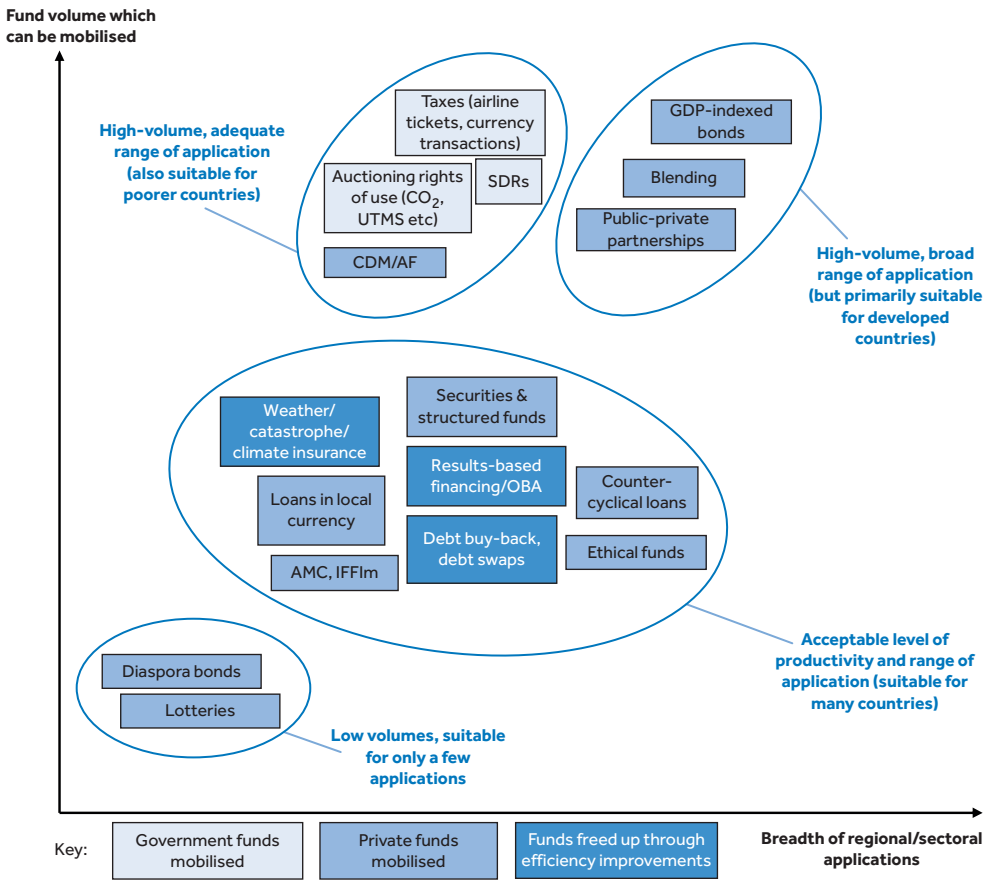
Source: UNDESA (2012b: 2)

(US$40 billion); the proposed international billionaire's tax of 1 per cent on individual wealth holdings of US$1 billion or more (US$50 billion); and the solidarity levy on airline tickets (US$1–10 billion) (UNDESA 2012a: vi–viii; 2012b: 1–2).

KfW looks at a wider range of instruments and mechanisms, and assesses them based on their breadth of application and their potential for raising large sums. These are shown in Figure 2.3.

KfW groups the instruments into four clusters. Instruments that 'should be pursued with vigour' generate a high volume of funds and have a broad or adequate range of application (top two clusters). Funds in this group include private funds followed by government funds. Instruments that 'could be considered more often' generate a fair

Figure 2.3 KfW assessment of instruments based on potential for application and for mobilising large sums



Source: KfW 2012: 5

level of volume, have a fair range of application (middle cluster) and are a mixture of private funds and efficiency gains. Finally, 'instruments that complete the former instruments in specific contexts' generate a low volume and have a limited range of application (bottom left cluster). These are private funds. For further information on the KfW assessment, see KfW 2012: 5–6 and KfW 2013. A number of these instruments are reviewed and assessed using the Commonwealth's own draft principles in Section 3 of this toolkit.

Again, caution is needed when considering these large amounts. As will become apparent in subsequent chapters, not all of the funds raised by these proposed mechanisms will necessarily be allocated to development, and those that are may not be additional to pre-existing levels of ODA.

2.2 The future of IFD

In conclusion, although there has been much discussion about IFD and how to define it, the amounts generated by it are rather small at present. IFD therefore needs to be scaled up considerably over and above existing ODA if it is to help to close development financing gaps.

In addition, Commonwealth developing countries need more clarity as to what is or is not IFD and how they might seek to tap into these different sources in order to plug their development financing gaps. Chapter 4 addresses this by defining a set of Commonwealth draft principles for IFD and discussing their application to a selected range of IFD instruments and mechanisms, which are assessed in Chapter 5.

Section 2

Commonwealth IFD Draft Principles and Instrument Selection

Overview

This section lays the foundations of the 'toolkit'. It proposes a set of draft Commonwealth principles for IFD and outlines a draft methodology for assessing IFD instruments to help policy-makers navigate the IFD landscape and start matching instruments and sources of finance to fund particular development goals. Chapter 3 highlights the short- and long-term steps needed to develop a robust 'toolkit' that can identify and match potential sources of IFD for achieving development goals in Commonwealth developing countries. The first of these steps, attempted in this book, is to identify new sources of development finance guided by a set of credible and broadly representative principles. Chapter 4 seeks to define a set of draft Commonwealth principles for IFD. These draw on, but go beyond, aid effectiveness principles to take account of critical issues including whether or not the funds are additional to ODA, whether they are predictable and sustainable, whether they benefit the poorest and whether they can be disbursed quickly. In addition, it looks at the cross-cutting issue of the capacity of beneficiary countries to own, implement and benefit from each instrument or mechanism. Chapter 5 briefly identifies the instruments and mechanisms to be assessed in more detail in Section 3 of the toolkit, and sets out a preliminary methodology for assessing these instruments.

Chapter 3

Towards a Toolkit for Matching Finance to Development Goals

Momentum is building internationally on the conceptual design and content of a post-2015 development framework. By the end of 2015, the international community is expected to have agreed a new development agenda and the means for implementing it. All indications are that this will be a unique and universal agenda, focusing on the eradication of extreme poverty in the context of sustainable development. This global discussion is being pursued in the context of a continuous and rapidly changing global economic, political and developmental environment; a context in which there are many new development actors, a new poverty map and persistent challenges to the underlying efforts to achieve structural transformation.

It is expected that a new post-2015 financing framework is likely to be agreed upon at the third International Conference on Financing for Development, held in July 2015. If the framework is to meet the financing challenge it will need to mobilise a more concerted effort to identify and leverage innovative finance at the national, regional and international level.

This emphasis and the growing importance of IFD necessitates a toolkit that can help policy-makers identify potential sources of IFD and match finance to particular development goals in Commonwealth developing countries. Such a toolkit would need to be very robust. Achieving this is a long-term project, but it can be started now.

From the perspective of the Commonwealth, three key steps are needed to begin the creation of such a toolkit:

The first step – attempted in this toolkit – is to identify available and in some cases untapped sources of finance that could be used to generate funds for development. This would be guided by a set of credible and broadly representative principles to help decision-makers, particularly those in Commonwealth developing countries, to assess the value of particular financing instruments to particular development goals. Towards this objective, this section of the toolkit outlines a preliminary list of such principles, explains how they have been derived and indicates how these principles are amenable to some form of objective measurement. It then goes on to assess a selection of specific instruments and mechanisms against the draft principles.

The second step comprises gathering more detailed evidence at the level of the beneficiary country about the overall value of specific instruments in achieving their development goals on the ground. This would also involve the emergence of a more detailed assessment methodology for evaluating the applicability of each principle that can be broadly agreed by the international community, together with an associated set of measurement tools.

A third step is the development of a more rigorous methodology for measuring the applicability of specific financial instruments and mechanisms in achieving an array of development objectives. This is a longer-term project that will require much closer inter-agency co-operation.

Chapter 4

The Commonwealth IFD Draft Principles

As a first step towards helping Commonwealth developing countries to match their development objectives with actual and as yet untapped sources of finance, this chapter endeavours to draw up a framework of draft principles that IFD instruments should fulfil. It is by no means intended to be a final assessment framework; rather, it is intended to provide preliminary guidance and stimulate debate that will lead to refinement of the draft principles and to the development of a much more rigorous assessment framework in the medium to long term. Drawing on its extensive work in aid effectiveness and capacity-building across the spectrum of its developing country membership, the Commonwealth believes firstly that the principles should draw on the strengths of the existing aid effectiveness principles and, secondly, that because they are insufficient on their own, they should be built upon in order to derive a set of principles that is more fully aligned with country concerns and conducive to country efforts to raise significant sustainable development finance. Each of these aspects is considered below.

4.1 Adapting the aid effectiveness principles

Important lessons learned from decades of experience with the delivery of development assistance are highly relevant in this wider context, with a slightly different emphasis in some cases. For example, ownership and integration with country priorities (and delivery systems in particular) are important to all sources of finance regardless of the motivation behind implementation. However, regarding harmonisation in this broader context, emphasis may be placed on the complementarity of different sources of finance and their comparative advantage. These important lessons have therefore been reflected in the Commonwealth draft principles.

The Paris Declaration outlines five fundamental principles for making aid more effective and increasing its impact (OECD 2005/2008):

- **Ownership:** Developing countries determine and implement their own development policies to achieve their economic, social and environmental goals.
- **Alignment:** Donors base their overall support on partner countries' national development strategies, institutions and procedures, committing to use country systems as the first option for aid programmes in support of activities managed by the public sector, with developing countries improving the quality and transparency of their public financial management system.

- **Harmonisation:** Donors make their actions more co-ordinated, transparent and agile, sharing information, simplifying procedures at country level and making full use of comparative advantages.
- **Managing for results:** Aid is implemented in a way that focuses on desired results and uses information to improve decision-making. Developing countries strengthen linkages between national development strategies and budget processes.
- **Mutual accountability** and transparency in the use of development resources and their results on the part of developing countries via parliament and civil society and on the part of donors via more predictable aid.

The aid effectiveness principles are well understood, and have been adopted by a wide range of stakeholders including Commonwealth member countries. The Commonwealth acknowledges that these principles are critical for ensuring effective aid and recognises their wider applicability, so they are included in a more condensed form in the Commonwealth draft principles. The Commonwealth draft principles, adapted from existing aid effectiveness principles, include:

1. national ownership (adapted from aid effectiveness principle 1);
2. international alignment and harmonisation (combined aid effectiveness principles 2 and 3); and
3. results and accountability (combined aid effectiveness principles 4 and 5).

As these principles are already well understood, they are not elaborated on further in this toolkit.

4.2 Adding to the aid effectiveness principles

In the context of generating sufficient innovative finance to meet development goals, the aid effectiveness principles are necessary but not sufficient. Several major challenges also need to be addressed. In particular, new finance should be:

- additional to existing sources of development finance (ODA in particular) in order to plug development financing gaps;
- sustainable and counter-cyclical wherever possible;
- pro-poor; and
- disbursed as quickly as possible.

Each of these points can be considered a principle in its own right, and they are elaborated on below. Finally, new flows will be of little use if countries do not have the capacity to manage and implement them. Capacity considerations cut across several principles and are also explained further below.

4.2.1 Additionality

To date, a significant share of what is classified as IFD is classified as ODA, and therefore its additionality is very limited. As a result, flows at the present time are insufficient to lift the populations of the poorest, smallest and most vulnerable countries out of poverty. For this reason, additionality is placed first in the Commonwealth draft principles.

4.2.2 Predictability and sustainability

The aid effectiveness principles address predictability and sustainability on various levels. Those relating to ownership, alignment and harmonisation each contribute to sustainability. Those relating to alignment, harmonisation, managing for results and mutual accountability arguably contribute to greater predictability. However, in the wake of the global financial and economic crises many of the poorest countries have witnessed that these principles are insufficient. The global downturn has severely challenged financing for development on several fronts, including by putting downward pressure on ODA and private capital flows including remittances. In addition, the operations of pro-poor vertical funds such as the Global Fund to Fight AIDS, Tuberculosis and Malaria have been compromised (see Chapter 11). This lack of predictability is very disruptive. Ideally, IFD would help to offset these destabilising pro-cyclical effects by either increasing during downturns (counter-cyclical) or acting neutrally to the effects of global downturns (a-cyclical). It is therefore very important for the Commonwealth draft principles to address the cyclicality of development finance in relation to sustainability and predictability.

4.2.3 Pro-poor

The draft principles address whether the finance under consideration is pro-poor, because this is by no means guaranteed, as evidenced by the descriptions of particular instruments and mechanisms in Section 3. Consideration of this issue is especially important in a world where growing inequality has become a pressing problem.

Pro-poor impacts may be direct, for example via enhanced provision of health or education to the poorest communities, or they may come via trickle-down effects, for example through wider economic development, such as from investment in infrastructure or the environment.

In the discussions and assessment that follow, both channels of impact are considered on equal terms, and no one channel is advocated over another. Both channels of pro-poor impact have their limitations, and the toolkit includes some discussion on these.

In the context of direct pro-poor impact, while rapid progress has been made in some areas, for example inoculation against specific diseases provided via vertical funds, other, less appealing, priorities in the same development sector may be

overlooked or insufficiently addressed. Similarly, some development sectors such as education may have hitherto benefited less from innovative financing than other sectors for the same reason. Thus the pro-poor benefits of innovative financing mechanisms are present in specific cases, but are uneven overall.

Indirect pro-poor impact is a less automatic process. It is clear that growth in many parts of the world is not translating into jobs, and certain groups may be benefitting over others, and as a consequence inequality is in fact on the rise.

Finally, a number of the instruments covered are *not inherently* pro-poor. For example, domestic taxes, strategies to reduce IFFs, and bonds issued by developing countries have no intrinsic features in their design that guarantee the use of their revenues towards development goals. In these cases, a conscious decision on the part of policy-makers is required to allocate revenues to development outcomes, and even then the pro-poor impact is not assured.

In the case of bonds, by publicly linking their bonds to specific development objectives, governments can help to market bonds more effectively to potential investors from the diaspora, and from the international community more widely. In the case of new taxes, indicating that their revenues will be linked towards related development objectives such as environmental taxes to address certain environmental externalities and market failures may also help in promoting compliance as part of a process of moral suasion.

The aforementioned limitations to pro-poor impacts apply in various ways to the majority of the innovative instruments and mechanisms covered in the toolkit, as well as to traditional finance. To overcome these limitations as much as possible, countries should consider identifying, implementing, adapting or subscribing to a portfolio of relevant instruments and mechanisms that have impacts on poverty (either direct or via trickle-down), as well as those with no inherent link but with a view to targeting development goals.

4.2.4 Disbursement

A lack of harmonisation among donors and conditionalities imposed by donors on beneficiary countries can both lead to delays in the disbursement of development-related finance. Co-ordination between donors and between donors and other stakeholders is crucial to reducing waste and maximising benefits to developing countries. However, harmonisation brings its own challenges. For example, harmonisation between many partners can further delay disbursements.

Delays in the release of funds can have devastating consequences for the poorest, smallest and most vulnerable countries. It is therefore essential that enhanced co-ordination procedures and the design of any donor conditionalities serve to accelerate rather than slow down the release of funds to where they are most needed. Fast disbursement is therefore reflected in the draft principles.

4.2.5 Country capacity

The aid effectiveness principles focus on results and outcomes, which can yield very positive outcomes quite quickly. Chapter 11 illustrates this by highlighting the experience of vertical funds, for example in rolling out inoculation programmes and saving lives. While the focus on results is necessary, it can sustain certain weaknesses and instil vulnerabilities into the system. For example, funding may be withheld if a country fails to meet specific targets, which impacts directly on the poorest. Funds may also circumvent national structures if development actors feel that these are too weak to be able to reach targets. Such challenges can be due to a variety of factors, and can be largely exacerbated by capacity constraints. Thus, if a country's capacity is weak, it cannot hope to benefit from IFD on a sustainable basis. These capacity constraints will most likely affect the countries that need finance the most, i.e. the smallest, poorest and most vulnerable countries and, as indicated, the poorest within those countries.

Given that many Commonwealth developing countries face severe capacity constraints and are thus vulnerable to potential arrests in funding, consideration of any IFD instrument or mechanism would therefore need to take country capacity into account. Based on the experiences of the poorest, smallest and most vulnerable Commonwealth member countries, it is necessary to reintroduce some focus on capacity and processes, which may have been lost in the drive to attain results. This cuts across three principles:

- National ownership: in order to assume ownership, countries must have the capacity to participate actively in the governance structures of international initiatives, or have appropriate legal and institutional frameworks in place to manage locally based and implemented initiatives.
- International alignment and harmonisation: again, countries need to have suitably strong legal and institutional arrangements in place so that national and international stakeholders can work most effectively through them.
- Results and accountability: countries need to have capacity in place in order to measure benchmarks and progress, define realistic targets, report transparently and in a timely way to stakeholders, and co-operate effectively with external evaluation.

4.3 Commonwealth draft principles for IFD

Taking the above into account and drawing on consultations with Commonwealth developing countries, regional and international experts, the Commonwealth proposes a set of draft principles for IFD (presented in Table 4.1). These are a first attempt to guide the smallest, poorest and most vulnerable countries and their development partners in identifying, evaluating and selecting suitable IFD instruments and mechanisms. Together with the accompanying assessment methodology outlined in Chapter 5, the draft principles are expected to be refined

Table 4.1 Commonwealth draft principles for IFD

Draft principle	Icon	Description
1. ADDITIONALITY Funds raised add to ODA, or have the potential to do so.	ADDITIONALITY	• Amounts generated must be additional to (not a re-categorisation of or substitute for) ODA, as defined by the OECD.
2. NATIONAL OWNERSHIP Recipient countries have the scope and capacity to implement the instrument and influence or own the process of implementation.	NATIONAL OWNERSHIP	• The beneficiary country should participate actively in the governance structures of innovative finance initiatives and has a major say in how revenues generated are used. • The beneficiary country should align the instrument or mechanism to its own development strategies, targeting both long- and short-term objectives. • National capacity: in order to assume ownership, the beneficiary country must have the capacity to participate actively in the governance structures of international initiatives, or have appropriate legal and institutional frameworks in place to manage locally based and implemented initiatives.
3. INTERNATIONAL ALIGNMENT AND HARMONISATION Instruments are aligned to recipient countries' nationally devised development strategies, with stakeholders working together, with the capacity to do this.	INTERNATIONAL ALIGNMENT AND HARMONISATION	• Stakeholders should work within existing national legal and institutional arrangements and use recipient country public financial management systems. • Donors must harmonise their support, working through multilateral channels wherever possible. • National capacity: countries should have suitably strong legal and institutional arrangements in place so that national and international stakeholders may work most effectively through them.
4. RESULTS AND ACCOUNTABILITY Clear development objectives, benchmarks and outcomes are established. All stakeholders are responsible for and have the capacity to achieve stated goals, report transparently and evaluate data.	RESULTS AND ACCOUNTABILITY	• Stakeholders should be encouraged to phase in realistic targets for development outcomes and fund-raising, against which their baselines and subsequent performance can be measured. Stakeholders should conduct rigorous monitoring and high-quality (timely, frequent, detailed, clear and transparent) dissemination of results, using agreed categorisations of IFD.

(continued)

Table 4.1 (Continued)

Draft principle	Icon	Description
		• Accountability depends on timely, frequent and transparent dissemination of IFD-related statistics. This should include scale, source and impact, using agreed categories linked to a detailed definition of IFD. • Regular independent evaluations should be made, including to measure progress against baselines and targets, and to recommend ways forward. • National capacity: recipient countries should have capacity in place in order to measure benchmarks and progress, define realistic targets, report transparently and in a timely way to stakeholders, and co-operate effectively with independent evaluation.
5. PREDICTABILITY AND SUSTAINABILITY Revenues are predictable, sustainable, maintained in downturns and cost-effective.	PREDICTABILITY & SUSTAINABILITY	• External sources of innovative financing should be predictable so that beneficiary countries can more effectively plan their programmes and budgets. • Revenues raised should be maintained during economic upswings and downswings (counter-cyclical or a-cyclical). • Instruments that generate actually or potentially the highest revenues relative to costs should be the subject of particular focus (it is noted that these may vary from country to country).
6. PRO-POOR Revenues benefit the poorest directly or indirectly, and do not widen existing inequalities.	PRO-POOR	• Instruments must target the poorest segments of society directly or via trickle-down without exacerbating existing income gaps. • For instruments that do not inherently require revenues to be spent on development, governments should commit to channelling these funds towards development goals.
7. DISBURSEMENT Funds are disbursed quickly.	DISBURSEMENT	• Mechanisms should be fast-disbursing to meet immediate need.

over time after further consultation with stakeholders. The consultative process so far has involved discussion of the issues at the Commonwealth Finance Ministers Meeting, a subsequent expert group meeting in 2011 co-hosted with the Organisation internationale de la Francophonie (OIF), and direct liaison with Commonwealth developing countries, international and regional organisations, forums and experts following these events.

The preliminary assessment methodology through which decision-makers and technical officers may consider each IFD instrument and mechanism is presented in the Chapter 5. However, it is first necessary to introduce the instruments and mechanisms to which this methodology will be applied, followed by a brief discussion of the development sectors to which they actually or might potentially apply.

Chapter 5

Selection of IFD Instruments and Assessment Methodology

5.1 Selection of instruments and mechanisms and their application by sector

The selection of IFD instruments and mechanisms for detailed assessment in Section 3 are presented in Table 5.1. In the absence of a clear and widely agreed definition, their diversity is intended to reflect the broad range of IFD. It is, however, only a shortlist and does not seek to be comprehensive.

Some of these instruments have been selected because Commonwealth developing countries and regions themselves have taken a lead in designing, implementing and owning them, thereby helping to reduce dependency on donors. These include various types of bonds, domestic public revenue-raising and insurance. Each of them has some track record of having been implemented by developing

Table 5.1 Categorisation and shortlist of IFD instruments and mechanisms

Bonds	Loans and guarantees	Public revenue	Insurance	Vertical funds
Diaspora bonds GDP-linked bonds Sovereign bonds issued on international markets Green bonds Social impact bonds Development impact bonds	Counter-cyclical loans Contingent credit facilities Development policy loan deferred drawdown options Catastrophe risk deferred drawdown options IDA credit (and IBRD loan) buy-downs Guarantees	Domestic financial transaction tax Domestic carbon tax Curbing illicit flows	Weather index-based insurance Caribbean Catastrophe Risk Insurance Facility	GAVI Alliance Global Fund (and UNITAID) Adaptation Fund

countries – most notably from the Commonwealth, but also from outside the Commonwealth. Other instruments have been designed and administered by international agencies, and these are included because Commonwealth developing countries benefit from them already. These include green bonds, loans and guarantees, and vertical funds.

The following icons summarise the beneficiary sectors of development for each instrument or fund.

Table 5.2 summarises how each of the instruments presented in this chapter impacts the above sectors. 'A' denotes actual impact based on information at the present time as to how the various instruments and mechanisms are used. 'P' indicates what the Secretariat considers are potential applications for each of these instruments and mechanisms. The analysis draws as much as possible on the existing experiences of Commonwealth countries, in order to facilitate the exchange of ideas between Commonwealth developing countries and between Commonwealth and other developing countries.

Table 5.2 shows that, while many instruments and mechanisms currently support just one development sector, they are sufficiently adaptable and can be applied to several additional sectors. This demonstrates that currently IFD has great potential to be scaled up in order to meet all development and environment needs, an issue which is taken up in Section 4.

Table 5.2 Applicability of IFD instruments and mechanisms to various development sectors

	ECONOMY	EDUCATION	ENVIRONMENT	FOOD SECURITY	HEALTHCARE	INFRASTRUCTURE
Bonds						
Diaspora bonds	A	P	P	P	P	A
GDP-linked bonds	A	P	P	P	P	P
Sovereign bonds issued on international markets	A	P	P	P	P	A
Green bonds	P	P	A	P	P	P
Social impact bonds	P	A	P	P	A	-
Development impact bonds	P	A	P	A	A	-
Loans and guarantees						
Counter-cyclical loans (CCLs)	A	P	P	P	P	P
Development policy loan deferred drawdown options (DPL DDOs) and catastrophe risk deferred drawdown options (Cat DDOs)	A	-	-	-	-	-
IDA credit (and IBRD loan) buy-downs	P	P	P	P	A	P
Guarantees	-	P	P	P	P	A
Public revenue						
Domestic financial transaction tax	A	A	P	P	A	P
Domestic carbon tax	A	P	A	P	P	P
Curbing illicit flows	A	P	P	P	P	P
Insurance						
Weather index-based insurance	A	-	-	-	-	-
Caribbean Catastrophe Risk Insurance Facility	A	-	-	-	-	-
Vertical funds	-	A	A	P	A	P

Key: A = Actual impact; P = Potential impact

5.2 Methodology for assessment of IFD instruments and mechanisms

The draft principles are summarised below.

Each instrument or mechanism is assessed according to each of the principles and given a rating on a scale of **high – medium – low**. Table 5.3 presents the template that will be used in Section 3 to present these assessments. The draft principle is given in column 1, the assessment in column 2 and the justifications for this assessment in column 3.

ADDITIONALITY

1. ADDITIONALITY

Funds raised add to ODA, or have the potential to do so.

NATIONAL OWNERSHIP

2. NATIONAL OWNERSHIP

Countries have the scope and capacity to implement the instrument and influence or own the process of implementation.

INTERNATIONAL ALIGNMENT AND HARMONISATION

3. INTERNATIONAL ALIGNMENT AND HARMONISATION

Alignment behind countries' nationally devised development strategies with stakeholders working together, with the capacity to do this.

RESULTS AND ACCOUNTABILITY

4. RESULTS AND ACCOUNTABILITY

Clear development objectives, benchmarks and outcomes with all stakeholders responsible for achieving stated goals, and reporting transparently with evaluation of data, with the capacity to do this.

PREDICTABILITY & SUSTAINABILITY

5. PREDICTABILITY AND SUSTAINABILITY

Revenues are predictable, sustainable, maintained in downturns and cost-effective.

PRO-POOR

6. PRO-POOR

Revenues benefit the poorest directly or indirectly, and do not widen existing inequalities.

DISBURSEMENT

7. DISBURSEMENT

Funds are disbursed quickly.

Table 5.3 Template table for the assessment of IFD instruments and mechanisms

Draft principle	Rating	Description
ADDITIONALITY		
NATIONAL OWNERSHIP		
INTERNATIONAL ALIGNMENT AND HARMONISATION		
RESULTS AND ACCOUNTABILITY		
PREDICTABILITY & SUSTAINABILITY		
PRO-POOR		
DISBURSEMENT		

Each of the descriptions or justifications listed in column 3 will be marked either positively ('✓') or negatively ('✗'). The assessment of (high, medium or low), is based on the combination of these positive and negative descriptions. Thus:

All ✓'s	High rating
A mix of ✓'s and ✗'s	Medium rating
All ✗'s	Low rating

Table 5.4 gives an example with respect to diaspora bonds.

As illustrated in this example, the assessment of each instrument according to each of the draft principles has been assessed based on concrete characteristics of the instrument itself. For example, the Secretariat has considered the additionality of diaspora bonds to be high because they are intended to tap into previously untapped sources of finance. In this case, the bonds target the diaspora's stock of wealth, which is separate from income flows that may translate into remittances. Assessments are also based on country experiences wherever these are available. Thus, while the methodology is preliminary, it offers a reasonable starting point to help decision-makers to assess each instrument and mechanism.

Table 5.4 Assessment of diaspora bonds

Draft principle	Rating	Description
ADDITIONALITY	High	✓ Bonds tap into long-term stocks of wealth rather than income flows related to remittances, and may be issued at a discount. ✓ Revenues are not classifiable as ODA when used for development.
NATIONAL OWNERSHIP	High	✓ Countries decide when, where and how to issue the terms, and how to spend the resources. ✓ Funds are generated through a desire to support the country. ✓ Funds raised can be used for specific economic and development goals in line with country priorities. ✓ National capacity: in some cases national agencies have experience in issuing bonds.
INTERNATIONAL ALIGNMENT AND HARMONISATION	High	✓ Bonds complement development efforts. ✓ Bonds may promote the deepening of the financial sector, (thus they may be able to seek access to international bond markets for the first time). ✓ National capacity, bonds work within existing institutional structures.
RESULTS AND ACCOUNTABILITY	Medium	✓ Listing on an internationally recognised exchange, for example the US Securities and Exchange Commission (US SEC), may enhance transparency and accountability. ✗ Listing on an internationally recognised exchange may be impractical for many small poor countries.

(continued)

Table 5.4 (Continued)

Draft principle	Rating	Description
PREDICTABILITY & SUSTAINABILITY	Medium	✓ Frequent issues enhance predictability and sustainability. ✓ Patriotic discounts can enhance sustainability. ✓ Diaspora bonds are counter- or a-cyclical depending on frequency and time of issue. ✗ There is no guarantee of demand (affected by diaspora's confidence in the home country) or willing ness to accept the discount. ✗ The issuance of bonds will increase debt levels and may adversely impact on debt sustainability in vulnerable countries. ✗ Diaspora may be less able to invest during global downswings, or unwilling to if they perceive economic problems as the fault of government
PRO-POOR	Medium	✓ Revenues are used to support development-related projects, and this appears to be part of their appeal to investors. ✗ There is no inherent link between the design of diaspora bonds and poverty reduction, and any such link therefore requires a conscious decision on the part of the issuing government.
DISBURSEMENT	High	✓ Countries can raise funds reasonably quickly

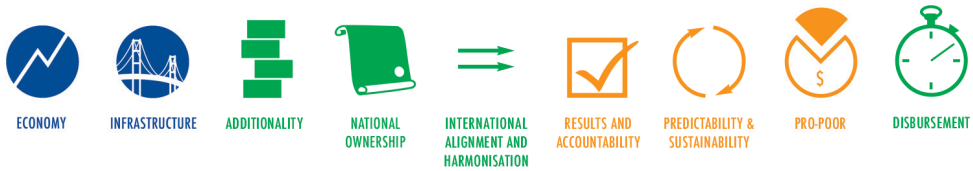
5.2.1 Use of icons

For ease of reference, each of the assessments in Section 3 opens with a series of icons, which, for convenience, are intended to display at a glance our assessment of each instrument and mechanism according to each of the draft principles, and to denote the development sectors to which each instrument and mechanism presently applies.

Assessment uses a traffic light system.

High
Medium
Low

The icon for a given draft principle is presented in green when the instrument has been rated highly in regards to that principle, amber when medium and red when low. The icons denoting the development sectors to which each instrument and mechanism presently apply are also given. Drawing on the assessment in Table 5.4, the following example relates to diaspora bonds.



From this, it is clear that diaspora bonds have thus far been issued to raise finance for economic development and infrastructure. Overall, they are rated very favourably. They are rated highly (denoted by green icons) for raising funds additional to ODA, national ownership, international alignment and harmonisation, and disbursement, and have a medium rating (amber icons) in terms of results and accountability, predictability and sustainability, and in being pro-poor.

The next chapter opens by summarising the assessments of the various instruments and mechanisms before assessing each of the instruments and mechanisms in detail.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Section 3

Assessment of IFD Instruments and Mechanisms

Overview

This section assesses each of the IFD instruments and mechanisms that were introduced in Section 2. Chapter 6 summarises the assessments, collating them into one table, and subsequent chapters present more summarised assessments of the various instruments and mechanisms.

Presentation of instruments and mechanisms in this section

Chapter 7 Bonds	Chapter 8 Loans & Guarantees	Chapter 9 Public Revenue	Chapter 10 Insurance	Chapter 11 Vertical Funds
Diaspora bonds GDP-linked bonds Sovereign bonds issued on international markets Green bonds Social impact bonds Development impact bonds	Counter-cyclical loans Contingent credit facilities Development policy loan deferred drawdown options Catastrophe risk deferred drawdown options IDA credit (and IBRD loan) buy-downs Guarantees	Domestic financial transaction tax Domestic carbon tax Curbing illicit flows	Caribbean Catastrophe Risk Insurance Facility Weather index-based insurance	GAVI Alliance Global Fund Adaptation Fund

Overview (continued)

The content of the descriptions in Chapters 7 to 10 are intended to be consistent across instruments and mechanisms, as shown below. Each opens with a discussion about the instrument; suggests some first considerations about applicability; describes how the instrument operates and assesses the instrument against the Commonwealth draft principles, drawing on all of this information. The chapter on vertical funds (Chapter 11) includes the same, with additional information on governance, financing arrangements and how to apply.

Presentation of information

Chapters 7 to 10
About
First considerations
Operation
Instrument assessment

Chapter 11
About
First considerations
Governance
Operation
Financing arrangements
Instrument assessment
How to apply

Chapter 6

Summary of Assessment of IFD Mechanisms and Instruments

Table 6.1 summarises the assessments of each instrument against the draft Commonwealth principles.

This table elicits the following tentative observations:

- Additionality: bonds and public revenue-raising measures will in general generate funds over and above ODA. This also applies to some of the loans and guarantees, as well as one vertical fund.
- National ownership: bonds, loans and guarantees will generally (but not exclusively) have the highest impact with respect to countries having the scope and capacity to implement the instrument and influence or own the process of implementation.
- International alignment and harmonisation: the picture is more mixed, although for the most part positive with respect to alignment behind national development strategies.
- Results and accountability: the picture is more mixed but for the most part positive.
- Predictability and sustainability: this poses greater challenges, with most instruments and mechanisms having only a medium rating.
- Pro-poor: vertical funds and loans and guarantees perform best overall, but some other instruments and mechanisms are also pro-poor.
- Disbursement: public revenue measures and, to a certain extent, bonds tend to be fastest disbursing.

Table 6.1 Assessment of IFD instruments against Commonwealth draft principles

	ADDITIONALITY	NATIONAL OWNERSHIP	INTERNATIONAL ALIGNMENT AND HARMONISATION	RESULTS AND ACCOUNTABILITY	PREDICTABILITY & SUSTAINABILITY	PRO-POOR	DISBURSEMENT
Bonds							
Diaspora bonds	H	H	H	M	M	M	H
GDP-linked bonds	H	H	H	M	M	M	H
Sovereign bonds issued on international markets	H	H	M	H		M	M
Green bonds	H	H	H	H	M	H	M
Social impact bonds	L	L	L	H	L	M	M
Development impact bonds	L	L	L	M	L	M	M
Loans and guarantees							
Counter-cyclical loans (CCLs)	M	H	H	M	H	H	M
Contingent credit facilities	M	H	H	M	H	H	M
Development policy loan deferred drawdown options (DPL DDOs)	H	H	M	H	M	H	M
Catastrophe risk deferred drawdown options (Cat DDOs)	H	H	M	H	M	H	M
IDA credit (and IBRD loan) buy-downs	L	H	M	H	M	H	L
Guarantees	H	H	H	M	M	M	L
Public revenue							
Domestic financial transaction tax	H	H	M	M	M	L	H
Domestic carbon tax	H	M	H	L	M	L	H
Curbing illicit flows	H	M	M	M	M	M	H
Insurance							
Weather index-based insurance	L	M	H	M	M	M	M
Caribbean Catastrophe Risk Insurance Facility	L	H	H	M	H	M	H
Vertical funds							
GAVI Alliance	L	M	M	M	M	H	H
Global Fund (and UNITAID)	L	M	M	M	L	H	L
Adaptation Fund	H	M	M	M	M	H	L

Key: H = High; M = Medium; L = Low

Chapter 7

Bonds

This chapter considers a selection of innovative bonds that can yield a wide range of benefits to developing countries. As with other instruments and mechanisms under discussion, the classification of some of these instruments as innovative is surprising. Some, such as green bonds, are relatively new to most countries, although they have already been issued by multilateral development banks. Others have existed for some time but have tremendous scope to be further innovated and adapted by new countries and regions. For example, Israel has issued diaspora bonds since 1951, and India since 1991, but interest in them is growing, even among developed countries such as Greece. GDP-linked bonds have also been issued in several countries, including Argentina, Bosnia and Herzegovina, Bulgaria and Costa Rica, as part of their debt restructurings. However, they have not been issued in 'normal times', i.e. when the country has been creditworthy. Issuing in normal times is desirable as the cost of issuance would be lower, even though the main benefit of such instruments is their ability to cope with exogenous shocks. In such cases, their adaptation may be seen as innovative.

The Commonwealth has already had a range of experience with bonds, which can be useful for information sharing among Commonwealth as well as other developing countries. India, for example, has issued diaspora bonds; Bangladesh and Kenya have actively targeted their diaspora in recent bond issuance; Nigeria plans to issue its first diaspora bond in late 2014; and Uganda and Rwanda are considering issuing them. Furthermore, India is considering the possibility of issuing GDP-linked bonds, and Kenya has issued domestic currency bonds.

Most of these bonds seek to raise **additional funding**. GDP-linked bonds would also serve to lower the risk of future crises in developing countries that are especially vulnerable to current account, financial and macroeconomic shocks.[1] Other benefits of bonds include diversification away from traditional North–South flows, and they have the advantage of **greater national ownership.** Bonds can be issued by a country in response to specific needs, and do not come encumbered with the conditionalities of many traditional North–South flows. They may also be considered on a regional or sub-regional level, and **tap into South–South flows** and those of the diaspora. Thus most of the bonds identified here would be issued by the beneficiary country itself. The exception is green bonds, which are issued by various multilateral development banks. They are included in this toolkit, as some developing countries may apply to benefit from the additional revenues raised for climate change adaptation and mitigation through the issuance of these bonds.

The limitations of bonds include the fact that they add to the debt burden of the country, so issuing countries must consider **debt sustainability**. In addition, many developing countries, especially the smallest and poorest, have nascent domestic capital markets and limited capacity or experience in issuing specialised bonds. Owing to their relative simplicity and relevance to many countries and regions, diaspora bonds may therefore be an appropriate first step for such countries to gain experience in designing and issuing a targeted bond.

7.1 Diaspora bonds

7.1.1 About

A diaspora bond is a debt instrument issued by a country to raise financing from its overseas diaspora. India has issued diaspora bonds on an ad hoc basis since 1991, and Israel has done so regularly since 1951. While diaspora bonds are not new, their use remains limited. Israel has raised US$25 billion predominantly for infrastructure, and India US$11 billion for economic purposes. Nepal and Ethiopia have issued bonds for infrastructure with mixed results. Other issuing countries are Sri Lanka and South Africa. Commonwealth members Bangladesh[2] and Kenya[3] have actively targeted their diaspora in recent bond issuance, Nigeria plans to issue its first diaspora bond in late 2014[4] and Uganda and Rwanda are considering the possibility of issuing diaspora bonds. A recent report by the AfDB estimates that sub-Saharan African countries could raise US$10–17 billion annually (approximately 1.3 per cent of the region's GDP) for infrastructure development through the issuance of diaspora bonds (AfDB 2012).

Diaspora bonds are an attractive option, as they can provide additional finance to remittances. This is because while remittances depend very much on the short-term income flows of those sending money home, diaspora bonds instead seek to tap into the diaspora's long-term stock of wealth. The beneficiaries of the two types of instrument also differ. While they may be triggered by other motivations such as investments, remittances assist households with short-term consumption needs. In contrast, bonds targeted at a diaspora provide longer-term stable finance to national governments, which can be used for development purposes. They can be counter- or a-cyclical depending on their objective and the frequency and timing of issue. A successful issue, along with access to steady new funding, may also help to improve a country's sovereign debt credit rating.

This finance can be raised at a discount if a country can persuade its investing diaspora to accept a patriotic discount; this would involve asking the investor to accept a lower return than could be earned by placing the money elsewhere. There is a strong element of national ownership, and revenues raised may be channelled towards development goals in line with a national development plan.

The issuance of diaspora bonds can also be an important first step for countries that wish to enter the international bond markets but which have no experience of such markets. Taking these further, countries might seek to target other constituencies with specific types of bond. Examples include Islamic bonds for Muslims from all over the world, and low-carbon bonds for socially responsible investors (CDPR 2011).

7.1.2 First considerations

Eligibility: Any country may consider issuing diaspora bonds. Large developing countries with large prosperous diasporas, including India and South Africa, are already benefiting, or have the potential to benefit most (Bangladesh, Pakistan and Nigeria).

Many small states such as Caribbean and Pacific states also have relatively large and prosperous diasporas, but may need to consider issuing bonds above the national level, for example a regional bond, to be viable (see Chapter 4 for a brief discussion).

As diaspora bonds ideally seek a patriotic discount, the issuing country must be perceived positively by targeted members of the diaspora in economic, political, governance and social terms. The diaspora's decision to invest in the bonds may also be influenced by reasons for its initial departure, the length of time spent away etc. The diaspora may also wish to see commitment that the money would be used towards some development objective or (perhaps in Greece's case) a long-term economic solution, and not be mismanaged.

Countries wishing to tap into particular retail markets may need to consider the desirability and capacity implications of registering with a securities exchange commission (a critical issue in the USA, for example).

Countries with weak credit ratings that have experienced difficulties in raising finance on the international market could potentially raise finance at a discount through the issuance of diaspora bonds. Greece, for example, considered this option in 2011.

7.1.3 Operation

As with any bond, the possibilities for how it is structured and issued are diverse. Some of these options are represented in Table 7.1.

Table 7.1 Diaspora bonds: considerations and options

Consideration	Options
Who can issue diaspora bonds?	Governments usually issue diaspora bonds, although they can also be issued by sub-sovereign entities and corporations. The lead agency may vary according to what the bond is intended for. For example, bonds have been issued by the State Bank of India, Development Corporation for Israel, Ethiopia's Ministry of Finance and the Ethiopian Electric Power Corporation (EEPCO), the last with a full government guarantee.
Objective	Ideally, bonds should be linked to national development plans. In this context it is highly desirable for countries to have a clear objective in mind, whether linked to a particular project or to resolve an economic challenge. This helps countries to market the bond more effectively by showing how it aligns to national priorities. Thus, Ethiopia has issued bonds to help finance hydro-electric power projects (but issued at a time of acute foreign exchange [forex] shortage), India to finance balance of payments, and Israel to finance development-related projects.

(continued)

Table 7.1 (Continued)

Consideration	Options
	Nigeria has indicated that revenues from its proposed bond will be tied to specific national priority projects in the real sector or in infrastructure (Vanguard 2012), and similarly Bangladesh has stated that revenues from its bonds will be allocated to government infrastructure projects including public–private partnerships (PPPs) to help pay off debts and other costs (*The Independent* 2011).
Target group	The target group for diaspora bonds varies from country to country. Bonds can be targeted to the diaspora alone (India) or opened more widely to other investors (Israel, Bangladesh). Ethiopia targets home nationals as well as foreign nationals of Ethiopian origin. Diaspora investors may be less susceptible to currency risk than non-diaspora investors (World Bank 2009, Ketkar and Ratha 2007; 2011, World Bank 2009, AfDB 2010) and, owing to superior knowledge (implying smaller asymmetries of information), they may be less affected by other risks that might deter non-diaspora or add to the premium. Furthermore, the chances of obtaining a patriotic discount may lessen beyond the diaspora unless the issuing country is able to tap into a strong sense of purpose and support. However, narrowing the focus of the bond to the diaspora limits its potential revenue. As a first step, the issuing country should research its diaspora, including its geographic spread and affluence. As indicated above, countries that are not accustomed to issuing bonds in international markets could use the issuance of diaspora bonds as a learning process prior to the issuance of further bonds that target other constituencies.
Frequency	Greater regularity and frequency of issuance can enhance sustainability and predictability of revenue. If the aim is to finance long-term development a-cyclically rather than address an emergency situation (a counter-cyclical option), then optimal frequency would be annual, or every three years. In reality, this varies. India's issuance has been infrequent, and Ethiopia has issued a diaspora bond twice, once in 2008 and once in 2011. Conversely, Israel's issuance has been regular and frequent.
Patriotic discount	The return must be appealing in order to attract investors, but equally the issuing country has the potential to benefit from a patriotic discount, which implies an opportunity cost for the investor. To some extent, countries must experiment with this, and market its bonds aggressively. It may wish to begin cautiously by offering a relatively small discount, so as not to deter large first-time investors. Israel initially enjoyed a large patriotic discount. For example, the gap between the average interest rate on fixed-rate Israeli bonds and that on ten-year US Treasuries widened to as much as 10 per cent in the early 1980s, for example (Ketkar and Ratha 2009: Figure 3.3) – although this has declined somewhat over time. However, Ethiopia's experience suggests that patriotic discounts are of quite marginal importance. Its first issue in 2008 with a yield of 5 per cent offered very little discount compared with yields on Certificates of Deposit in the USA, the country where most Ethiopian migrants resided. Revenues fell short

(continued)

Table 7.1 (Continued)

Consideration	Options
	of expectation because of concerns about debt servicing, the government guarantee, and the political situation. Its second and slightly discounted issue in 2011 at 4 per cent was more popular, but this is thought to be due to improvements in other terms, such as the obligation to pay bondholders in convertible currency, and a move from fixed returns to returns linked to LIBOR. The Ethiopian government has also promoted its second issue through directives and incentives (AfDB 2012a: 5–6). India included no patriotic discount in its Resurgent India Bond of 1998: its rate of 7.75 per cent on US-dollar denominated bonds was at least 50 basis points higher than that offered on BB-rated US corporate bonds, and only a small 40 basis point discount on its India Millennium Deposits of 2000 (Ketkar and Ratha 2007: 10).
Terms and conditions	There is a great deal of flexibility in terms and conditions, which may appeal to investors. This includes rates (fixed or floating) and maturities, and minimum subscriptions and increments. Rates may be fixed (India) or floating, or a country may offer a range of options (Israel, Ethiopia). Similarly, maturities may vary according to need, with different rates offered for different maturities. Greece was planning a range from 3 to 10 years. Ethiopia has offered 5-year bonds, or 5- to 10- year bonds (CDPR 2011). Israel offers maturities of 2, 3, 5 and 10 years. The minimum subscription and subsequent increments may be set at different levels (Israel, Ethiopia) in order to attract those with more limited means as well as those considering investing on an experimental basis. Ethiopia reduced the lowest denomination of its new Renaissance Dam Bond to US$50 to overcome some challenges faced with its earlier Millennium Corporate Bond (Daily Ethiopia 2011, People Move 2011). Israel is similarly offering a bond with a minimum subscription of US$100.
Currency and accessibility	Countries may investigate denominating bonds in either domestic currency (to address the issue of currency risk) or foreign currency. Ethiopia sells both its forex and domestic bonds via a commercial bank, making use of branches, embassies, consulates and other representative offices, and accepts money transfers. Ethiopia is also facilitating a secondary market by permitting the purchase of bonds on behalf of others, or as a gift with the facility to transfer it to up to three people.
Marketing	Marketing can be undertaken by the issuer (Israel, Ethiopia) or by third parties favoured by the diaspora (India). Regular and frequent issuance is likely to assist marketing as bonds are more desirable to investors if they can rely on bonds to be issued at particular times. Intensive marketing is highly desirable, and can be boosted by linking investment to a development-related objective that can capture the imagination of the diaspora, and perhaps persuade them to accept a discount. To maximise the success of issuance, a country should have a good relationship with its diaspora and should lay the groundwork with a sequence of information campaigns. For example, Kenya's Ministry of Foreign Affairs has established a special department to engage the diaspora in economic activities and to place the diaspora in jobs.

Box 7.1 illustrates how India, Israel and Ethiopia have offered a range of options in the issuance of its bonds.

Box 7.1 Conditions of and interest rates on the diaspora bonds of Israel, India and Ethiopia

Israel

Israel issues the majority of its bonds four times per month. The terms and conditions on recent bonds illustrate the variety of options that can be offered to attract a wide range of investors. As shown in Table 7.2, their minimum subscriptions diverge widely from US$100 to US$25,000, appealing to different budgets and preferences, although clearly higher minimum subscriptions garner a higher rate of interest. Most bonds are issued with different maturities (generally 2, 3 or 5 years, with one bond at 10 years) and longer maturities are rewarded more. While most bonds offer fixed rates, investors have the option to invest in a floating rate bond.

Table 7.2 Selected terms and conditions on Israel's bond issues (sales period 1–7 June 2012)

Bond (series)	Minimum subscription (US$)	Increment (US$)	Rate (2-year) (%)	Rate (3-year) (%)	Rate (5-year) (%)	Rate (10-year) (%)
Jubilee Issue (7th)	25,000	5,000	0.74	1.31	2.32	3.70
Maccabee (7th)	5,000	1,000	0.59	1.06	2.02	-
Sabra (4th)	1,000	500	-	0.95	-	-
Mazel Tov (4th)	100	10	-	-	1.32	-
Floating Rate LIBOR (10th)	5,000	1,000	0.75 (0 bp*)	0.90 (15 bp)	1.05 (30 bp)	-

Note: bp = basis point
Source: Adapted from Development Corporation for Israel 2012

India

India's bonds have been issued on three occasions to date. Each has been offered with five-year maturity in multiple currencies at fixed rates, as shown in Table 7.3.

(continued)

Box 7.1 Conditions of and interest rates on the diaspora bonds of Israel, India and Ethiopia (continued)

Table 7.3 Selected terms and conditions on India's bond issues (1991, 1998 and 2000)

Bond (year issued) Currency	Minimum subscription	Increment	Rate (5-year) (%)
India Development (1991)			
US$	n/a	n/a	9.5
£	n/a	n/a	13.25
Resurgent India (1998)			
US$	2,000	1,000	7.75
£	1,000	500	8.00
DM	3,000	1,000	8.25
India Millennium Deposits (2000)			
US$	2,000	1,000	8.50
£	2,000	1,000	7.85
€	2,000	1,000	6.85

Source: Adapted from Table 2 in Ketkar and Ratha 2007

Ethiopia

The terms and conditions for the two Ethiopian bonds are presented in Table 7.4, which shows that Ethiopian bonds are more accessible in terms of the relatively lower minimum subscriptions and increments. They also offer a range of options for maturity and interest.

Table 7.4 Selected terms and conditions on Ethiopia's bond issues

Bond (series)	Minimum subscription (US$)	Increment (US$)	Rate (5-year) (%)	Rate (7-year) (%)	Rate (10-year) (%)
EEPCO Millennium Corporate Bonds	500	100	4	4.5	5
Renaissance Dam Bond (non-interest bearing, but with option for interest)	50	50	LIBOR + 1.25	LIBOR + 1.5	LIBOR + 2

Source: AfDB 2012: 5

7.1.4 Instrument assessment

Table 7.5 Diaspora bonds assessment

Draft principle	Rating	Description
ADDITIONALITY	High	✓ Bonds tap into a long-term stock of wealth (rather than income flows related to remittances) and may be issued at a discount. ✓ Revenues are not classifiable as ODA when used for development.
NATIONAL OWNERSHIP	High	✓ Countries decide when, where and how to issue, the terms, and how to spend the resources. ✓ Funds tap into a sense of wanting to support the country. ✓ Funds raised can be used for specific economic and development goals in line with country priorities. ✓ National capacity: national agencies may have experience in issuing bonds.
INTERNATIONAL ALIGNMENT AND HARMONISATION	High	✓ Bonds complement development efforts. ✓ They may promote financial sector deepening (thus low-income countries may be able to seek access to international bond markets for the first time). ✓ National capacity: bonds work within existing institutional structures.
RESULTS AND ACCOUNTABILITY	Medium	✓ Listing on an internationally recognised exchange, e.g. the US SEC, may enhance transparency and accountability. ✗ Listing on an internationally recognised exchange may be impractical for many small poor countries.
PREDICTABILITY & SUSTAINABILITY	Medium	✓ Frequent issues enhance predictability and sustainability. ✓ Patriotic discounts can enhance sustainability. ✓ Diaspora counter-or a-cyclical depending on frequency and time of issue. ✗ There is no guarantee of demand (affected by diaspora's confidence in home country) or willingness to accept the discount. ✗ The issuance of bonds will increase debt levels and may adversely impact debt sustainability in vulnerable countries. ✗ Diaspora may be less able to invest during global downswings, or unwilling if they perceive economic problems as the fault of government.
PRO-POOR	Medium	✓ Revenues are used to support development-related projects, and this seems to be part of their appeal to investors. ✗ There is no inherent link in design between diaspora bonds and poverty reduction, and this requires a conscious decision on the part of the issuing government.
DISBURSEMENT	High	✓ Countries can raise funds reasonably quickly.

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7.2 GDP-linked bonds

7.2.1 About

One way in which developing countries can reduce their vulnerability to external shocks is to increase their economic and financial resilience.[5]

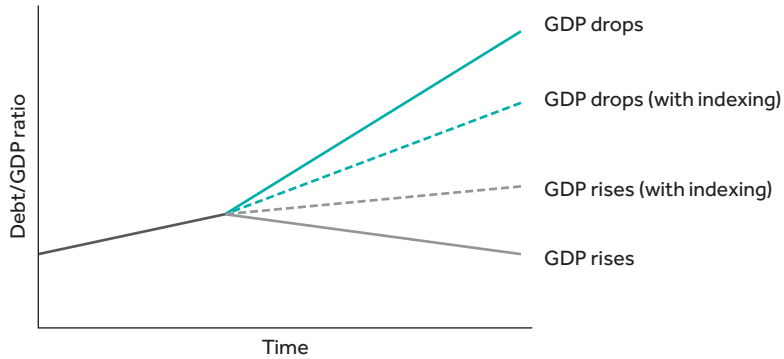
Many developing countries have taken steps to improve their financial resilience by building their foreign exchange reserves. Reserves have increased dramatically in absolute terms from U$13 billion in 1999 to US$68 billion in 2009, while growth in months of import coverage has been less impressive, from 3.8 to only 4.9 months over the same period (World Bank Global Development Finance online). In spite of this overall progress, reserves accumulation is a sub-optimal solution for building financial resilience as it comes with a high opportunity cost, as the funds cannot be used for development purposes. Developing and implementing counter-cyclical mechanisms to defend against shocks is thus of paramount priority, especially for the poorest and most vulnerable countries.

GDP-linked bonds are one such mechanism (another is CCLs, discussed in Chapter 8). These instruments may also be referred to as GDP-indexed bonds or warrants. The concept is not new but interest in it has been revived following the global crisis of 2008 and the recent European debt crisis. For example, the Bank of England (2014) and Bank of Canada (2013) have recently published research espousing the potential benefits of GDP-linked bonds, which include the potential to reduce the incidence of costly default, provide additional fiscal space and facilitate a more stable and predictable fiscal policy. The research suggests that countries with volatile GDP may particularly benefit from the issuance of GDP-linked bonds.

GDP-linked bonds tie payments on sovereign debt to the rate of economic growth. They are designed so that debt service is higher when economic growth is higher and lower when growth is low or negative. Figure 7.1 demonstrates how a country's debt to GDP ratio changes in the event of a rise and a fall in GDP growth with and without GDP-linked payments (indexing).

Without indexing, the variation in the ratio of debt to GDP is much more extreme, as shown by the solid lines. With indexing, the level of debt to GDP rises or falls to a much lesser degree relative to changes in GDP, as shown by the broken lines, therefore incorporating greater stability and predictability into a country's debt service.

Figure 7.1 Debt to GDP ratio with and without bond indexing



Source: Based on Borensztein and Mauro 2002

GDP-linked bonds have several advantages over conventional debt:

- From the borrower's perspective, they can provide additional fiscal space and can assist the borrowing country to stabilise public spending by adjusting debt service upwards under conditions of favourable growth, and downwards with less favourable growth, reducing the likelihood of default and debt crises, and facilitating more rapid recovery after a downturn.
- From an investor's perspective, they help to lower risk of exposure to default, may yield higher payments than conventional bonds and provide a means of portfolio diversification.
- They are a suitable option for developed countries (such as Portugal, Greece and Ireland) as well as developing countries.
- Finally, GDP-linked bonds also trigger a number of system-wide externalities, as they have the potential to improve the functioning of the international financial

Box 7.2 GDP-linked bond illustration

In this example, country A has trend annual GDP growth of 5 per cent, and can borrow on standard terms at 10 per cent per year. It chooses to launch a GDP-linked bond that pays 1 per cent above the standard terms for every 1 per cent that its *actual* rate of GDP growth exceeds its *trend* rate, and vice versa. Thus during a downswing if actual GDP grows at only 3 per cent (2 per cent less than trend) it would pay 8 per cent on its bond (2 per cent less than standard terms and without indexation). But during a boom it would pay out correspondingly higher than the standard terms and without indexation. Therefore, if actual GDP grows at 6 per cent (1 per cent above trend) it would pay 11 per cent on its bond.

> system by fostering greater country self-insurance, reducing contagion risks and reducing the reliance on large-scale official sector support programmes to resolve crises. Their greater use would mean that international institutions would be less likely to witness further debt crises, and contagion risks would be lowered. They provide a more reflective market for an economy itself than stock exchanges, which cover only a part of the economy (Griffith-Jones 2012b).

GDP-linked bonds are relatively new, so their impact is difficult to assess.[6] Costa Rica, Bulgaria, and Bosnia and Herzegovina have issued them as part of their debt restructurings (Griffith-Jones and Sharma 2009). Argentina introduced a GDP-linked warrant into its debt restructuring package in 2001, which was well received much later by investors, but proved quite expensive for Argentina as its economy grew significantly more than expected. Greece issued a GDP-linked warrant in 2012 as part of its debt restructuring package, about which investors were generally sceptical, owing to poor expectations of growth. Simulations conducted on Mexican debt have shown that if half of its total debt had been GDP-linked bonds, it would have saved 1.6 per cent of GDP in interest payments during the financial crisis in 1994–95 (Borensztein and Mauro 2004). However, there is no experience of a country issuing them in good or normal times, which would be particularly desirable. Some examples of issuance terms are presented in Section iii below.

A recent study by the Reserve Bank of India also recognised the potential benefits of GDP-linked bonds while noting practical challenges (Reserve Bank of India 2010). The benefits echo those listed above: they help to stabilise government spending and reduce the likelihood of default and the possibility of crises, and thus provide stability and predictability for investors. The identified challenges relate to concerns about moral hazard and the accuracy of GDP data, market illiquidity and pricing difficulties. Each of these points is dealt with in more detail below.

7.2.2 First considerations

Eligibility: All countries can issue GDP-linked bonds, with countries that are vulnerable to volatile growth rates and exogenous shocks most likely to benefit from them.

Issuing countries need to have accurate, timely GDP data for the index to be credible. While GDP-linked bonds may be safer than other types of bonds, as default and costly debt restructurings are less likely, a premium may be required to attract investors initially. Ensuring sufficient market liquidity is also important.

7.2.3 Operation

GDP-linked bonds can operate in the same way as conventional floating rate bonds, tying the coupon payment to the level of GDP growth, while guaranteeing a minimum pay out even in downswings (Griffith-Jones 2012b).

A number of practical concerns need to be addressed if they are to work effectively (see Table 7.6).

Table 7.6 GDP-linked bonds: considerations and options

Consideration	Options
Pricing and novelty premium	Pricing is a primary consideration. The 'Monte Carlo' approach is commonly used by market participants (Chamon and Mauro 2006, IMF 2008). It assumes that risk-neutral investors take advantage of the no-arbitrage condition that the expected return on a bond issued by an emerging market borrower should equal the return on a bond issued by a development country borrower (RBI 2010). At least initially, in setting their price countries may consider paying a novelty premium above the interest rate that it would ordinarily offer, in order to attract investors. Investors are likely to charge a premium as return is uncertain and illiquid markets make pricing difficult. Greater liquidity would reduce the novelty premium that a first time issuer would have to pay. Some suggest that this premium could be small (Griffith-Jones and Sharma 2009, Borensztein and Mauro 2002), and some advocate that the additional cost is outweighed by the benefits (Bank of England 2014). For example, Argentina's experience shows that the residual premium paid by its warrants was initially higher than that of standard bonds, but declined rapidly and significantly by 600 basis points during the first year and a half of trading, with most of the reduction taking place in the first three months (IMF 2008). Countries may also consider setting a floor, below which the coupon rate cannot fall, depending on the requirements of the investors.
Currency	It is possible to issue in domestic and foreign currency. For example, Argentina has issued in domestic currency (47 per cent of total distribution), with the remainder issued in US dollars (28 per cent), euros (24 per cent), and yen (1 per cent) (IMF 2008: 8).
Legal support	The underlying legal protection may have a bearing on how potential investors perceive the bonds. Argentina has adopted a mixed approach, issuing its domestic currency bonds under Argentinian law, its US dollar-denominated bonds under New York law (23 per cent) and Argentinian law (5 per cent), its euro-denominated bonds under UK law, and its yen bonds under Japanese law. Greece's bonds are being governed under UK rather than Greek law (Hellenic Republic 2012).
Payment terms	Countries have flexibility to define the terms for their bonds. However, at least initially they are likely to be met with some suspicion by investors when issued during times of need. The Argentine approach pays out subject to three conditions being met: 1) actual real GDP must exceed baseline real GDP in the reference year; 2) growth in actual real GDP must exceed growth in baseline real GDP in the reference year; and 3) the cumulative amount of past payments should not exceed 0.48 per unit of security (in its corresponding currency). If all of these conditions are met, the total payment on all warrants is a fraction of the excess GDP in the reference year (i.e. the difference between actual GDP and baseline GDP). Payments are annual, made on 15 December of the year following the reference year (IMF 2008: 8–9). The credibility of Argentina's warrants has been greatly helped by strong economic performance in Argentina.

(continued)

Table 7.6 (Continued)

Consideration	Options
	Holders of Greece's new bonds will also receive a 'detachable' GDP-linked security with a notional amount equal to the face value of the new bonds, provided for annual payments beginning in 2015 of an amount of up to 1 per cent of their notional amount in the event that nominal GDP exceeds a defined threshold and real GDP growth is positive and in excess of specified targets (Hellenic Republic 2012). Greece's bonds are regarded somewhat sceptically compared with their Argentinian equivalents, owing in large part to Greece's growth prospects (FT 2012, IFR 2012) although it should be noted that Argentinian warrants were also initially viewed with some scepticism.
Accurate data and timeliness	Perceptions about poor data may lead to investor concerns about moral hazard, as there is an incentive to under-report GDP growth under certain circumstances. For example, if a bond is issued with a trigger threshold of 5 per cent growth, a rate of 5.1 per cent could lead to a large payment, while a rate of 4.9 per cent would imply much less or none. Timeliness of data is also an important issue, as lags in the provision of GDP data could have a pro-cyclical effect, as savings on interest payments could materialise at a time when the economy might already be rebounding. Countries thus need to have credible, timely and transparent GDP data, which would require huge improvements especially in poorer countries. Third parties such as international financial institutions and/or the United Nations could be considered as partners to help address these challenges and provide verification. Many countries are already implementing International Monetary Fund (IMF) programmes on this. GDP data are typically subject to revision, so contracts would need to detail very clearly how revisions would be treated.
Time horizons	Long-term instruments might help future governments, but may serve as a deterrent to current governments, as some may be unwilling to pay a premium to issue indexed bonds that ultimately benefit future governments. Secondly, launching such a bond during an upswing might give the wrong signals to investors regarding growth prospects, and this would therefore need to be addressed through awareness creation.
Market liquidity	Boosting market liquidity enables bonds to be actively traded, thereby facilitating price discovery and minimising the issuance premium. Multilateral and regional development banks could play an important role as 'market makers' to overcome liquidity and scale issues. Multilaterals and donors could also encourage several countries to issue bonds at the same time, and purchase a portion of them in order to guarantee a minimum size for the market (Council of Economic Advisers 2004). In addition, multilaterals could lend in a GDP-linked way, then sell bundles of such loans in financial markets. Capital protection may also reduce risk and encourage investors.

7.2.4 Instrument assessment

Table 7.7 GDP-linked bonds assessment

Draft principle	Rating	Description
ADDITIONALITY	High	✓ Bonds aim to raise additional funds. ✓ Revenues are not classifiable as ODA.
NATIONAL OWNERSHIP	High	✓ Countries decide when, where and how to issue, the terms, and how to spend the resources. ✓ Funds raised can be used for specific economic and development goals in line with country priorities. ✓ National capacity: agencies may have experience in issuing bonds.
INTERNATIONAL ALIGNMENT AND HARMONISATION	High	✓ Bonds complement development efforts. ✓ National capacity: bonds work within existing institutional structures. ✓ Bonds trigger broader positive system-wide externalities for the global financial system.
RESULTS AND ACCOUNTABILITY	Medium	✓ Independent verification of GDP data might boost transparency. ✗ There may be an incentive to misreport, though this may be mitigated by the fact that all governments wish to show good performance. ✗ National capacity: inaccurate and lags in GDP data pose a challenge.
PREDICTABILITY & SUSTAINABILITY	Medium	✓ Bonds respond to actual trends, reduce repudiation risk and help maintain government spending during downturns. ✓ Payments are set counter-cyclically. This helps to maintain critical government spending during downturns. ✗ Pricing is a challenge and investors may demand a high premium.
PRO-POOR	Medium	✓ Bond revenues may benefit the poor by maintaining social spending in downturns. ✗ There is no inherent link to pro-poor spending.
DISBURSEMENT	High	✓ Countries can raise funds reasonably quickly if there is the appetite.

7.3 Sovereign bonds issued on international markets

7.3.1 About

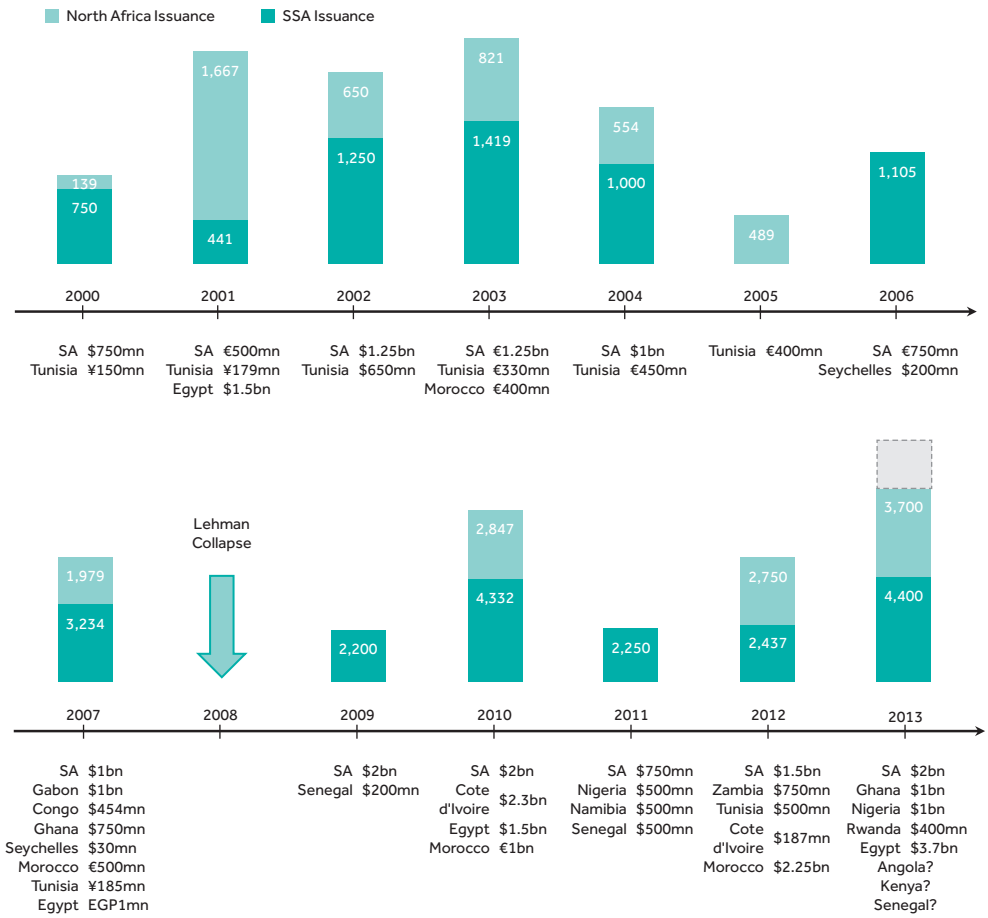
Developing countries have long issued bonds on domestic markets. Until recently, very few (South Africa, Tunisia and Morocco in Africa) have been issuing in international markets. However, this is now changing. Debt sustainability in many developing countries has been restored with successive rounds of debt relief, and improvements in debt management, strengthened macroeconomic management, and favourable growth prospects have enabled debut bond issuance in the international markets by some developing countries. At the same time, a continued search for higher yield in a low global interest environment and a desire for portfolio diversification by investors has increased the range of viable financing options for many developing countries, including access to international capital markets.

Bonds have also been issued in Commonwealth Caribbean countries such as Jamaica and Trinidad and Tobago, and Asian countries such as Sri Lanka. This section focuses on Africa, as this is where activity is new, with high potential for growth.

In many sub-Saharan countries domestic debt markets are in the early stages of development and are consequently limited in size, comprise short-term instruments and are mostly illiquid. This impedes the ability of the country to issue long-term debt in the domestic market, and can also mean that domestic debt is more expensive. Sovereign bond issuance on the international capital markets therefore presents, subject to debt sustainability considerations, an attractive form of additional finance which is relatively cheaper than new sources of external finance to fund economic growth. Many sub-Saharan countries are taking advantage of favourable global credit conditions to access relatively cheaper sources of financing to fund infrastructure projects which do not come attached with any conditionality.

As shown in Figure 7.2 below, momentum in sub-Saharan Africa has been gathering since 2009, with a record high of US$4.4 billion issued in 2013, equivalent to 12 per cent of FDI inflows and 20 per cent of ODA in 2013. South Africa has issued Eurobonds for a number of years, and more recently a number of Commonwealth sub-Saharan countries such as Ghana, Kenya, Namibia, Nigeria, Rwanda and Zambia have made debut issues on the international capital markets. Tanzania and Cameroon are also considering issuance in the near future and Uganda has recently postponed its plans in light of cheaper finance from China.

Figure 7.2 African bond issuance



Source: Moody's 2013

Table 7.8 summarises key characteristics of sub-Saharan African Eurobond issuance during the period 2007–2012.

Many similarities can be observed between the bonds presented in Table 7.8:

- all bonds are issued in US dollars;
- all bonds pay coupons twice per year;
- most bonds are listed on two stock exchanges, with London and Berlin almost exclusively favoured;
- face values are set either at US$100,000 or US$200,000;
- amounts raised are quite substantial, varying between US$0.5 and 1 billion. For small developing countries this makes the bonds a highly attractive means of

Table 7.8 Issue of ten-year Eurobonds in sub-Saharan Africa (excluding South Africa)

Country	Issue date	Listing	Issue manager	Credit rating	Interest rate (%)	Amount (US$ millions)	Face value (US$ 1000s)	Purpose
Gabon	Dec 2007	London Berlin	JP Morgan Citigroup	BB-	8.2	1000	100	Early repayment of Paris Club debt
Ghana	Apr 2007	London Berlin	Citi UBS	B+	8.5	750	100	Energy, roads and railways
Namibia	Nov 2011	London Berlin	Barclays Capital Standard Bank	BBB-	5.5	500	200	Financing Medium Term Expenditure Framework commencing 2011–12
Nigeria	Jan 2011	London	Citigroup Deutsche Bank	BB-	7	500	200	Energy sector
Senegal	May 2011	Luxembourg Berlin	StanChart Standard Bank	B+	8.75	500	200	Toll road outside Dakar, and energy deficit
Zambia	Sept 2012	London	Barclays Capital Deutsche Bank	B+	5.6	750	100	Budget support; energy, railways, roads etc. under sixth National Development Plan

Sources: compiled from AfDB 2013, African Capital Markets News 2012a, 2012b, Arise Nigeria 2011, Cbonds (various pages), Ghana Web 2007; 2012, The Namibian 2010, Oxford Business Group 2010: 111, Reuters 2012a, Wall Street Journal 2013

plugging developing financing gaps, subject to debt sustainability and macroeconomic considerations;

- bond revenues are used largely to finance infrastructure development, and in some cases are being used to provide budget support, and undertake debt management operations such as refinancing and restructuring;
- interest rates are commercial (5.5–8.75 per cent); and
- issuing countries (except Namibia) have sub-investment grade ratings.

The issuing countries also share certain characteristics: most (with the exception of Senegal) are resource rich, and therefore presumably anticipate high revenues from their commodities with which to service the bonds. For many African countries, issuance is a means to obtain internationally recognised credit ratings from Fitch, Moody's, or Standard and Poor's, as shown in Table 7.9.

The bonds have been very favourably received, and many have been heavily over subscribed:

- Ghana's 2007 bond issue was five times over subscribed (Myjoyonline 2008). Having been issued at 8.5 per cent it was recently traded in secondary markets at around 5 per cent. The order book comprised 158 investors of which 40 per cent were US investors, 36 per cent UK investors, and 24 per cent European investors (Ghana Web 2007).
- Namibia's 2011 bond was 5.5 times over subscribed, and many investors have held on to their bonds. The order book included over 160 leading institutional investors from the USA, Europe and Asia, with the breakdown as follows: USA (47 per cent), UK (27 per cent), Europe (19 per cent) and the Middle East, Asia and Africa (7 per cent) (The Namibian 2012).
- Nigeria's 2011 bond was 2.5 times over subscribed, in spite of concern about its depleted oil savings at the time (Reuters 2011).
- Senegal's 2011 US$500 million bond was also over subscribed, with final demand reaching US$2.4 billion. Analysts felt that with a yield of 9 per cent, it overstated Senegal's credit risk, and therefore offered intrinsic value (African Capital Markets News 2011).
- Zambia's 2012 bond was 15 times over-subscribed, with a demand of US$11.9 billion. This led to it being issued more ambitiously than the initial guidance, with a lower interest rate of 5.6 per cent (versus 5.9 per cent), and a higher amount of US$750 million (versus US$500 million). This is still cheap compared with issuances by countries such as Spain (rated BBB) and Portugal. This has been helped by strong economic growth of 6.4–7.7 per cent during 2009–12, over falling inflation, low debt and stable balance of payments, and has come in spite of fears about possible mining sector reform and nationalisations.

Table 7.9 Sub-Saharan African credit ratings and bond issues

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Angola																FMS		
Benin									S									
Botswana							MS											
Burkina Faso										S								
Cameroon									FS									
Cape Verde									F					S				
Gabon													**FS$**					
Ghana									FS				**$**					
Kenya												S	F					M
Lesotho								F										
Madagascar										S								
Mauritius	M																	
Mozambique									F	S								
Namibia											F						**$**	
Nigeria												FS	**$**					M
Rwanda												F					S	
Senegal						S									$		M	
Seychelles												**S$**				F		
Uganda											F			S				
Zambia																	FS	**M$**

Index: F=Fitch; M=Moody's; S=Standard & Poor's; **$=bond issue**
Note: Excludes The Gambia, Malawi and Mali (which had ratings withdrawn), and South Africa.
Source: http://blogs.ft.com/beyond-brics/2013/03/04/chart-of-the-week-sub-saharan-eurobonds-creeping-doubts/#axzz2QXxqBU90

- Rwanda's 2013 US$400 million bond attracted US$3.5 billion of orders, and was eight times over subscribed. This allowed a tightening of the yield to 6.875 per cent, comfortably below the 7–7.5 per cent that had initially been expected. Investors were undeterred by the fact that the size of the bond would exclude it from influential bond indices, which typically require a minimum benchmark size of US$500 million. The proceeds will be used to repay government debt, complete the construction of a convention centre in Kigali and finance a hydropower project (Financial Times 2013c).
- Kenya's first debut Eurobond issuance in 2014 was over subscribed. Kenya originally sought to raise US$1.5 billion but raised US$2 billion after it attracted bids four times its initial target (BBC 2013).

The upward trend in sovereign bond issuance is set to continue in the short term at least. Angola plans to issue a US$2.6 billion bond to finance infrastructure in 2014 and Rwanda plans a second Eurobond issue of up to US$1 billion in 2015 (Economist Intelligence Unit 2014). Improved economic performance and sub-Saharan growth trajectories have contributed to high investor demand for sub-Saharan bonds. In the medium-term, growth prospects are strong and Moody's (2013) expects sustained investor interest in sub-Saharan bonds. However, the favourable global credit conditions that have contributed to the surge in sovereign bond issuance are likely to become less favourable. It is generally anticipated that the USA's Federal Reserve tapering programme will have an effect on the cost of bond issuance as benchmark interest rates are set to increase, which will diminish the attractiveness and cost advantage of international bond issuance.

The borrower's perspective

The main attractions of bond issuance in the international capital markets include:

- In many sub-Saharan countries domestic debt markets are underdeveloped,[7] limited in size, mostly illiquid and comprise short-term instruments. These factors constrain the ability of countries to raise affordable finance in their domestic capital markets. Issuance in international capital markets therefore provides a source of long-term finance that can be used for development, especially infrastructure development.
- Bonds in the international markets may be issued at rates lower than bonds issued in domestic currency on the domestic market. They do not come with the kinds of conditionalities that are attached to loans from the IMF or World Bank, and issuance in international capital markets enables countries to reduce reliance on traditional donors. Sovereign bonds may provide additional incentives to strengthen macroeconomic and debt management and move forward with structural reforms as a result of investor scrutiny of the domestic economy.
- Establishment of the sovereign's presence in the international capital markets can facilitate broader access for domestic non-sovereign entities to the international capital markets as it often serves as a benchmark and acts as a reference point in the evaluation of country risk by international investors.

- Sovereign bond issuance on international capital markets broadens a country's investor base.

Issuance in international capital markets also entails a number of risks for the borrower, which must be considered. These include:

- The need for a country to maintain a sound macroeconomic framework, especially fiscal sustainability, to maintain creditworthiness. This is especially important as international investor confidence in developing countries is often fragile and quickly reversible.
- Countries are exposed to and need to manage currency risk. Exchange rate depreciation can make repayments more expensive, and volatility can make repayments and budget planning more unpredictable, putting pressure on other items in the budget.
- The amounts borrowed are significant, and the debt will need to be serviced and repaid. Commercial borrowers are not likely to be as flexible as official or multilateral creditors. Countries need to therefore consider debt sustainability issues and ensure that the proceeds are invested in productive projects that will generate return to service the debt.
- Countries will need to manage the rollover risk associated with possible refinancing when the debt matures, especially in periods of tight international financial liquidity conditions.
- Countries will need to manage the macroeconomic risks associated with large capital inflows, which include volatility in capital flows and exchange rates, credit booms and inflation.
- Resource-rich countries take high risks when deciding whether or not to issue on the back of high commodity prices such as oil, as commodity prices are highly volatile. There is no guarantee that prices will not plummet after a bond has been issued when prices were high, and this will significantly impact on revenues that may be used to service the bond.
- Sovereign bonds are more expensive than concessional loans and grants. Borrowing at high interest rates may send the wrong signals to donors, leading to a reassessment of their concessional lending policies.
- The experiences of the countries above in issuing or considering issuing would suggest that the bonds are highly pro-cyclical, issued under favourable circumstances or postponed under unfavourable circumstances.

The investor's perspective

- In spite of their mainly sub-investment grade ratings, the bonds offer higher returns than those issued by developed countries. The search for higher yields has fuelled investor appetite in the current favourable global credit environment.

- Relative to 'peripheral' European countries, investors find African countries a more desirable location for the excess liquidity generated from quantitative easing.
- Foreign investors may be interested in seeing the money raised being allocated to spending that is likely to stimulate long-term growth (such as in infrastructure) rather than on financing current spending (Financial Times 2013a). Levels of political stability and governance across the African continent are perceived to be improving (Financial Times 2013b).
- The presence of natural resources means that investors may be prepared to accept higher risks.

7.3.2 First considerations

Eligibility: Bonds can be issued by developing country governments. As a precondition, countries should have strong macroeconomic fundamentals and strong institutional capacity to access the international capital markets.

Issuing countries require listing on established international markets, with support from investment banks. There is currently an appetite for African bonds from international investors, but this is driven by a combination of both domestic and global factors, which will shift over time. Countries considering issuing bonds should assess the climate for bond issuance. As has been previously mentioned, the current record low interest rates in the USA will increase in the medium term, which will impact the cost of sub-Saharan bond issuance and the demand of investors as yields increase in safe havens. On the domestic side, stronger policy and institutional frameworks, macroeconomic management, strong projected economic growth and expanding natural resource sectors should sustain investor interest.

Before deciding to issue a bond in the international capital markets, appropriate analysis should be undertaken by the issuing country to understand the debt sustainability implications within a medium-term macroeconomic framework. In this process a number of strategic and tactical considerations would need to be made as outlined in Table 7.10.

7.3.3 Operation

Table 7.10 Sovereign bonds issued on international markets: considerations and options

Consideration	Options
Alternatives	Countries should explore whether funds could be obtained more cheaply elsewhere, and whether they will be able to service the debt.
Appropriateness	When considering issuing a Eurobond, countries should consider whether they have natural resources or otherwise well regarded political stability and economic prospects that would attract investors.

(continued)

Table 7.10 (Continued)

Consideration	Options
Obtaining a credit rating	If a country does not have a credit rating already, a first step would be to approach one of the main rating agencies.
Deciding on uses for the funds	A clear plan for the use of the proceeds will make the bond issue more attractive to investors. There are a number of reasons why a sovereign may wish to issue in the international markets: • Capital expenditure – linking funds to specific development objectives such as infrastructure projects (in the context of national development plans) can send positive signals to investors and the domestic population. A country should ensure that the project has high economic multipliers. • Benchmarking – a country may wish to issue in the international capital markets to develop the sub-sovereign bond market. • Debt management operations – a country may issue to refinance existing debt with cheaper debt; obtain finance at a lower cost, or as part of debt restructuring.
Choice of currency denomination	Bonds have been issued in US dollars to date. Selling local currency bonds in international markets may not be appropriate for low-income countries with high rates of inflation, due to low investor appetite for taking on currency risk. Countries issuing in foreign currency will need to manage currency risk. Countries should consider the impact of tapering of quantitative easing in the USA on their exchange rate, which may well increase this risk, as exchange rates may depreciate.
Deciding how much to raise	The decision of how much to raise should be made in the context of debt sustainability. A country should consider how much it needs to raise in the next few years and decide whether to raise this by issuing one bond or more. A country should not raise finance in excess of financing needs, so as not to incur high carrying costs. A country must also assess and balance two risks: liquidity and rollover or repayment risk: • Liquidity – the issue should be large enough to assure liquidity, in order to make the bond more attractive and reduce illiquidity premiums. • Rollover or repayment risk – the country must manage risk associated with possible refinancing when the debt matures, especially in periods of tight financial liquidity. A larger issue will have higher rollover or repayment risk. Countries must also consider the external climate for bond issuance, which affects investor demand. It may be worth considering starting small, for example with a more manageable US$100–200 million issue, and reviewing progress over the life of the bond before considering a more ambitious issue, especially for smaller developing countries.

(continued)

Table 7.10 (Continued)

Consideration	Options
Listing on Emerging Markets Bond Index	Listing helps to raise visibility with a larger pool of investors. Countries may want to consider listing on JP Morgan's Emerging Markets Bond Index (EMBI). This lists US dollar-denominated sovereign bonds for a selection of emerging market issuing countries and is considered the most widely used and comprehensive benchmark, serving also to increase the visibility of emerging market sovereign debt (Financial Times Lexicon, 2014). The EMBI requires a minimum issue of US$500 million. Thus a drawback to the above suggestion for starting with a smaller issue would mean the bond would not be EMBI eligible.
Listing	Listing should be on a major exchange, supported by an established issue manager, which would help with the promotion and marketing of the bond.
Interest rate	The rate needs to be serviceable to the country, while also appealing to investors. A country would also need to decide whether the interest rate would be fixed or flexible.
Maturity	Generally, sovereign debut bonds have shorter maturities than those of sovereigns that have regularly issued in the international markets. Investors prefer shorter maturities initially due to insufficient country knowledge and an unproven repayment history.
Repayment structure	Countries must decide between issuing a 'bullet' bond or an amortising bond. A bullet bond, where the principal is repaid at maturity, tends to increase rollover or repayment risk. Amortising bonds smooth the repayment profile and reduce rollover or repayment risk. Small developing countries may wish to issue an amortising bond to minimise this risk.

7.3.4 Instrument assessment

Table 7.11 Sovereign bonds issued on international markets assessment

Draft principle	Rating	Description
ADDITIONALITY	High	✓ Bonds aim to raise new finance from new sources. ✓ Revenues are not classifiable as ODA.
NATIONAL OWNERSHIP	High	✓ Countries can earmark funds for development in line with their national priorities and plans. ✓ Bonds are issued and owned by the country. ✓ National capacity: the experience of a growing number of African countries with these bonds shows that capacity exists to issue them even among the poorest countries. ✓ Diversification of financing reduces dependence on traditional ODA and can finance projects that are not traditionally financed by ODA.
INTERNATIONAL ALIGNMENT AND HARMONISATION	Medium	✓ These bonds help to integrate countries more closely into international capital markets. They make use of and reinforce national systems. ✗ National capacity: bond issues may not be consistent with seeking concessional donor support.
RESULTS AND ACCOUNTABILITY	High	✓ These bonds may provide additional incentives to strengthen macroeconomic and debt management, as well as move forward with reform due to investor scrutiny of the domestic economy. ✓ Issuance on international exchanges, and (if over US$500 million) listing on the EMBI, means that transparency is enhanced, as international regulatory standards are adhered to. ✓ National capacity: support is available to help countries meet standards for listing on the EMBI.
PREDICTABILITY & SUSTAINABILITY	Low	✗ Bonds are in foreign currency, risking mismatch. ✗ Adverse developments, such as in commodity prices, may make servicing very difficult to plan and execute. ✗ The appetite of foreign investors for risk in developing countries has been subject to herd behaviour and hence has proved highly volatile in the past. ✗ Bonds are pro-cyclical, issued during favourable times, and postponed during unfavourable times.
PRO-POOR	Medium	✓ Revenues can be linked to development objectives. ✗ There is no guarantee that revenues will be used for development.
DISBURSEMENT	Medium	✓ Some countries have raised funds quickly (within a year of obtaining a credit rating). ✗ It may take time to ensure that all the necessary conditions are in place to issue the bond.

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7.4 Green bonds

7.4.1 About

Developing countries need up to US$100 billion a year to mitigate and adapt to climate change. The private sector will play a key role in mobilising the finance required to address this global priority and green bonds are an important instrument to unlock private capital. Since 2008, multilateral and regional development banks have issued green bonds to mobilise private sector financing and raise additional finance for climate change adaptation and mitigation projects. Developing countries access these funds through the submission of adaptation and mitigation project proposals to these institutions. They are therefore different to the other bonds discussed in this section, which are initiated, owned and issued by the countries themselves. The funds raised are additional as they do not qualify as ODA (OECD 2011).

Green bonds may be acyclical in that countries could apply and access funding from supranational institutions at any time and are not tied to economic trends. The bonds target private investors that wish to integrate environmental concerns into their investment decisions.

Green bonds were pioneered by supranational institutions: the European Investment Bank (EIB) pioneered the first environmental-themed bond, the Climate Awareness Bond, in 2007, and the World Bank issued its inaugural green bond in 2008. The amounts generated in a reasonably short time are quite significant. The market has grown rapidly and it continues to evolve with first time corporate issuance in 2013, and sovereign development banks such as Germany's KfW considering issuance in 2014. Issuance in the first six months of 2014 has already doubled the total green bond issuance in 2013, and it is estimated that total green bond issuance could reach US$40 billion in 2014, compared with US$11 billion in 2013 (FT 2014a). The Climate Bond Initiative estimates that US$15 billion was outstanding at the end of 2013.

The largest issuer to date is the World Bank Group via the International Finance Corporation (IFC) and IBRD, which has raised over US$6.3 billion since 2008.[8] The EIB's Climate Awareness Bonds have raised US$3.16 billion since 2007,[9] the ADB has issued US$0.9 billion of environmental bonds for clean energy and water, the AfDB[10] issued its inaugural green bond of US$0.5 billion in 2013[11] and the European Bank

for Reconstruction and Development (EBRD) has issued its first green bond at US$0.25billion.[12] Table 7.12 presents examples of green bonds issued by supranational institutions.

Multilateral and regional development banks assess the potential eligible green bond projects according to set green criteria. For example, the IFC's criteria for determining eligibility have been independently certified by the Center for International Climate and Environmental Research in Oslo.

Five of the top ten underwriters of green bonds are from Sweden and Japan,[14] reflecting strong interest in and government incentives for environmental projects in these countries, and a subdued appetite for new risk among banks in the USA and Europe. It also reflects a declining government appetite for certain renewable energy incentives in the USA, UK, France, Germany and Spain. However, several of these countries have a track record in supporting renewable energy: the UK will increase its subsidies to wind farms by 10 per cent in 2014 (The Guardian 2013) and Spain too has been a leader in backing alternative solar and power sources, but, owing to high levels of debt in its renewables industry, is currently reconsidering the generous

Table 7.12 Selected supranational green bond issuance

Issuer	Year	Type	Amount (US$ millions)	Terms (years)	Objectives
IFC	2013[13]	Benchmark Green bond	1,000	3	Investment in climate-smart investments in the private sector; investment in renewable energy, energy efficiency, and other areas that reduce greenhouse gas emissions such as installing solar and wind power; and providing financing for technology that helps generate energy more efficiently.
EBRD	2013	Green bond	250	4.7	Investment in the bank's Green Project Portfolio in the following areas: energy efficiency, clean energy, water management, waste management, sustainable living, environmental services and sustainable public transport.
AfDB	2013	Green bond	500	3	Financing of low-carbon and climate-resilient projects including those in renewable energy generation, energy efficiency, vehicle energy efficiency fleet retrofit or urban transport modal change, biosphere conservation projects, solid waste management, fugitive emissions and carbon capture, urban development, and water supply and access.

incentives it has been providing (Financial Times 2013). Owing to its investment in renewables, Germany has doubled the renewable share of its total electricity consumption in the past six years to 23 per cent in 2012, and this is expected to double by 2025 (Rocky Mountain Institute 2013). Investors are attracted to these bonds as the yield is double that of US Treasury Notes, and there is potential to raise significantly more finance, with demand expected to rise (Bloomberg 2012b). The World Bank is marketing them as a 'good introduction for investors that are looking to incorporate environmental, social and governance issues within fixed income' (Institutional Investor 2012). Presently, projects are being implemented in 13 countries, of which only one (India) is a Commonwealth country.

Companies have begun issuing green bonds and have now overtaken international finance institutions (IFIs) in the amount that they issue. In November 2013, French energy group EDF raised US$1.9 billion to fund investment in renewable energy projects and was twice oversubscribed. In March 2014, Unilever issued a US$415 million bond earmarked for reducing waste, water use and greenhouse gas emissions. In March 2014, Toyota issued US$1.75 billion to help finance consumer loans and leases for hybrid and electric cars. Just as issuers have changed, investors have changed. Previously the preserve of public-sector institutional investors, now large asset managers are investing in green bonds (FT 2014). For example, in July 2014, Zurich, an insurance firm, said it would invest up to US$2 billion in green bonds, and has appointed an asset manager to manage the portfolio. Countries could consider and explore the potential for issuing sovereign green bonds or state-owned enterprise green bonds.

7.4.2 First considerations

Eligibility: Country access to funds raised by IFIs through the issuance of green bonds is determined by their classification with development banks. World Bank projects, for example, are open to IBRD-eligible countries, but not to IDA-eligible countries.

Multilateral and regional development banks assess the eligibility of green bond projects according to pre-determined green criteria. For example, the IFC's criteria for determining eligibility have been independently certified by the Center for International Climate and Environmental Research in Oslo.

Green bond revenues are appropriate for countries seeking to implement climate adaptation and mitigation projects. Examples of eligible mitigation projects include solar and wind installations; new technologies and rehabilitation of existing plants and transmission facilities leading to significant reduction in greenhouse gas emissions; improved transport efficiency; waste management and energy-efficient buildings; and reforestation and avoidance of deforestation.

Examples of eligible adaptation projects include protection against flooding, including reforestation and watershed development; food security improvement

and stress-resilient agricultural systems, which slow down deforestation; and sustainable forest management and avoidance of deforestation (World Bank Treasury 2012).

7.4.3 Operation

Table 7.13 Green bonds: considerations and options

Consideration	Options
Application	Countries may submit project proposals to the multilateral and regional development banks using the same channels as they would for other project applications.
Project cycle	Projects can follow a similar cycle to those for other projects. In the World Bank /IBRD case, this begins with identifying development priorities within the context of the Country Assistance Strategy, identifying ideas with impact, designing project documents for appraisal and approval (a difference being that earmarked funds are channelled into a special account), implementation and supervision, completion and evaluation (World Bank Treasury 2011).
Disbursement	Disbursements are made based on project milestones and may be spread over several years.

Projects tend to be on a large scale and are likely to be run by the government. Table 7.14 presents examples of World Bank Green Bond eligible projects in India.

Table 7.14 World Bank Green Bond eligible projects: examples from India

Project	Purpose	Term	IBRD finance (US$ millions)	Mitigation
Power System Development Project IV	Strengthen India's transmission infrastructure resulting in decreased greenhouse gas emissions through efficiency gains.	2008 –2014	600 million	Access to renewable energy (hydropower) in underserved areas through better interregional power exchange; increased efficiency of transmission.
Rampur Hydropower Project	Scale up access to renewable energy.	2007 –2013	400 million	Renewable energy.
Sustainable urban transport	Improve government capacity for climate-friendly urban transport solutions.	2009 –2014	105 million	Sustainable urban transport.

Source: World Bank Treasury (n.d.)

7.4.4 Instrument assessment

Table 7.15 Green bonds assessment

Draft principle	Rating	Description
ADDITIONALITY	High	✓ Bonds aim to raise new and additional finance from private sources that wish to invest in development, environment and climate change initiatives, and so may accept lower than market rates of return on their investments (UNDP 2012: 8). ✓ Revenues are not classifiable as ODA (OECD 2011b).
NATIONAL OWNERSHIP	High	✓ Countries can define projects in need of support using revenues from green bonds issued by IFIs. ✓ National capacity: countries do not issue the bonds themselves. Projects using bond revenues are within the country's capacity to implement.
INTERNATIONAL ALIGNMENT AND HARMONISATION	High	✓ Green bond initiatives are supported by international agencies and are in line with climate change mitigation and adaptation initiatives. ✓ National capacity: how to use funds raised is discussed within the framework of country assistance strategies.
RESULTS AND ACCOUNTABILITY	High	✓ Project appraisal is linked to relevant evaluation criteria. ✓ There is ongoing evaluation in line with relevant evaluation criteria. ✓ National capacity: evaluation criteria are agreed upfront, and committed to by countries.
PREDICTABILITY & SUSTAINABILITY	Medium	✓ Amounts generated by the bonds themselves are large, with the potential to grow. ✓ The bonds are a-cyclical in that funds could in theory be applied for at any time, and they are not tied to economic trends. ✗ Sustainability depends on the success of project proposals. New applications might need to be submitted to sustain existing projects. ✗ Predictability is affected by meeting conditionalities.
PRO-POOR	High	✓ Projects may benefit poorer communities directly, for example through watershed development, or indirectly through wider climate change mitigation and adaptation strategies.
DISBURSEMENT	Medium	✓ Several projects began soon after bonds were launched, suggesting reasonably fast disbursement. ✗ Bond revenues are in effect a loan from development banks with conditions attached, and may not be fast disbursing.

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7.5 Social impact bonds

7.5.1 About

A social impact bond (SIB) is a contract in which socially focused investors finance the provision of a specific service in return for a pay out, which is dependent on certain results being achieved. SIBs have attracted considerable attention in recent years due to their potential to help fund improved social outcomes that result in public sector savings. Pioneered in the UK to finance a prisoner rehabilitation programme, they are now being used in other developed economies (see Table 7.16). Examples of projects include reducing homelessness, reducing the number of criminal reoffenders, addressing health issues such as asthma management and improving educational outcomes.

SIBs are a form of payment by results (PBR), which allows the funding of public services whereby the government pays for services if and when they show improvements in defined and measured outcomes for their target group. In prior PBR arrangements, service providers have been paid by results. With SIBs, however, financing is obtained from private, third-party investors who provide upfront funding for the operations of a social service programme. This enables the expansion of smaller service providers that may be well placed to deliver services that respond to the needs of their local communities, and that would be unable to bear the upfront costs of providing services without PBR schemes.

The government agency holding the contract commits to repaying the capital, plus returns, to the private investor only if the intervention successfully meets its targets. If the programme does not meet its targets, the investors lose their entire investment. This shields service providers and governments from performance and outcome risks.

Although experiences of SIBs are limited, pilots show that they face a number of difficulties. These include large costs associated with the complexity of designing the contract and measuring outcomes. Furthermore, gains from additionality are limited, as governments have to account for any potential pay out in the budget (McKay 2013).

7.5.2 First considerations

Eligibility: As most SIBs are in a pilot phase, it is difficult to clearly indicate eligibility.

SIBs may benefit developed countries facing fiscal constraints to address specific and measurable social issues. However, several prerequisites are necessary for successful implementation (Early Intervention Foundation 2014; RAND Corporation 2011):

Table 7.16 Examples of social impact bonds worldwide

Stage	Country	Location	Social issue	Contract duration	Outcome payment (US$ millions)	Investment needed or raised (US$ millions)
Design	Australia	New South Wales	Intensive family support services	5 years		9.2 (10A$)
Implementation	Australia	New South Wales	New parent and infant family support	7 years	7+ (7.6+A$)	6.4 (7A$)
Design	Australia	New South Wales	Recidivism	6 years		6.4 (7A$)
Design	Canada	Nova Scotia				
Design	Israel		Workforce development for ultraorthodox Jews			
Design	Israel		Workforce development for Arab citizens of Israel			
Design	Israel		Recidivism			
Implementation	UK	Peterborough	Recidivism	8 years	12.2 (£8 million)	7.6 (£5 million)
Design	UK	Essex County	Foster care	5 years	10.6	4.7 (£3.1 million)
Design	UK	Greater Merseyside	Workforce development	3 years	6.8 (£4.5 million)	3 (£2 million)
Design	UK	Shoreditch, London	Workforce development	3 years	4.9 (£3.2 million)	1.4 (£0.9 million)
Design	UK	Stratford, Canning Town, Royal Docks, Cathall	Workforce development	3 years	2.0 (£1.3 million)	4.9 (£3.3 million)
Implementation	UK	West Midlands	Workforce development	3 years	5.0 (3.3 million)	
Design	UK	Nottingham City	Workforce development	3 years	4.4 (£2.9 million)	
Design	UK	Perthshire and Kinross, Scotland	Workforce development	3 years	1.8 (£1.2 million)	
Design	UK	West London	Workforce development	3 years	4.6 (£3 million)	
Design	UK	Cardiff and Newport	Workforce development	3 years	3.0 (£2 million)	

(continued)

Table 7.16 (Continued)

Stage	Country	Location	Social issue	Contract duration	Outcome payment (US$ millions)	Investment needed or raised (US$ millions)
Implementation	UK	Greater Manchester	Workforce development	3 years	5.0 (£3.3 million)	
Design	UK	Thames Valley	Workforce development	3 years	5.6 (£3.7 million)	
Implementation	UK	London	Homelessness	4 years	7.6 (£5 million)	8 (£5 million)
Design	UK	Wales	Foster care			
Design	UK	Cornwall	Ageing in place			
Design	UK	Country-wide	Adoption	10 years		3 (£2 million)
Design	US	Illinois				
Implementation	US	Massachusetts	Recidivism	7 years	27	18
Implementation	US	New York City	Recidivism	4 years	2.1	9.6
Implementation	US	New York State	Employment for formerly incarcerated individuals	5.5 years	21.5	13.5
Design	US	National	Workforce development		20	
Design	US	Massachusetts	Homelessness	3 years	25	
Design	US	Salt Lake City	Early childhood development	1 year		7
Design	US	California	Asthma management			
Design	US	South Carolina	Neonatal care (nurse family partnership)			

Source: www.instiglio.org/en/sibs-worldwide/

- Data and verification: A defined and measurable group of recipients is essential to measuring the impact of the service provided, and to ensure that the service is provided to those who need it. In addition, the target outcomes must be precise, objective, clear, easily measured and externally validated.
- Track record and reputation of social investment market: The social investment market should be sufficiently developed to attract a wide range of investors that require information about investing outcomes. Currently SIBs do not have a track record as an asset class.

7.5.3 Operation

Although actual bonds are not typically issued, the government contracts with investors, a programme manager and not-for-profit service providers. Investors provide funding to the programme manager, who then pays a service provider to affect a desired social outcome. As services are delivered, an independent evaluator funded by the government assesses the outcomes. If the targets are met, the government reimburses the investors for their capital, along with a return on investment. If the targets are not met, the investors receive no compensation from the government and lose their investment. Figure 7.3 shows the key parties and relationships for funding a service via a SIB model.

Experiences from the Peterborough SIBs and other SIBs have shown mixed results. Although they have been successful in raising funds, financing has mainly relied on charitable foundations. Thus it is uncertain whether commercial investors would be interested in funding these services.

In addition, McKay (2013) argues that additionality from SIBs may be limited, as governments must still account for the possible pay out in their operating budget. The UK

Figure 7.3 Example of a social impact bond

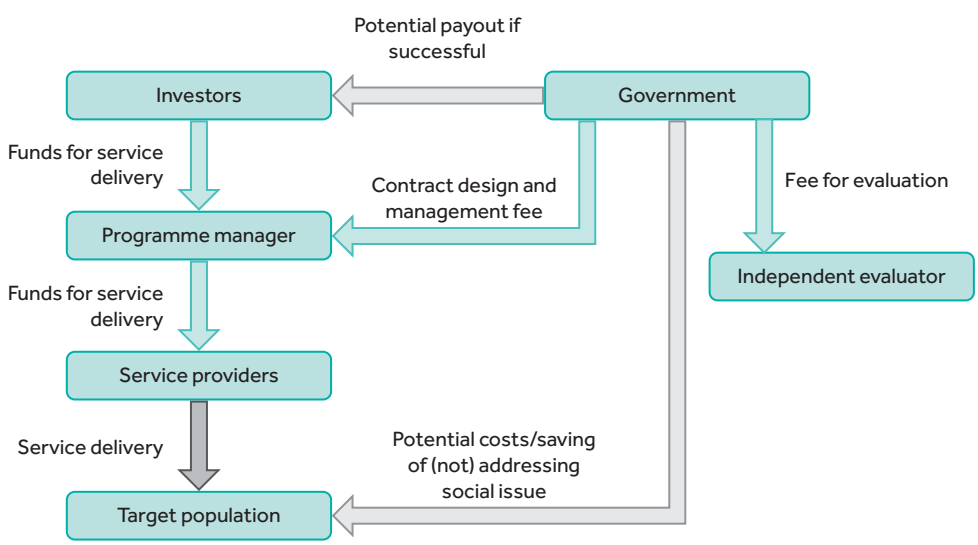


Table 7.17 Case study: Peterborough UK social impact bond

Feature	Description
Sponsor(s)	Ministry of Justice and Big Lottery Fund.
Co-ordinator/ project manager	Social Finance (not for profit financial intermediary, which obtained investment funding).
Investors	17 social investors, consisting of charities or foundations.[15]
Service provider	One Service, a voluntary scheme delivered by paid caseworkers and volunteers designed to reduce re-offending rates.
Funding and launch date	£5 million raised/ launched in September 2010.
Terms and target	The investment is used to fund work with 3,000 male, short-sentence prisoners (divided into cohorts of 1,000) leaving Peterborough prison. Sponsors are to pay investors if there is a reduction of 10 per cent in the frequency of reconviction events in each cohort of 1,000 prisoners compared with the baseline generated by a comparable control group. In addition, if a 10 per cent reduction in reconviction events is not detected for any of the three cohorts, at the end of the entire SIB period a return will be paid if there is reduction in conviction events of 7.5 per cent or more across all 3,000 offenders compared with the control group. It is estimated that if reconviction events are reduced by 10 per cent in one or more individual cohorts, investors can expect the equivalent of an annual internal rate of return of approximately 7.5 per cent (to a maximum of approximately 13 per cent, depending on the scale of the reduction in reconviction events). If there are no reductions in reconviction events, investors receive no return and lose their initial investment (Ministry of Justice 2014).
Results	Results from the first cohort are expected to be published later in 2014, but interim reconviction rates published by the Ministry of Justice indicate that the frequency of reconviction events among offenders released from Peterborough has declined by 11 per cent over the period of the pilot, while the equivalent national figures have risen by 10 per cent. The Peterborough experience, however, has shown that SIBs are sensitive to policy shifts. In April 2014, the Ministry of Justice proposed an alternative funding arrangement for the third and last cohort in light of the UK government's 'Transforming Rehabilitation' programme, which comes into force at the end of 2014 and extends rehabilitation services to all offenders across the UK, regardless of the length of their sentences. This would make measuring the impact of 'One Service' against a control group impossible, hence the outcomes payment has been removed from the third cohort. It is uncertain how this may impact investors for future SIBs.

government pre-funded the Peterborough pilot programme, so the financing was not additional. Furthermore, there are significant costs associated with lawyers, consultants, programme evaluators and the potential return on investments. RAND's study of Peterborough emphasised the difficulty and complexity of designing the contract, which took over two years to develop. This is also consistent with the experience in Maryland, USA (McKay 2013). Together, these concerns may limit cost savings for governments.

Finally, the Peterborough experience shows how SIB pilots are sensitive to policy shifts. This may suggest that SIB pilots may be better placed to inform policy rather than offering an alternative financing model for pressing social issues.

7.5.4 Instrument assessment

Table 7.18 Social impact bond assessment

Draft principle	Rating	Description
ADDITIONALITY	Low	✗ Governments must still account for the possible pay out in their operating budget. The UK government pre-funded the Peterborough pilot programme. ✗ Although funds have been raised for pilots, they have mainly come from foundations and charitable sources.
NATIONAL OWNERSHIP	Low	✗ A SIB financed programme would create a new system of private service delivery. ✗ Countries may not have capacity to set up and manage complex structures.
INTERNATIONAL ALIGNMENT AND HARMONISATION	Low	✗ Extra costs may be incurred by government departments that have to design, manage and evaluate the SIB programme. ✗ The creation of a parallel system administered by the private sector may impede integration with national policy.
RESULTS AND ACCOUNTABILITY	High	✓ Strong focus on measured results ✓ Investors are paid only if results are achieved.
PREDICTABILITY & SUSTAINABILITY	Low	✓ Upfront financing may enable essential services to be provided where governments lack resources. ✗ It is too early to assess predictability, but private investment is likely to be contingent on economic and project-specific factors. ✗ Potentially large costs are associated with consultancy and management fees as well as successful pay outs with high returns to investors. ✗ SIBs are sensitive to policy shifts and other environmental factors.
PRO-POOR	Medium	✓ SIBs are focused on pressing social issues and aim to have a positive social outcome. ✗ Private investors are likely to invest in projects that are more likely to result in pay-outs. This may mean that areas that are plagued by worse social outcomes may struggle to attract funds.
DISBURSEMENT	Medium	✗ Experience from Peterborough and Maryland show that designing contracts can be a lengthy process, taking over two years in the latter cases. ✓ The same experiences showed that once contracts had been designed, funds were quickly disbursed to service providers.

7.6 Development impact bonds

7.6.1 About

Development impact bonds (DIBs) are an adaptation of SIBs intended to provide new sources of financing from private investors to improve development outcomes. DIBs provide upfront funding for development programmes implemented by socially motivated private investors, who are then reimbursed and paid a return by donors or host-country governments if the programmes achieve pre-agreed outcomes. If interventions fail, investors lose some or all of their investment. DIBs differ to SIBs in that in developing country governments with limited budgets, donor agencies may make all or some of the repayments to investors when the results have been demonstrated.

As shown in Table 7.19, DIBs are being developed in at least six countries. However, they remain at the design stage and have not yet been implemented.

Key advantages of DIBs include their ability to raise money for social investments in developing countries, improve the effectiveness of public service delivery and improve the efficiency of aid spending. It is argued that DIBs may improve the performance of social programmes by allowing service providers to experiment with different intervention models (Center for Global Development and Social Finance UK 2013).

Table 7.19 Examples of development impact bonds (DIBs) worldwide

Stage	Country	Location	Social issue	Contract duration	Outcome payment (US$ millions)	Investment needed or raised (US$ millions)
Design	Colombia	Medellin	Teenage pregnancy	4–5 years		
Design	India	Rajasthan	Education			
Design	Mozambique		Malaria			25–30
Design	Pakistan	Punjab	Primary education			25
Design	Swaziland		Prevention of HIV and TB	3 years		10
Design	Uganda		Sleeping sickness	8 years		20–30
Design	Uganda		Secondary education	10 years		35 (£23 million)

Source: www.instiglio.org/en/sibs-worldwide/

Key challenges include the high transaction costs of early DIB pilots. The costs associated with creating new and complex contracts, unusual financial arrangements, and a social sector performance management framework may appear unreasonable when compared with costs of existing non-DIB projects. In addition, it may be challenging to find programmes where the impact of the DIB can be isolated. Furthermore, only in areas such as health and education can results be easily measured within a short period of time (less than ten years). Finally, additionality may be limited as donor agencies and developing country governments have to budget for possible pay-outs.

7.6.2 First considerations

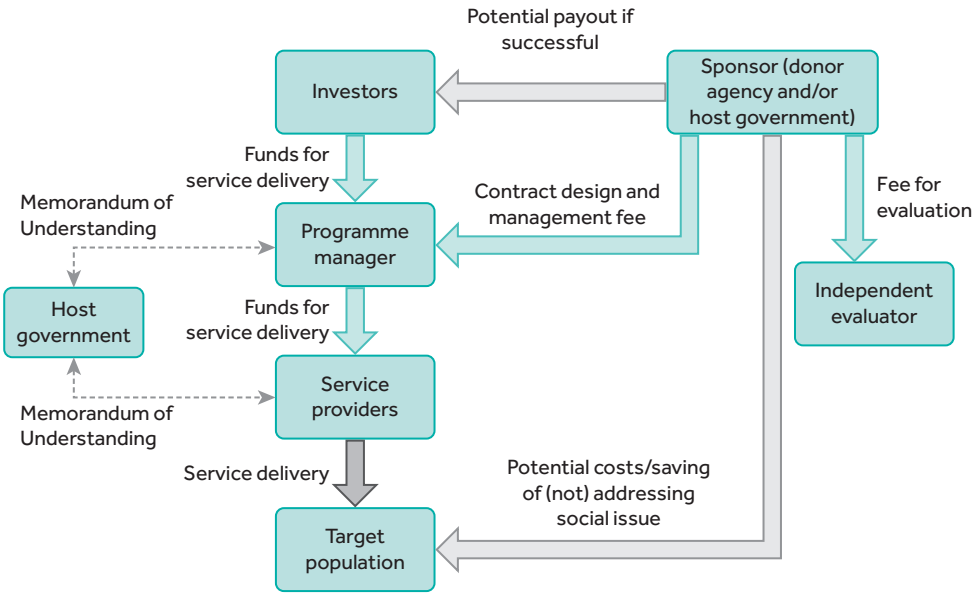
Eligibility: As most DIBs have not yet been implemented and are pilots, it is difficult to accurately indicate eligibility. DIBs may help developing countries facing fiscal constraints to address specific and measurable social issues. They may also provide donor agencies with an alternative way of funding development programmes. However, several prerequisites would be necessary for successful implementation:

- Data and verification: A defined and measurable group of recipients is essential to measure the impact of the service provided, and to ensure that the service is provided to those who need it. In addition, targeted outcomes must be precise, objective, clear, easily measured and externally validated. DIBs may be limited to areas such as health and education, where results may be measured within a reasonably short period of time (less than ten years).
- Track record and reputation of social investment market: The social investment market should be sufficiently developed to attract a wide range of investors who require information about investing outcomes. Currently DIBs and SIBs do not have a track record as an asset class.
- Capacity: Developing countries may face further challenges as they may not have the capacity that advanced economies have in terms of supporting social finance projects and measuring outcomes. Donors would need to fund designers to conduct studies into prospective programmes, and help governments adapt their procurement systems to DIBs. Rigorous, low-cost evaluations would also be necessary to measure the benefits of DIB pilots.
- In line with national priorities: Although the role of developing country governments would vary depending on the DIB, they would need to ensure that the DIB is in line with their national goals and priorities. In addition, donors would have to ensure that DIB projects do not create parallel systems and undermine the capacity of the host government.

7.6.3 Operation

DIBs operate much like SIBs, but the sponsor in the case of DIBs would be a donor agency and/or the developing country government. Although actual bonds are not

Figure 7.4 Example of a development impact bond



typically issued, the sponsor contracts with investors, a programme manager, and not-for-profit service providers. Investors provide funding to the programme manager, who then pays a service provider to affect a desired social outcome. As services are delivered, an independent evaluator funded by the sponsor assesses the outcomes. If the targets are met, the sponsor reimburses the investors for their capital, along with a return on investment. If the targets are not met, the investors receive no compensation from the sponsor and lose their investment. The host government may draw up a formal Memorandum of Understanding to clarify government objectives and the way in which the programme manager and/or service provider should help to meet them. Figure 7.4 shows the key parties and relationships for funding a service delivery in a DIB model.

7.6.3 Instrument assessment

Table 7.20 Development impact bonds assessment

Draft principle	Rating	Description
ADDITIONALITY	Low	✗ Sponsors would still have to account for the possible pay out in their operating budget. ✗ High costs are related to the implementation and design of the contract.
NATIONAL OWNERSHIP	Low	✗ A DIB financed programme may create a new system of private service delivery and may undermine the capacity of the host government. ✗ There may only be a limited role for the host country government. The donor agency would usually be the sponsor and oversee the DIB. ✗ However, this may be limited by formal agreements between the host government and the programme manager and/or service provider..
INTERNATIONAL ALIGNMENT AND HARMONISATION	Low	✗ There may be extra costs for government departments, which may co-monitor the DIB programme and contracts. ✗ The creation of a parallel system administered by the private sector may impede integration with national policy.
RESULTS AND ACCOUNTABILITY	Medium	✓ There is a strong focus on measured results. ✓ Investors are paid only if results are achieved. ✗ The need for measurable and isolated results may limit the scope of programme areas for successful DIBs. Measurement and evaluation may be trickier in capacity-constrained developing countries.
PREDICTABILITY & SUSTAINABILITY	Low	✓ Upfront financing may enable essential services to be provided where governments and donor agencies lack resources. ✗ It is too early to assess predictability, but private investment is likely to be contingent on economic and project-specific factors. ✗ Potentially large costs are associated with consultancy and management fees as well as successful pay outs with high returns to investors. ✗ DIBs are sensitive to policy shifts and other environmental factors.
PRO-POOR	Medium	✓ DIBs are focused on pressing social issues in resource-constrained countries and aim to have a positive social outcome. ✗ Private investors are likely to invest in projects that are more likely to result in pay outs. This may mean that areas that are plagued by worse social outcomes may struggle to attract funds.
DISBURSEMENT	Medium	✗ Contracts may take a long time to design due to their complex nature.

Notes

1 Interest in GDP-linked bonds and state contingent debt has been revived following the global economic crisis. The advantages of state contingent debt have recently been discussed by the Bank of Canada (2013) and the Bank of England (2014).

2 Bangladesh has two US dollar-denominated bonds in issue that mainly target its diaspora but are open also for investment by any non-resident individual or institution regardless of nationality. These are available via authorised banks in Bangladesh or their branches and correspondents abroad, offering 7.5 per cent and 6.5 per cent per annum. Interest on one of the bonds is payable in domestic currency. Bond revenue has been used to fund power and communications infrastructure development (The Independent 2011).

3 In 2012 Kenya actively targeted its infrastructure bond at its diaspora but has not yet issued a dedicated diaspora bond.

4 Nigeria is planning to issue a US$100–300 million diaspora bond by the end of 2014. The bond will be sold only to off-shore diaspora investors with no onshore participation.

5 The other method (boosting productive resilience through, for example, diversifying the export base and trading partners) is beyond the scope of this toolkit.

6 Other index-linked bonds are not new. Commodity-linked bonds, for example, have been a popular choice, assisted by good quality data and relatively high price growth for commodities, e.g. gold, silver or oil. Inflation-linked bonds have also become established instruments.

7 Notable exceptions in sub-Saharan Africa which allow for long-term local currency issuance include Kenya, Mauritius, Nigeria and South Africa.

8 World Bank Treasury website, retrieved 14 July 2014, http://treasury.worldbank.org/cmd/htm/WorldBankGreenBonds.html

9 EIB website, retrieved 14 July 2014, www.eib.org/investor_relations/sri/index.htm

10 AfDB website, retrieved 14 July 2014, www.afdb.org/en/news-and-events/article/afdb-launches-3-year-usd-500-million-inaugural-green-bond-12359/

11 These are the top four issuers. Others include Kommunalbanken AS (US$0.4 billion), Nordic Investment Bank (US$0.2 billion), and EBRD (US$63 million).

12 EBRD website, retrieved 14 July 2014, www.ebrd.com/pages/workingwithus/capital/sri.shtml

13 The IFC issued a second benchmark US$1 billion green bond in November 2013.

14 Skandinaviska Enskilda Banken AB of Sweden has underwritten the most (US$1.9 billion), followed by Daiwa Securities Group Inc of Japan (US$1.2 billion). Green bonds form part of a wider strategy for Daiwa, which has underwritten US$4 billion in bonds for climate change as well as for social impact in the last three years. This is consistent with Daiwa's strategy to reach a new customer base, and taps into willingness among depositors to have a positive social impact (Bloomberg 2012).

15 These include the Barrow Cadbury Charitable Trust, Esmée Fairbairn Foundation, Friends Provident Foundation, The Henry Smith Charity, Johansson Family Foundation, LankellyChase Foundation, The Monument Trust, Panahpur Charitable Trust, Paul Hamlyn Foundation and the Tudor Trust (Social Finance 2010).

Chapter 8

Loans and Guarantees

Growing evidence shows that the frequency and depth of economic downturns has exacerbated poor growth in LICs (Winters et al. 2010). Development finance should thus strive to cushion developing countries during times of crisis and provide alternative sources of liquidity during downturns. Counter-cyclical, concessional and more flexible development finance mechanisms are best suited to this, as they help to ensure that essential social and development-related spending can be maintained during crises. In addition to GDP-linked bonds (considered in the previous chapter) innovation in loans and credit as a form of compensatory finance should be considered in this respect.

This chapter includes a selection of these instruments, including CCLs and contingent loans as well as mechanisms that add concessionality to existing loans (buy-downs). As with all debt-based finance, developing countries should take debt sustainability into account when considering these instruments and mechanisms.

This chapter draws on the experiences of Commonwealth developing countries in order to promote the exchange of information and best practice across the Commonwealth. Mozambique and Tanzania, for example, have benefitted from CCLs piloted by the French; Mauritius has been approved for a World Bank Development Policy Loan Deferred Drawdown Option; Pakistan and Nigeria have benefitted from IDA credit buy-downs; and Botswana from an IBRD loan buy-down.

This chapter also includes a selection of guarantees made available by the development banks to low- and middle-income countries to leverage significant additional private investment and commercial loans for development-related projects. Again, there is scope for much experience-sharing across the Commonwealth. A third of World Bank guarantees, for example, have been allocated to projects in Bangladesh, Botswana, Ghana, Kenya, Mozambique, Pakistan and Uganda. Regional development banks also offer such guarantees, with the AfDB approving guarantees to Cameroon and South Africa.

8.1 Counter-cyclical loans (CCLs)

8.1.1 About

CCL facilities are of direct interest to the Commonwealth's smallest, poorest and most vulnerable member countries, and the Commonwealth Secretariat is actively engaged in taking this interest forward. The Commonwealth has been advocating the provision of more innovative counter-cyclical shock finance since 2009, when it was discussed at a joint meeting of the Commonwealth Ministerial Debt Sustainability Forum (CMDSF) and OIF in April 2009, by Commonwealth ministers in October 2010, and subsequently by ministers of the Francophonie in April 2011 in Chad. Commonwealth ministers recognised the utility of and need for such instruments and called upon the international community to develop counter-cyclical lending instruments to help vulnerable developing countries cope with large, unforeseen, exogenous shocks.

CCLs allow the deferment of debt service with no penalties in the face of exogenous shocks. In these debt contracts it is agreed ex ante that debt servicing will automatically be allowed to fall or become zero in periods when external shocks (measured in a particular way, such as a fall in the value of exports) hit a particular country. This is facilitated by a floating rate grace period in the loan which a country can call on to defer debt service when a shock hits. The broad-based development and implementation of both official and private counter-cyclical lending has the potential to provide a complementary and innovative global automatic shock facility. Although there is increasing interest in introducing this innovation in private lending, this section focuses on official lending.

The obvious advantages of this kind of innovation include:

(i) the automatic suspension of debt servicing without the need for time-consuming negotiations to secure access to new finance facilities;

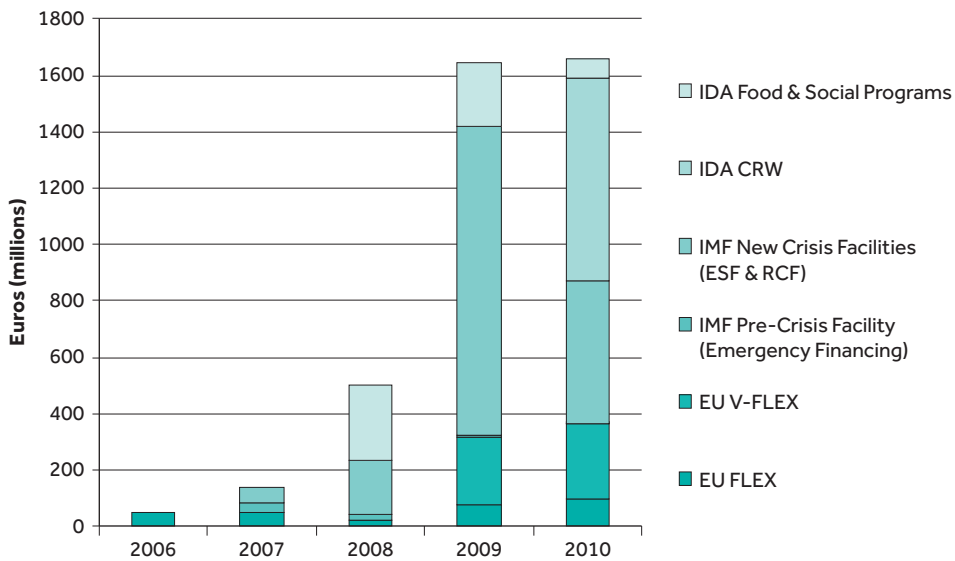
(ii) the provision of more fiscal space, which allows for more counter-cyclical fiscal policy and reduces the costs of unnecessary adjustment thereby protecting growth; and

(iii) the provision of flexibility ex ante which helps to reduce the likelihood of costly crises and disruptive debt crises, defaults and debt restructuring.

Counter-cyclical lending should be seen as a complement to rather than a substitute for existing international shock facilities provided, for example, by the IMF,[1] World Bank[2] and EU,[3] which have been dramatically increased in recent years (as shown by Figure 8.1) in direct response to the global crisis. In order for the mechanism to be effective, it would need to be adopted broadly by major bilateral donors, as well as IDA and the regional development banks. This would ensure scale and ensure its effectiveness in staving off debt crises.

CCLs are not new, but their application remains limited, with only the Agence Française de Développement (AFD) having introduced this innovation in its lending. During 2008–10, the AFD extended €200 million in agreements to five countries as part of a pilot project. Its CCL works by allowing the debt-servicing country to suspend its debt service payments for particular years when certain conditions are met, for example a decline in the value of exports. This is done by replacing the ten-year grace period of a typical concessional loan with a fixed initial grace period of five years, and a subsequent floating grace period of a maximum of five years, which can be used in the event of a shock. The country can ask for a suspension when the shock occurs and the trigger is met. The trigger of the AFD loans is a fall of 5 per cent in the borrower's export revenues compared with the average revenue observed over the previous five years. Two of the beneficiary countries, Mozambique and Tanzania, are

Figure 8.1 Shock financing in millions of euros (2006–10)



Source: Griffith-Jones 2012b

Commonwealth members.[4] Table 8.1 lists the current AFD loans that feature this innovation. The short time period with which these loans have been operating, and the fixed five-year grace period at the start of the loan, has meant that countries have not yet exercised this innovation. However, a hypothetical study revealed that if a sample of 24 highly indebted poor countries (HIPCs) had borrowed using CCLs in 1975, on average they would have been able to suspend payments on debt service at least five times during 1975–2004 (AFD 2010).

The Commonwealth Secretariat initiated studies in 2012 to explore the feasibility and desirability of this innovation from both the lenders' and borrowers'

Table 8.1 AFD counter-cyclical lending in Africa

Borrowing country	Objective	Amount (€ millions)
Burkina Faso		***15***
07/11/2007	Cotton price stabilisation	15
Mali		***84.5***
27/05/2009	Access to water	12
15/12/2010	Support for national planning	10.5
16/12/2010	Urban development & access to water	19
13/12/2011	Vocational training	4
14/12/2011	Access to water	39
Mozambique		***20***
04/11/2009	Suburban electrification	20
Senegal		***146***
20/12/2007	Sanitation & depollution	30
01/10/2008	Energy sector restructuring	30
12/07/2009	Urban development & roads	30
16/12/2009	Urban development & roads	30
06/07/2011	Education & vocational training	4
07/11/2012	Food security & market access	22
Tanzania		***30***
30/09/2009	Access to water	30
Total		**295.5**

Source: Adapted from AFD 2013

perspectives. The Secretariat is in close liaison with the AFD about its experiences; has conducted workshops in conjunction with the UNDP in the Caribbean, Africa and the Pacific; and plans to meet with official lenders to discuss supply-side issues in late 2014 (Commonwealth Secretariat 2013a). Initial findings indicate that Commonwealth developing countries were not aware of this kind of innovation but found the concept highly attractive and were keen to deepen knowledge and awareness as well as engage in further dialogue. Lenders also found the concept appealing and recognised the obvious benefits. However, they also identified a number of design concerns and possible limitations including concerns around trigger design and availability of data; the need for widespread adoption to be effective in terms of scale; liquidity risks; increased administrative burden; moral hazard; and difficulty in designing ex ante instruments that tailor support to meet actual needs.

8.1.2 First considerations

Eligibility: CCLs would be most beneficial to poor countries that are highly vulnerable to debt distress in the face of external shocks such as export or import shocks. This may include countries dependent on commodity exports or imports such as oil, or those which are at risk from adverse weather conditions or natural disasters. In considering a CCL, countries should be aware of political and market risk factors; liquidity issues on the part of creditors; and various trade-offs, namely the choice between a payment holiday and new financing, a reduction in the scale of loans due to the need for prudent liquidity management, and the choice between CCLs and other traditional loans with a policy reform agenda.

Currently the AFD targets its CCLs at LDCs, but it is exploring the possibility of adapting them to a broader range of countries, exploring a broader range of triggers; and introducing this innovation into its less concessional portfolio. Indeed AFD's CCLs could in theory be extended to other AFD-supported countries,[5] but the facility as it currently stands is relevant only to countries that have borrowed substantially in the past.

Table 8.2 CCLs: considerations and options

Consideration	Options
Objective	AFD's CCLs aim to prevent the possible build-up of a debt crisis in the aftermath of a shock. Unlike an insurance scheme, it is not intended to provide compensation for losses due to export shocks.
Scale	The scale of funds must be large enough in absolute terms and by country level in order to respond adequately to shocks and crises. AFD's CCL portfolio totals €295.5 million across five countries.
Approval process	The approval process should be simple, not too burdensome and aligned with the needs and circumstances of the country.
Design and mechanism	Ideally the instrument should be simple and flexible in design. AFD's CCL comprises two components: the loan, and a debt service reserve account for repayments of capital during the five years following the fixed grace period. The loan's amortisation profile is adaptable according to the borrower's economic circumstances based on two options: 1) suspension of capital repayments; and 2) capital repayments drawn from the debt service reserve account. These two options are activated based on the observation of a trigger.
Trigger	Triggers should be realistic (i.e. the facility must be accessible at reasonable levels), and ideally should be linked to the most frequent/disruptive shock that a country is likely to experience. There is a comprehensive range of shocks reflective of the diverse challenges that developing countries face but some shocks to consider could include falls in natural resource commodity prices for commodity exporters; oil price increases for countries highly dependent on oil imports; and natural disasters such as hurricanes. AFD's CCLs are currently relatively narrow – they can only be triggered if merchandise exports fall by 5 per cent or more in relation to the moving average of the previous five years. However, the AFD does incorporate a degree of flexibility in defining the shock and the trigger.
Length of support	Owing to the depth, length and frequency of crises that poor countries in particular may be exposed to, the support offered should ideally be long term, and have some flexibility built in, such as the possibility to extend and repeat. AFD's CCL has a 25- to 30-year maturity, and a 5- to 10-year grace period, of which the first five years are fixed and the next five years can 'float' (AFD 2013, 2010). This floating 'debt holiday' can be used automatically by the debtor country any number of times for up to five years in order to suspend debt servicing whenever the trigger is triggered.
Automaticity, speed of disbursement and data quality	In principle, the mechanism should be extremely fast disbursing in order to respond to the country's need. It must thus act in a genuinely counter-cyclical way. Data quality directly affects the efficiency and speed with which these mechanisms operate.

(continued)

Table 8.2 (Continued)

Consideration	Options
	AFD's CCL triggers are trade related and rely on the availability of export data with very little lag, using the Global Trade Atlas (or any other database chosen in agreement with the borrower). The country monitors its exports through the Global Trade Atlas and asks for a suspension whenever the shock criterion is met (but is under no obligation to ask for a suspension). To accelerate disbursement, AFD uses merchandise export indicators as they are made available, with a four-month lag at most, together with mirror statistics from trading partners to ensure objectivity. While this marks an improvement, countries may experience challenges with Global Trade Atlas data. A key issue in designing the trigger is therefore the availability of timely, objective and accurate data, as the efficiency of the mechanism relies heavily on the availability of data with little lag. For example, if the trigger were linked to the incidence of hurricanes, immediate objective parametric data are available, which could be used in many regions.
Concessionality	Ideally the instrument should be highly concessional, though it should also be noted that the benefits of a CCL could also apply to less concessional loans. AFD's CCL has a 1 per cent concessional interest rate, and AFD is investigating possibilities for adjusting concessionality according to the magnitude of external shocks.

Source: Details about the instruments are available in AFD 2013 and 2010.

8.1.3 Operation

Box 8.1 presents two examples of how the CCL can work. In the first case, the borrowing country experiences export shocks in the period immediately following the termination of its five- year fixed grace period. It therefore requests a suspension of payments for five years, making use of its five-year floating grace period. As it will have exhausted the entirety of its grace in the first ten years, it has no additional suspensions available, and the CCL expires after 30 years.

Box 8.1 CCLs in Mozambique and Burkina Faso

Mozambique

Mozambique relies on ODA for over 50 per cent of its budget. It was hit hard by the fuel price and food crises, and so to align with very concessional rates from other development finance institutions given the macroeconomic situation and exposure to external shocks, AFD offered the country a CCL.

(continued)

Box 8.1 CCLs in Mozambique and Burkina Faso (continued)

Mozambique's CCL is well aligned with its national Poverty Reduction Action Plan and France's co-operation strategy, which focuses on infrastructure (urban water, energy, transport and telecommunications), the environment and budget support. The CCL's objectives relate directly to infrastructure, in particular to improving access to electricity in the environs of Maputo and Cabo Delgado, and drinking water supply in Maputo.

The CCL is part of a package of financing for projects with a total cost of US$215 million. Other contributors include IDA (US$80 million loan), EIB (US$47 million loan), AFD (US$27 million loan), an Arab grant (US$38 million) and the Government of Mozambique. Mozambique acquired its CCL in 2010, so is presently well within its initial fixed grace period. It recognises that the CCL is providing much needed low-cost, low-risk support (Government of Mozambique 2013; AFD 2013).

Burkina Faso

To assist Burkina Faso's Cotton Producers' Association, in 2008 AFD provided a €15 million loan to finance a cotton price stabilisation fund. The loan is considered to be the responsibility of both the government and the Cotton Producers' Association. Implementation of the loan took place in a period of difficulty for cotton producers, with price volatility resulting in a fall in income and production. The loan was thus a financial rather than technical response to sector-level challenges, so while it will not improve competitiveness or productivity per se, it is expected to encourage production and investment by providing greater stability and certainty. The loan is still in its fixed grace period, although this is due to end shortly. Hence there has been no experience of repayments or suspension requests (AFD 2013).

Owing to the newness of the AFD's instruments, it is too soon to assess country experience with them. It is also not possible to document AFD experience with respect to repayments or triggering suspensions, as these loans are still within their initial fixed five-year grace period. However, several observations may be made regarding the expected efficacy and adaptation of AFD's instruments, based on discussions initiated by the Commonwealth Secretariat and UNDP in Africa, the Caribbean and the Pacific.

Possible future adaptation of the CCL

Feedback on the general utility of CCLs has been unanimously positive among African, Caribbean and Pacific officials, and international and regional organisations. They have recognised its country-driven approach, predictability, the flexibility offered by a floating grace period and relative simplicity. Discussions have also yielded several constructive proposals for enhancing and adapting the CCL in future, including:

- making more information available on the costs of accessing payment holidays. To date, this has been free for LDCs, but this could change if the CCL is adapted for borrowers other than LDCs;
- greater flexibility to accommodate changes to a country's risk factors, which might arise from a change in the structure of the economy;
- expanding the range of triggers. At present AFD uses exports for triggers, but is considering using other triggers such as imports and inflation. In the Caribbean, as tourism is the main income earner as opposed to commodity exports as in Africa, the triggers would need to reflect risks to the tourism industry. The Caribbean is also vulnerable to natural disasters, so triggers could, for example, relate to parametric triggers for hurricanes.
- African countries would like to see greater flexibility in the CCL with respect to a change in risk factors. If, for example, a country strikes oil two years after successfully negotiating a CCL loan that has a trigger linked to tourism earnings, it would most likely wish to adjust the trigger from tourism to oil prices, as oil would have become the main source of national income and consequently oil price volatility would be the major risk to sustainable growth and debt service repayment.

8.1.4 Instrument assessment

Table 8.3 CCLs assessment

Draft principle	Rating	Description
ADDITIONALITY	Medium	✓ There is much scope for scaling up, especially if multilateral and regional development banks become involved. ✗ Additionality to existing development finance will be low if loans come from existing ODA.
NATIONAL OWNERSHIP	High	✓ CCLs give countries the flexibility to trigger the floating grace mechanism in the event of an adverse shock. ✓ Countries are under no obligation to trigger the floating grace period. ✓ Funds may be used for a range of purposes as decided by the borrowing country. ✓ National capacity: the process for triggering the floating grace period appears to be quite simple.
INTERNATIONAL ALIGNMENT AND HARMONISATION	High	✓ CCLs can complement debt relief initiatives, and support countries vulnerable to debt distress and external shocks. ✓ National capacity: CCLs can complement national development strategies, and therefore work within these frameworks.
RESULTS AND ACCOUNTABILITY	Medium	✓ CCL triggers can be based on clear proxies. ✗ National capacity: data quality and timeliness can be a concern for the trigger.
PREDICTABILITY & SUSTAINABILITY	High	✓ CCLs are by design counter-cyclical, and can therefore promote predictability and sustainability.
PRO-POOR	High	✓ Funds can be used to support directly pro-poor or more widely pro-development projects.
DISBURSEMENT	Medium	✓ Disbursement can be fast if data proxies used to trigger the release of funds are timely and reliable. ✗ Data weaknesses and conditionalities can affect the speed of disbursement.

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8.2 Contingent credit facilities

8.2.1 About

Contingent credit facilities are another source of counter-cyclical finance. They differ from CCLs in that the finance is earmarked for access, but has not yet been drawn down. In contrast, countries with a CCL receive the face value of the CCL and the debt is marked on the balance sheet of the country.

In September 2012 the IADB announced the launch of two new contingent credit facilities for Latin America and the Caribbean worth US$8 billion. The first is the new Development Sustainability Contingent Credit Line (DSL), which replaces the previous Emergency Lending Facility, and will make US$6 billion available to 26 countries during 2012–2014 to help protect their poorest citizens from sharp fluctuations in commodity prices, global liquidity crises and other exogenous factors.

A separate Contingent Credit Line for Natural Disasters (CCLND) will, during the same period, make up to US$2 billion available to help countries cover urgent financing needs arising immediately after a natural disaster. The CCLND is additional to the IADB's pre-existing Contingent Credit Facility for Natural Disasters, which is being expanded (IADB 2012).

8.2.2 First considerations

The IADB's scheme is available to IADB borrowing member countries, many of which are Caribbean small island states as well as larger countries in mainland Latin America. In theory, this could be broadened to other countries and regions.

8.2.3 Operation

Table 8.4 Contingent credit facilities: considerations and options

Consideration	Options
Objective	As with CCLs, contingent facilities focus on ensuring that development gains are protected in the event of a crisis. The IADB's DSL provides liquidity to mitigate the direct effects of exogenous economic shocks (systemic or country-specific) on the poor and the vulnerable; protect funding for social programmes that benefit the poor, avoid the reversal of policy reform programmes, particularly those that are pro-poor; and provide liquidity to regulated financial institutions to finance short-term working capital operations and trade credits for MSMEs. IADB's CCLND aims to provide borrowers with resources to cover urgent financing needs that arise immediately after a natural disaster until other sources of funding can be accessed.
Scale	The scale of funds needs to be large enough in absolute terms and by country level in order to respond adequately to shocks and crises. It should also be additional to ODA. IADB's DSL provides US$6 billion in total, and up to US$300 million or 2 per cent of GDP per country, whichever is less. IADB's CCLND is capped at US$2 billion overall, allowing up to US$100 million or 1 per cent of GDP per country, whichever is less.
Approval process	The approval process should be simple, not too burdensome, and aligned with the needs and circumstances of the country. The IADB's DSL requires an Independent Macroeconomic Assessment by the IADB, an IMF Article IV or request letter, and the identification of programmes and expenditures within national development plans that are to be protected. The IADB's CCLND requires a country to have a sound macroeconomic framework in place (assessed by IADB); an established Integrated Disaster Risk Management (IDRM) programme; a policy matrix, which should include measures on risk analysis, prevention, mitigation, emergency preparedness and disaster response; and provisions for adequate and sustainable financing of the remaining retained or transferred risks.
Design and mechanism	Ideally the instrument should be simple and flexible in design. The IADB's credit contingent facilities appear to be similarly structured to normal loans with regard to aspects such as grace, maturity, drawdown period, spread and fees. Both facilities are activated based on the observation of a trigger.
Trigger	Triggers should ideally be realistic (i.e. the facility needs to be accessible at reasonable levels), and link to a comprehensive range of shocks reflective of the diverse challenges that developing countries face.

(continued)

Table 8.4 (Continued)

Consideration	Options
	The IADB's DSL is triggered by the Emerging Market Bond Index for systemic crises, and by country-specific tailored triggers included in the loan proposal for country-level crises. This builds in some flexibility for triggers to relate directly to specific country circumstances. The IADB's CCLND is triggered by a country's official declaration of a state of emergency by the competent authority. This declaration can be made at the national, state or municipal level.
Length of support	Owing to the depth, length and frequency of crises that poor countries in particular may be exposed to, the support offered should ideally be long-term, and have some flexibility built in, such as the possibility to extend and repeat. The IADB's DPL and CCLND both come with drawdown periods of three years from the date of the loan contract, and grace periods of three years. DPL has a maturity of six years, compared with 14 years for the CCLND.
Automaticity, speed of disbursement and data quality	In principle, the mechanism should be extremely fast disbursing in order to respond to the country's need. Thus it should act in a genuinely counter-cyclical way. Data quality directly affects the efficiency and speed with which these mechanisms operate. Disbursement under the IADB's DSL is made when the crisis is identified. Disbursement is conditional on compliance with the aforementioned triggers, a satisfactory independent macroeconomic assessment, the availability of an IMF Article IV or request letter, and compliance with the matrix of protected expenditures. If a country's macroeconomic framework has deteriorated substantially from the time of approval, then a borrowing arrangement with the IMF is required. Disbursement of the IADB's CCLND (once a state of emergency has been declared) is conditional on the country maintaining a sound macroeconomic framework, and the conditions included in its policy matrix. Progress is monitored by the IADB every 12 months. The IADB advises the borrower promptly in the event that conditions are not fulfilled.
Concessionality	Ideally the instrument should be highly concessional. The IADB's DPL has a lending spread of ordinary capital plus 165bps (currently 249bps), a cost base of three-month LIBOR, a stand-by fee of 50bps on undisbursed balance and a front-end fee of 50bps on total amount. The IADB's CCLND has a variable ordinary capital lending spread (currently 84bps), a cost base of three-month LIBOR + funding spread and a front-end fee of 50bp.

8.2.4 Instrument assessment

Table 8.5 Contingent credit facilities assessment

Draft principle	Rating	Description
ADDITIONALITY	Medium	✓ Amounts are quite significant, and there is potential to scale up further. ✗ Additionality to pre-existing finance will be low if loans come from existing ODA.
NATIONAL OWNERSHIP	High	✓ Country-specific triggers may be included in the loan agreement, as in the case of the DSL. ✓ Triggers can be effected at national and sub-national level, and the mechanism operates within a national IDRM system (CCLND). ✓ Funds are available for a wide range of development objectives. ✓ National capacity: the process for triggering appears to be quite straightforward.
INTERNATIONAL ALIGNMENT AND HARMONISATION	High	✓ The facilities can complement existing macro support programmes and debt relief initiatives, and support countries vulnerable to debt distress and external shocks. ✓ National capacity: facilities can complement national development strategies, and therefore work within these frameworks.
RESULTS AND ACCOUNTABILITY	Medium	✓ Triggers can be based on clear proxies. ✗ National capacity: compliance with various macro and other conditionalities can be a concern for the trigger.
PREDICTABILITY & SUSTAINABILITY	High	✓ Credit contingent facilities are by design counter-cyclical, and can therefore promote predictability and sustainability.
PRO-POOR	High	✓ Funds can be used to support directly pro-poor or more widely pro-development projects.
DISBURSEMENT	Medium	✓ Disbursement can be fast if data proxies used to trigger the release of funds are timely and reliable. ✗ Conditionalities can affect the speed of disbursement.

8.3 Development policy loan deferred drawdown options

8.3.1 About

A development policy loan deferred drawdown option (DPL DDO) is a counter-cyclical instrument that provides immediate liquidity in the case of macroeconomic shocks. It acts as a contingent loan, which the borrower can postpone drawing down for up to three years.

Here we cover the deferred drawdown options of the World Bank and the IADB.

The World Bank has approved DPL DDOs totalling US$220 million for Chile and Latvia, US$2 billion for Indonesia, US$500 million for Costa Rica, and in the Commonwealth US$100 million for Mauritius, whose experiences are described below along with those of Indonesia. As DPL DDOs are based on standard non-concessional IBRD lending products and qualify as multilateral non-concessional outflows when disbursed, they do not count as ODA (OECD 2011b), and may therefore provide additional finance to pre-existing development finance.

In September 2012, the IADB launched its own DDO as a means of providing long-term support to maintain ongoing reform programmes if a financing need materialises. These work in the same way as any policy-based loan, but give the option to defer disbursements. The drawdown period is three years, with a grace of five years, maturity period of 20 years and a variable lending spread (IADB 2013).

8.3.2 First considerations

Eligibility: World Bank DPL DDOs are available to all IBRD-eligible borrowers and IADB DDOs to all IADB-eligible countries, conditional upon meeting pre-approval criteria including appropriate macroeconomic policy framework, and satisfactory implementation of the overall programme. IDA-only borrowers are therefore not eligible.

The instrument may suit MICs that meet the conditions for World Bank development policy loans.

8.3.3 Operation

Some of the key terms and conditions of DDOs are highlighted in Table 8.6 (see World Bank Treasury 2012b for further information).

Table 8.6 Development policy loan deferred drawdown options: considerations and options

Terms	Description
Currency	As with regular IBRD loans, loans are denominated in US dollars, but countries can request a loan conversion.
Drawdown	IBRD loans may be drawn down at any time during the three-year drawdown period unless the World Bank judges the above-mentioned pre-approval criteria are not being met. Up to the full amount may be drawn down within three years of the loan being signed. IADB drawdown can similarly take place at any time unless the IADB has notified the borrower that programme conditions (both policy and macroeconomic framework) are not being met. The DPL DDO is renewable for an additional three years following adverse economic events such as natural catastrophes, downturns in economic growth or adverse changes in commodity prices or terms of trade. The IADB DDO is also renewable for three years, following the same process as extensions of disbursement period for any IADB loan. During the drawdown period, both policy reforms and macro frameworks are monitored no less than every 12 months.
Lending rate	As with regular IBRD loans, this includes a variable base rate (six-month LIBOR for most currencies) plus a spread. The rate is reset semi-annually, coinciding with interest repayment dates. The spread may be fixed for the life of the loan, or variable and reset semi-annually on 1 January and 1 July.[6]
Pricing	For IBRD, a front-end fee (0.75 per cent of the loan amount) is due within 60 days of the effectiveness date, and may be financed out of the loan proceeds. There is a standby fee (0.5 per cent) of the undisbursed balance accruing from the effectiveness date and a renewal fee of 0.5 per cent of the undisbursed balance. Conversion fees are the same as for regular IBRD loans. The IADB DDO has a standby fee of 0.25 per cent, a front-end fee of 0.5 per cent and a renewal fee of 0.5 per cent (when renewed after three years).
Other	Terms and conditions for currency and interest rate conversions, caps, collars, payment dates and repayments are the same as for regular IBRD loans.

Box 8.2 presents a brief description of the rationale behind Mauritius' and Indonesia's DPL DDO.

Box 8.2 DPL DDOs in Mauritius and Indonesia

Mauritius

The World Bank approved Mauritius's US$100 million DPL DDO on 31 March 2009, and the loan period ended on 31 December 2011.

Mauritius contracted the DPL DDO while it was one of Africa's strongest performing economies, and the support was requested during favourable times. The rationale behind the decision was three-fold, relating to imminent precautionary and long-term strategic concerns.

Firstly, Mauritius had lost its trade preferences in sugar and textiles. In response, it required support via the DDO to reposition its economy to become globally competitive in high value added knowledge and skills-intensive services.

Secondly, Mauritius sought resources via the DDO to mitigate fiscal risks triggered by the global financial crisis.

Thirdly, the DDO was integral to the country's longer-term Country Partnership Strategy (2007–13); Mauritius is using a series of four DPLs as the main instrument to address fiscal consolidation, public sector efficiency, competitiveness, investment climate, social inclusion and sustainability. The country allocated 90 per cent of its DPL funds to public administration, industry and education. Not all of the projects were MDG oriented; the MDG component of the project involved developing global partnerships for development. Unfortunately no evaluation documents are available for this project, so it is difficult to assess its impact at this stage (World Bank 2009b).

Indonesia

The World Bank approved Indonesia's US$2 billion DPL DDO on 3 March 2009, implementable by the Ministry of Finance. In the wake of a 32 per cent fall in its stock market in response to the global financial crisis, Indonesia contracted this loan as a means to maintain public expenditures and preserve economic stability. It also implemented a financial safety net regulation which defines the roles and responsibilities of the Bank of Indonesia, the Ministry of Finance and the Deposit Insurance Corporation in the event of a financial crisis. The primary objective of Indonesia's DPL DDO is to help respond to the possible adverse impacts of the current global financial crisis and address the issues that the current situation poses, which would suggest some flexibility in how the funds are used.

8.3.4 Instrument assessment

Table 8.7 Development policy loan deferred drawdown options assessment

Draft principle	Rating	Description
ADDITIONALITY	High	✓ The finance is not counted as ODA, and is therefore additional to pre-existing development finance.
NATIONAL OWNERSHIP	High	✓ The borrower can choose to draw down at any time during the three-year period, with the possibility to renew. ✓ The loan may be aligned to country priorities. ✓ National capacity: the loans are based on standard non-concessional products, which beneficiary countries have experience with.
INTERNATIONAL ALIGNMENT AND HARMONISATION	Medium	✓ Creditor and beneficiary countries co-operate closely. ✗ National capacity: alignment may be limited by pre-approval criteria and conditions.
RESULTS AND ACCOUNTABILITY	High	✓ The creditor monitors compliance. ✓ National capacity: compliance is in line with conditions negotiated with the borrowing country.
PREDICTABILITY & SUSTAINABILITY	Medium	✓ DDOs are counter-cyclical, providing liquidity in adverse economic conditions. ✗ Conditionalities limit predictability and sustainability.
PRO-POOR	High	✓ DDOs can help sustain the overall development strategy.
DISBURSEMENT	Medium	✓ DDOs can provide immediate liquidity. ✗ This is subject to conditionalities being met.

8.4 Catastrophe risk deferred drawdown options

8.4.1 About

Catastrophe risk deferred drawdown options (Cat DDOs) are contingent loans provided by the IBRD, which offer immediate liquidity to IBRD-eligible countries after a natural disaster. As such, they are of potential benefit to a number of Commonwealth developing countries.

At least 12 Cat DDOs have been approved since 2008, mainly in Latin America and the Caribbean, and one in the Philippines and Sri Lanka. Between 2009 and 2010, Costa Rica, Guatemala and Colombia drew down Cat DDOs of US$24 million, US$85 million and US$150 million respectively to finance reconstruction after the eruption of a volcano, earthquake, tropical storm, floods and landslides (World Bank Treasury, 2011b). Based on one drawdown, on 31 December 2011 the World Bank announced the immediate release of US$500 million to assist the Philippine Government's recovery and reconstruction efforts following devastation caused by a tropical storm during 17–18 December 2011 (World Bank: 2011b).

As Cat DDOs are based on standard non-concessional IBRD lending products, they do not count as ODA (OECD 2011b) and may therefore be additional to existing development finance.

8.4.2 First considerations

Eligibility: Cat DDOs are available to IBRD-eligible countries, subject to their having a satisfactory macroeconomic policy framework and a disaster risk management programme in place. IDA-only countries are therefore not eligible.

The instrument is targeted at MICs that are vulnerable to recurrent natural disasters.

8.4.3 Operation

Table 8.8 Catastrophe risk deferred drawdown options: considerations and options

Terms	Description
Currency	The loan currencies available are euro, yen and US dollar.
Drawdown	Borrowers can secure immediate access to financing of up to US$500 million or 0.25 per cent of GDP, whichever is less. Limits for small states are considered on a case-by-case basis. Proceeds may be drawn down in the event of a natural disaster at any time during the three-year drawdown period. Funds become available for disbursement after the borrower has declared a state of emergency following a natural disaster, subject to approval based on implementation of the disaster risk management programme. As the scope and procedures for declaring a state of emergency vary from country to country, the Cat DDO trigger is defined on a case-by-case basis. The drawdown period can be renewed up to four times for a maximum of 15 years in total. The pre-approval criteria would have to be reconfirmed and updated upon renewal.
Lending rate	The interest rate charged on disbursed and outstanding amounts is the rate for variable spread or fixed spread loans respectively, in effect at the time of withdrawal. The loan is repayable up to a maturity limit of 30 years, as determined by the bank. For example, Costa Rica's loan has a variable interest rate approximately equal to the six-month LIBOR, and is repayable in 29.5 years, including a five-year grace period. Colombia's loan is repayable in 24 years, including an 11-year grace period.
Pricing	A front-end fee (0.5 per cent) is applied to the approved loan amount when the loan becomes effective. There is also a renewal fee of 0.25 per cent of the undisbursed balance.

8.4.4 Instrument assessment

Table 8.9 Catastrophe risk deferred drawdown options assessment

Draft principle	Rating	Description
ADDITIONALITY	High	✓ The finance is not counted as ODA, and is therefore additional to pre-existing development finance.
NATIONAL OWNERSHIP	High	✓ The borrower can trigger a drawdown following a natural disaster by declaring a state of emergency, and has the scope to renew. ✓ The instrument is aligned to national development and disaster management priorities. ✓ National capacity: the loans are based on standard non-concessional products, which beneficiary countries have experience with.
INTERNATIONAL ALIGNMENT AND HARMONISATION	Medium	✓ There is close co-operation between the World Bank and the beneficiary country. ✗ National capacity: alignment may be limited by pre-approval criteria and conditions.
RESULTS AND ACCOUNTABILITY	High	✓ The World Bank monitors compliance. ✓ National capacity: monitoring is in line with conditions negotiated with the borrowing country.
PREDICTABILITY & SUSTAINABILITY	Medium	✓ The loans are counter-cyclical, providing liquidity in adverse economic conditions. ✗ (As with any loan) conditionalities limit predictability and sustainability.
PRO-POOR	High	✓ The loans can help sustain the overall development strategy.
DISBURSEMENT	Medium	✓ Loans can provide immediate liquidity. ✗ This is subject to conditionalities being met. Cat DDO is contingent on meeting pre-approval criteria.

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8.5 IDA credit (and IBRD loan) buy-downs

8.5.1 About

IDA credit buy-downs aim to assist developing countries in accessing low-cost funds to eradicate polio, by allowing a third-party donor to pay off all or part of a specific IDA credit on behalf of the government, conditional upon performance criteria. A US$50 million investment will buy down US$120–140 million in World Bank IDA loans. Commonwealth developing countries have been among the beneficiaries; since 2003 Pakistan and Nigeria have received US$150 million to buy down US$300 million in credits towards their Eradicate Polio projects.

IBRD loan buy-downs are similar in that they increase the concessionality of IBRD loans by blending them with a grant, again conditional on performance. This is presently aimed towards the health and education sectors. Again, Commonwealth developing countries are potential beneficiaries. A US$50 million loan for HIV/AIDs to Botswana was supported by a results-based US$20 million IBRD buy-down funded by the EC in 2008. As Botswana was an upper middle-income country, it was ineligible for support under IDA, and it therefore asked the World Bank for its National HIV/AIDS Prevention Support Project to be financed by this new IBRD facility. However, it is not clear if this is a regularly financed facility with a central pool of funds and clearly defined qualification criteria, or if it is subject to donor approval of particular country projects, such as the EC's support for Botswana's buy-down, in which EC funds were provided directly to Botswana's Ministry of Finance and Development Planning (World Bank n.d.).

In both cases, official contributions by donor countries would count as ODA when the donor transfers funds to the trust fund. If buy-downs are not triggered and funds are returned to donors, they are recorded as negative ODA. But contributions by foundations to the IDA buy-down are private grants and therefore not ODA (OECD 2011b).

8.5.2 First considerations

Eligibility: The IDA scheme is for IDA-eligible developing countries seeking to eradicate polio. The IBRD scheme is for IBRD-eligible countries seeking concessionality of IBRD loans in order to pursue measurable development objectives.

8.5.3 Operation

IDA credit buy-downs are funded through a donor trust fund. IDA lends to a country to enable it to buy polio vaccinations as part of its polio eradication programme.

Upon successful completion of the polio eradication programme, donors buy down all or part of the net present value of the IDA credit. An independent reviewer assesses whether or not criteria have been met, upon confirmation of which funds for the buy-down are released. Box 8.3 presents a case study from Nigeria.

For the IBRD loan buy-down, a donor commits to blend an IBRD loan with a grant. Required funds are held in a trust, as in China, or governed by a bilateral agreement between donor and recipient, as in Botswana. Debt is then bought down once predefined 'development' results have been achieved.

Box 8.3 Nigeria Partnership for Polio Eradication Project (IDA credit buy-down)

As part of the WHO-led global polio eradication effort, Nigeria has been striving to eradicate polio since 1998, and has received World Bank support since 2003.

World Bank support (US$33 million for 2003–5, US$50 million for 2005–8, and US$50 million for 2008–12) was targeted for the procurement of oral polio vaccines through the United Nations Children's Fund (UNICEF) (funded through the buy-down arrangement); supplemental immunisation operations; and surveillance, monitoring and evaluation.

Performance criteria included the timely arrival at the national level of oral polio vaccines (measured by UNICEF's vaccine arrival report) and coverage of supplemental vaccination activities of at least 80 per cent in each endemic state (measured by cluster sample surveys).

Under the buy-down partnership, Nigeria receives a normal IDA credit with two special conditions: that the credit will be bought down upon successful completion, and that the borrower will repay the credit to IDA if unsuccessful.

A study by Nigeria's National Health Care Development Agency (NPHCDA, 2010) found that the IDA buy-down arrangement has made an important contribution by ensuring stable vaccine supplies; the World Bank's credit requirements could be cumbersome and need to be simplified in future; and performance indicators need to be targeted and realistic.

According to WHO, Nigeria experienced an unprecedented 95 per cent fall in polio cases during 2009–10; the number of cases fell from 4000 cases in 2003, to 612 in 2008, to 21 cases in 2010. In light of this, the World Bank approved an additional US$60 million credit to help finance polio vaccines during 2011 and support other aspects of primary health care (World Bank 2011d).

8.5.4 Instrument assessment

Table 8.10 IDA credit (and IBRD loan) buy-downs assessment

Draft principle	Rating	Description
ADDITIONALITY	Low	✗ Official contributions count as ODA so are not additional to pre-existing development finance.
NATIONAL OWNERSHIP	High	✓ Funds earmarked for development are in line with national priorities. ✓ National capacity: countries use the funds to contribute to addressing existing national priorities.
INTERNATIONAL ALIGNMENT AND HARMONISATION	Medium	✓ This instrument involves co-operation between the World Bank and the beneficiary country. ✓ National capacity: the instrument uses and reinforces national systems supported by WHO, UNICEF, IDA or IBRD. ✗ National capacity: procurement is by UNICEF, which suggests government systems are not being fully used. ✗ National capacity: alignment might be limited by conditionalities.
RESULTS AND ACCOUNTABILITY	Medium	✓ Measurable performance criteria are independently assessed. ✗ Indicators might not be sufficiently targeted and realistic. ✓ National capacity: availability of detailed data suggests that countries are managing to provide the necessary information.
PREDICTABILITY & SUSTAINABILITY	Medium	✓ New disbursements may be made to consolidate gains. ✓ Funds are expected to stimulate further financial flows. ✓ Funds are a-cyclical, addressing longer-term development objectives rather than being linked to shocks. ✗ (As with any other loan) disbursement is conditional on performance.
PRO-POOR	High	✓ Projects benefit the poorest directly.
DISBURSEMENT	Low	✗ Cumbersome credit requirements identified by users may impact the speed of disbursement. ✗ Funds are subject to conditionalities, which can slow down disbursement.

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8.6 Guarantees

8.6.1 About

Guarantees aim to encourage private sector investment in developing countries by mitigating risks that are of concern to private sector lenders. They can help to achieve better leverage, maturities and financing costs, and can provide cover against a wide range of risks. Guarantees are available to both low- and middle-income countries and usually require a counter-guarantee from the borrowing government. They mainly target large infrastructure projects, and have benefitted a number of Commonwealth developing countries. They may be counter-cyclical.

A range of guarantees are provided by the World Bank, AfDB, ADB and IADB. These include:

- partial risk guarantees (PRGs) to ensure payment if a government or public entity fails to perform its contractual obligations for a private sector project;
- partial credit guarantees (PCGs), which cover private lenders against all risks for a specific period of the debt term for a public investment. They are designed to lower the cost and extend the maturity of debt; and
- policy-based guarantees (PBGs), which cover a portion of debt service on borrowing (loans or bonds) by sovereign government from private foreign creditors in support of agreed structural, institutional, and social policies and reform. By the end of 2011, the World Bank had approved 28 guarantees, representing an exposure of US$1.4 billion, and which have leveraged US$12 billion of private resources for projects worth US$28 billion (World Bank 2011e). A third of these have been issued to Commonwealth-based projects in Bangladesh, Botswana, Ghana, Kenya, Mozambique, Pakistan and Uganda. Of these, Uganda has received three (one of which is joint with Kenya) and Pakistan two. The guarantees have predominantly targeted power projects (six), followed by gas (two), trade and transport projects. The AfDB has approved guarantees in Cameroon and South Africa (Noman 2011), and the ADB and IADB also offer guarantees.

Official agencies and private institutions are also considering establishing global or regional guarantee facilities to support infrastructure projects in developing countries. GuarantCo, for example, established by bilateral donor group Private Infrastructure Development Group (PIDG), offers partial guarantees for debts from private infrastructure projects and companies, public utilities and municipalities.[7]

8.6.2 First considerations

Eligibility: These guarantees can benefit low and middle-income countries, including IDA-eligible poor countries, and can apply to projects and sectors in the early stages of development, larger-sized operations and projects highly dependent on government support, mostly in the power sector. Table 8.11 summarises eligibility for each of the development banks.

Table 8.11 Guarantee eligibility for different development banks

AfDB	ADB	IADB	World Bank
Borrowers are eligible for AfDB private sector and enclave project loans.	All borrowers are eligible for bank lending, including ADB-only countries.	Borrowers are eligible for bank lending for projects located in member countries.	Eligible to IBRD and enclave project loans. IDA guarantees are available only to IDA countries (PRG only). Private sector guarantees are covered by IFC. The Multilateral Investment Guarantee Agency (MIGA) gives additional PRG.

8.6.3 Operation

Table 8.12 Guarantees: considerations and options

Features	AfDB	ADB	IADB	World Bank
Coverage	Guarantees cover the most appropriate lending instruments for the projects (bond issues, commercial bank loans, ADB loans and private placements). Equity is excluded.	Guarantees cover a wide variety of debt instruments.	Guarantees cover loans to mobilise finance for projects.	Guarantees cover the most appropriate lending instruments for the projects (bond issues, commercial bank loans, private placements and equity).

(continued)

Table 8.12 (Continued)

Features	AfDB	ADB	IADB	World Bank
Link to bank loan	Not necessary.	The bank guarantees projects in which it has a stake (for example a direct loan, subscription to a bond issue or an equity investment).	Not necessary.	Not necessary.
Counter-guarantee from government/ indemnity agreement	Required for public sector projects and PRGs.	Required for public guarantees to public sector entities, but not for private sector guarantees. Generally required for PRGs.	Not a requirement, but recommended.	Required for all IBRD guarantees.
Treatment of claim (i.e. procedure if guarantee is called)	The bank pays and activates the counter guarantee. The counter guarantor owes the bank the money, which is paid out according to the guarantee agreement.	The bank pays, and then seeks reimbursement from the borrower/ counter guarantor.	Funds are disbursed promptly, at which point they become a loan to be repaid by the counter guarantor/ borrower within a pre-defined period.	The IBRD pays and activates the counter guarantee whereby the counter guarantor owes the bank the money paid out according to the guarantee agreement.

Source: Adapted from Noman 2011

Guarantee facilities can be established to support several small projects in the same sector. Multilateral and bilateral agencies have helped countries to establish guarantee facilities by providing seed capital or contingent credit to the government. In Ghana, IDA and the IFC are developing a local currency PCG programme to encourage local banks to lend to small and medium-sized enterprises (SMEs). Box 8.4 shows how Kenya is using World Bank PRGs to enhance electricity supply and access.

Box 8.4 The Kenya Private Sector Power Generation Support Project

This project aims to mobilise private sector finance to enhance reliable power supply to households and businesses. It is in line with the government's Vision 2030, which, in addition to creating jobs and promoting economic development, growth and competitiveness, aims to increase energy access to 40 per cent by 2030, and increase electricity generation capacity.

Towards this objective, the World Bank provided US$166 million worth of PRGs to private investors in the state-owned electricity utility. These guarantees provide liquidity by backstopping three months of Kenya Power's ongoing payment obligations. The strategy includes several players; the Multilateral Investment Guarantee Agency is supporting with political risk insurance for the equity and commercial lending, and IFC is contributing long-term loans.

The guarantees have helped to leverage a total of US$623 million, of which US$357 million was composed of private sector investment and commercial loans.

Source: World Bank 2012

8.6.4 Instrument assessment

Table 8.13 Guarantees assessment

Draft principle	Rating	Description
ADDITIONALITY	High	✓ Although guarantees represent donor support, they leverage additional funds in the form of private investment and commercial loans. Guarantees are not currently included in ODA.
NATIONAL OWNERSHIP	High	✓ Governments may request support in line with their national development requirements. ✓ The projects may be in line with national development strategies, and bring the public and private sector and donors together. ✓ National capacity: the guarantees appear to be simple for the beneficiary country to implement.
INTERNATIONAL ALIGNMENT AND HARMONISATION	High	✓ Programmes are in line with national priorities. ✓ National capacity: programmes work within national arrangements.
RESULTS AND ACCOUNTABILITY	Medium	✓ Guarantees are implemented according to the guarantee agreement. ✓ Governments are held accountable for providing fair and effective regulation for investors. ✗ National capacity: guarantees do not ensure that the investor is held accountable to the regulator or government.
PREDICTABILITY & SUSTAINABILITY	Medium	✓ Guarantees may encourage investment despite political and regulatory risks and during times of uncertainty, hence they may be counter-cyclical. ✗ However, private investment is likely to fall and commercial loans to dry up during global crises.
PRO-POOR	Medium	✓ Projects feed into overall development strategies, benefitting poor households in poor countries. ✗ Projects covered by guarantees may not necessarily have a pro-poor element, and are usually of a commercial nature.
DISBURSEMENT	Low	✗ Complex financial arrangements with many stakeholders take time to establish.

Notes

1 The IMF's rapid credit facility and the standby credit facility.

2 The World Bank's crisis response window.

3 The EU's Flex and V-Flex facilities.

4 Other countries are Burkina Faso, Mali and Senegal.

5 Commonwealth countries supported by AFD include Botswana, Cameroon, Ghana, India, Kenya, Mauritius, Mozambique, Namibia, Nigeria, Pakistan, Rwanda, South Africa, Sri Lanka, Tanzania, Uganda and Zambia.

6 A fixed spread consists of IBRD's projected funding cost margin relative to LIBOR, plus IBRD's contractual spread of 0.5 per cent, a risk premium, a maturity premium for loans with average maturities greater than 12 years and a basis swap adjustment for non-US dollar loans. A variable spread consists of IBRD's average cost margin on related funding relative to LIBOR plus IBRD's contractual spread of 0.5 per cent and a maturity premium for loans with average maturities greater than 12 years.

7 Current PIDG members include DFID, the Swiss State Secretariat for Economic Affairs, the Netherlands Ministry of Foreign Affairs, the Swedish International Development Cooperation Agency (SIDA), the World Bank, Irish Aid and the Austrian Development Agency.

Chapter 9

Public Revenue

This chapter presents some measures to raise domestic public revenue that developing countries may consider in order to generate significant additional funds. These measures include a domestic financial transaction tax, domestic carbon tax and reducing the amount of funds lost via illicit flows.

There is already great interest in domestic financial and carbon taxes in the Commonwealth, including in developing countries. As many as 26 Commonwealth countries have implemented some form of domestic financial transaction tax at some point in time, including the UK. There is growing interest in carbon taxes within the Commonwealth, with implementation in the UK, some Canadian provinces and India. Furthermore, New Zealand has operated an emissions trading scheme and South Africa recently passed legislation to launch carbon taxes in 2016. Australia's carbon tax which has been subject to heated debate, for and against, was abolished by the Australian government in July 2014. Clearly, then, this is a highly topical issue for both Commonwealth developing and developed countries, and there is much scope for experience sharing and for learning from each other's experiences, as well as from those of non-Commonwealth countries.

Domestic taxes are already generating significant revenue quickly, which can be channelled towards development priorities. To their advantage, they are owned and can be designed by the implementing country, working within existing institutional frameworks. There is a huge range of options for introducing and implementing each type of tax to ensure that they can be phased in over time and adapted according to need.

Funds raised may be pro-cyclical as the revenues raised are positively correlated with the level of economic activity. Furthermore, although funds raised so far in this way have been channelled to development, there is no guarantee that they will be used in this way, hence they are not inherently pro-poor. In addition, the introduction of domestic taxes and the curbing of illicit flows (which reduce tax revenue) are highly challenging from a practical perspective. They require institutional and legal reinforcement to make them fully effective, and some countries will need to make progress in this area in order to make them viable.

9.1 Domestic financial transaction tax

9.1.1 About

Financial transaction taxes (FTTs) in developing countries are motivated by the need to raise revenue for development and promote financial and economic stability. They are usually pro-cyclical, as revenue is likely to positively correlate with the level of economic activity. However, revenues raised may also vary with changes in their rates and coverage, as shown by the case studies below. If designed well, domestic FTTs can generate huge additional and sustainable revenues for development and contribute to macro stabilisation.

The various types of FTT are shown in Table 9.1.

Table 9.1 Types of financial transaction tax (FTT)

Type of FTT	Type of financial transaction that is taxed
Securities transaction tax (STT)	Equities, debt and derivatives
Currency transaction tax ('Tobin Tax')	Foreign exchange transactions and their derivatives
Capital levy	Increases in business capital (debt or equity)
Bank transaction tax	Deposits and/or withdrawals from bank accounts
Insurance premium tax	Special sales tax on insurance premiums
Real estate transaction tax	Value of land and/or structures when sold

Source: Adapted from IMF 2011a

There has been a revival of interest in securities and currency transaction taxes as a means to reduce financial volatility and generating new sources of much needed development finance. The idea is not new; Keynes (1936) proposed an STT to reduce speculation, Tobin (1978) proposed a currency transaction tax to reduce currency market volatility and Spahn (1995) proposed a modified version of the Tobin tax.

In 2009 the G20 asked the IMF to present options 'as to how the financial sector could make a fair and substantial contribution toward paying for any burden associated with government interventions to repair the banking system'. In response, the IMF proposed two forms of contribution. The first was a Financial Stability Contribution or levy to cover the fiscal cost of future government support to the sector. This would be payable by all financial institutions into a fund to facilitate the resolution of weak institutions or into general revenue. Initially it would be at a flat

rate (varying by type of financial institution) but later refined according to individual institution riskiness and contributions to systemic risk. The contribution would be linked to a resolution mechanism.

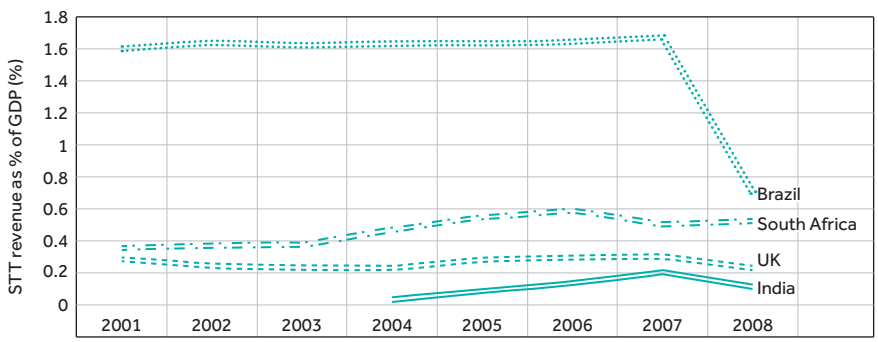
The second contribution proposed by the IMF was a financial activities tax (FAT) on the sum of the profits and remuneration of financial institutions, which would be paid into general revenue (IMF 2010). Much debate has taken place on whether a FAT is preferable to an FTT, although it should be noted that these taxes are not mutually exclusive (Shaviro 2012). Discussions around the FAT have included how best to use such a tax to help stabilise the global financial system, and practical implementation aspects, with less discussion around the potential to allocate revenues towards development. There is no internationally co-ordinated approach to implementing a FAT. Many countries are undertaking discussions domestically rather than in international forums, and some are moving faster than others. Iceland introduced its FAT in 2012, and expects its FAT to generate ISK5.5 billion in revenue in 2013 (Iceland Ministry of Finance 2012). The primary purpose of the Icelandic FAT is the promotion of financial stability.

The EC conducted an impact assessment of a common FTT (EC 2011a), and an international FTT is being advocated for by the Leading Group on IFD (Leading Group on IFD 2010) and by CSOs in consultation with leading economists, business people and other stakeholders (e.g. the Robin Hood Tax campaign).

Many developed and developing countries have implemented domestic STTs including 26 Commonwealth countries[1] and at least 16 others – both G20 countries and non-G20 (IMF 2011a: Table 1; Grabel 2005 in Beitler 2010: Table 3.1a).[2] The revenues they generate can be significant relative to GDP, as Figure 9.1 shows for selected Commonwealth countries and Brazil.

Brazil is included in Figure 9.1 because its experience demonstrates how a developing country can benefit from high, stable, predictable and sustainable revenue relative to

Figure 9.1 STT revenue to GDP in selected Commonwealth countries and Brazil (2001–8)



Source: India, South Africa and UK adapted from IMF 2011a: Table 2, Brazil, from Institute of Applied Economic Research (IPEA) 2011

GDP through implementing STTs. Its revenue has arisen from two taxes, one of which was repealed in 2008, explaining much of the significant drop this year. Changes in the remaining tax have partially offset the decline in overall revenue. For further information, see the case study in Box 9.2.

While domestic FTTs are not new, they are considered in this toolkit because innovation at the domestic level often relies on the take-up of an FTT by more countries. Furthermore the FTTs would need to be adapted over time to keep pace with rapid innovation and the growing complexity of financial instruments. The potential of an international FTT is discussed in Chapter 12. This section will therefore focus on domestic FTTs, with particular reference to securities and currencies.

9.1.2 First considerations

Eligibility: All countries experience financial flows via either organised markets or over-the-counter (OTC) trades, and are therefore eligible to consider some form of domestic FTT.

From an administrative perspective, the introduction and design of a domestic FTT depends on the types of financial transactions/instruments relevant to a particular country, and whether these trades take place in exchanges, OTC or as foreign exchange (forex). While the IMF distinguishes forex instruments as a third category based on their scale and global importance, these are also traded OTC or on exchanges, as shown in Table 9.2.

All three categories are relevant for developing countries. However, exchanges in several LICs are likely to lack the depth for an FTT to be a serious consideration at this stage. They may have very few companies listed on them (generally they list only a country's largest foreign investors), and are characterised by low liquidity in trades. As revenues from FTTs are driven by transactions, this would impact on the amounts and predictability of revenues generated. In such countries, most businesses are MSMEs, and most transactions in their equity (usually in the form of FDI rather than portfolio) take place outside of formal

Table 9.2 Common types of financial transactions

Category	Common types of financial transactions/instruments
Exchanges	Most equities, some bonds, some derivatives.
OTC	Some equities, most bonds, most money market instruments, many derivatives including swaps.
Foreign exchange	Traditional products account for US$3.7 trillion per day (spot, forex swaps, outright forwards) and non-traditional products for US$0.3 trillion (currency swaps and options). Most trading is OTC and concentrated in the hands of a few large financial institutions.

Source: Adapted from IMF 2011b

exchanges, making OTC transactions perhaps more relevant. There may also be limited trade in derivative-related instruments.

In light of the above, LICs may wish to consider other types of FTT that would supplement domestic revenue-raising. One such option could be a tax on real estate sales covering both land and buildings, if one does not exist already. Studies carried out by several LICs have found that construction and real estate sectors are among the most profitable, generating returns on equity of over 20 per cent in peak years (for example, see Bhinda and Martin 2009: 36). This tax can be tied easily to property registration, and is difficult to avoid. It is not discussed further here, as it is well established in many countries.

9.1.3 Operation

This section focuses on practical considerations in implementing domestic FTTs, drawing on examples including from the Commonwealth and Brazil. Whether taxing exchange-traded or OTC instruments, each country faces a similar set of choices in designing its FTT.

Countries need to assess the administrative feasibility of implementing an FTT. In theory, an FTT on exchange-traded transactions is easier to administer than OTC transactions due to the existence of regulation and centralised systems such as clearing houses, central securities depositories, settlement banks and a small number of broker-dealers. However, as noted above, this may be less appropriate in many LICs owing to relatively under developed capital markets. With respect to forex transactions, these share many of the same considerations, depending on whether they are OTC or exchange traded.

Table 9.3 presents a more detailed assessment of these considerations. Discussion applies to exchange-based, OTC and forex transactions unless indicated otherwise.

Like any other tax, an FTT is open to the risk of non-compliance. Thus when implementing an FTT a country should pre-empt or mitigate risks related to under-reporting, migrating transactions to non-taxable jurisdictions, and substituting non-taxed for taxed assets (IMF 2011b). These risks exist for all transactions, but are generally greater for those taking place outside of exchanges, forex or otherwise (see Table 9.4).

The experiences of the UK and Brazil provide examples of well-established and successful STTs, as described in the boxes below.

Table 9.3 Domestic financial transaction tax: considerations and options

Consideration	Options
Which instruments should an FTT target?	An FTT may target an instrument or a range of instruments. For an FTT to be appropriate it should apply to the types of instruments a country is exposed to and their respective scale. In practical terms, rapid innovation has made financial instruments hugely more complex (especially for OTC transactions), posing challenges to FTT design. In order to plug any loopholes, an FTT would need to consider, in addition to an underlying asset, any instruments that may be used as close substitutes, and their derivatives. An FTT would additionally need the flexibility to adapt to keep pace with innovation.
Which territories should be subject to the tax?	This chapter addresses a domestic FTT, i.e. one that takes place within the borders of the implementing country. This would apply regardless of the residency or nationality of those engaging in the transaction. It should be noted that the EU's proposal would work on a regional level; its FTT would be levied on all transactions on financial instruments between financial institutions when at least one party to the transaction is located within the EU. In practice, establishing a domestic FTT is simple for exchange-based transactions, as the territory is defined by the location of the exchange. OTC transactions across borders are more challenging because another territory is involved. This may require co-ordination with other countries that impose an FTT.
At what point should the tax be payable?	An FTT may be applied when a transaction is settled (cash rule) or entered into (accrual rule). In practice, each approach has weaknesses and there is a case for using both (hybrid rule). The cash rule may give the incentive to delay payments on OTC transactions (less likely for payments settled via a clearing house), while the accrual rule can make it difficult to calculate the tax liability precisely. Applying the cash rule where the transaction price is not initially known and the accrual rule where the transaction price is agreed may help to mitigate these problems.
Who should be subject to the tax?	The tax could be applied to the buyer or seller, or shared between both. The latter would have the advantage of allowing the tax authority to make cross-checks. An FTT may also exempt certain actors. In practice, ensuring payment of the tax is simpler for exchange-based transactions, which have a limited number of registered broker dealers. OTC transactions require more effort as they involve unregistered participants, many of whom may be small end-users who are impractical to target directly.
What amount should be taxed?	This can be based on the total amount exchanged (the 'consideration'), but thought should be given as to whether this is gross or net. In practice this is simple to calculate for exchange-based transactions, and for several OTC transactions. Challenges can occur, for example when several OTC transactions take place between counterparts that are netted out. This would mean that the tax would be applied to the net rather than gross amounts and therefore the revenue would be less.

(continued)

Table 9.3 (Continued)

Consideration	Options
What should be the tax rate?	The tax rate needs very careful consideration. In practice, rates tend to be low in order to reduce risks of non-compliance (discussed below) and avoid market distortions, but low rates can still generate substantial sums if the number and size of transactions is high. Alternatively, a country may choose to adopt relatively higher rates for certain types of transaction if it opts to use the tax as a means to influence the composition of capital inflows and their impact on the exchange rate (see the example of Brazil in Box 9.2). Depending on the range of instruments covered and whether it is applied to inflows and/or outflows, it may be appropriate for a country to set multiple rates. It may take a percentage of the transaction or alternatively apply a flat rate.
How should taxes be assessed and collected?	Assessment and collection may be charged to exchanges, clearing houses or market participants. In practice, assessment and collection of taxes on exchange-traded instruments or on OTC instruments settled by an exchange or clearing house reduces compliance costs for broker-dealers, collection costs for the tax authority and scope for evasion. Examples include the CLS Bank for forex transactions, and the UK's CREST for securities (see below). OTC transactions settled outside a clearing house and not involving registered dealers or large market participants need further consideration.
What mechanisms are needed?	As an FTT is a tax like any other, countries will already have systems in place. Countries establishing an FTT for the first time need to draft and enact appropriate legislation and regulation. Administration and computer systems, staff training and institutional arrangements and awareness creation for taxpayers can also be considered within existing frameworks.

Table 9.4 Risks of non-compliance and mitigation against these risks

Risk	Level of risk	Mitigation strategies
Under-reporting	Risk is greater for OTC transactions that are not subject to mandatory reporting or settled via an exchange or clearing house. Matters can be complicated by subsidiaries and branches of international banks keeping records at booking sites rather than at dealing sites.	Risk may be mitigated by collection via a clearing house or exchange; reducing the number of exemptions; requiring broker-dealers to charge and remit taxes for off-exchange transactions; intensive audit with realistic and enforceable penalties; awareness creation; and incentives for compliance.
Migration	Risk may be greater for OTC transactions given the existence of globalised markets for instruments such as swaps which are not necessarily tied to the territory in which the underlying asset is issued.	The extent of this risk is related to the costs and benefits of relocation; keeping tax rates sufficiently low will therefore help. Legislation may also be an issue.

(continued)

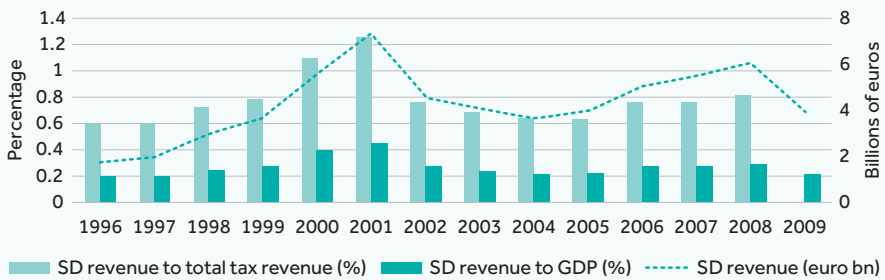
Table 9.4 (Continued)

Risk	Level of risk	Mitigation strategies
Asset substitution	Investors may seek to invest in non-taxed assets that are close substitutes for taxed assets, and this can motivate financial innovation.	Widening the tax base from the underlying shares to their derivatives would reduce this risk, as would granting the tax authority the flexibility to introduce reporting requirements for particular types of transaction, and the ability to re-characterise as taxable those instruments that it deems to have been designed mainly to avoid tax.

Box 9.1 The UK's Stamp Duty and the Stamp Duty Reserve Tax

The UK has implemented stamp duties for a significant number of years. Its current Stamp Duty and Stamp Duty Reserve Tax (1986) are cheap to implement, and raise substantial amounts. Stamp Duty Reserve Tax is charged on electronic 'paperless' share transactions. Most shares are bought and sold this way in the UK. Stamp Duty is paid on the purchase of shares using a paper stock transfer form. As shown in Figure 9.2, revenues are pro-cyclical, peaking during the dot com boom and immediately prior to the global financial and economic crisis.

Figure 9.2 Revenue from UK Stamp Duties (1996 to 2009)



Source: Prepared with data from EC 2011b, Annex 8, Table B1

Is it pro-poor? The duty is used for general revenue-raising, so there is no inherent link to pro-poor spending.

Which instruments are subject to the tax? Stamp Duty taxes transactions in UK securities by residents and non-residents, covering stocks, exercised equity options, futures on shares and shares in investment and unit trusts. Corporate and government

(continued)

Box 9.1 The UK's Stamp Duty and the Stamp Duty Reserve Tax (continued)

bonds are not liable. The Stamp Duty Reserve Tax covers the beneficial ownership of stocks without notification to the registrar. To partially mitigate asset substitution risk, the UK excludes derivatives from asset classes admissible for the solvency test of life insurance companies and pension funds, thereby making derivatives a more costly investment.

In which territories does the tax apply? The tax applies to UK securities transacted in the UK and abroad.

Who does it tax? The purchaser of the security is liable. Exemptions exist in order to generate liquidity. These are for registered charities and broker-dealers who purchase for trade rather than making an investment.

What amount is taxed? Valuation is based on the total amount of money transacted.

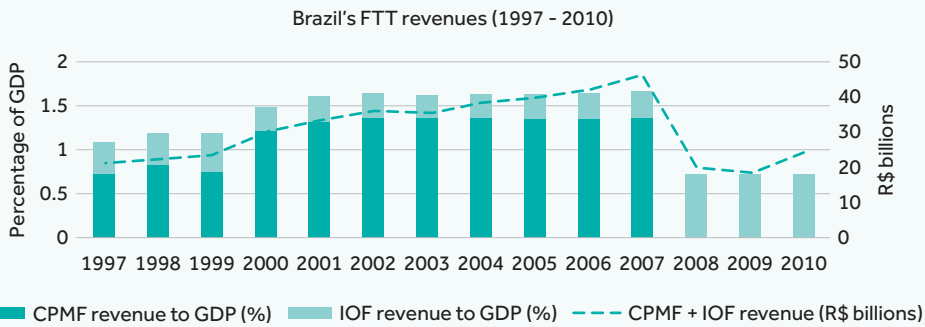
What is the tax rate? A flat rate of 0.5 per cent applies to both based on the value of consideration paid rather than the value of the asset. To mitigate migration risk, the UK charges a higher rate on overseas transactions on UK shares (1.5 per cent).

How is the tax assessed and collected? Collection is done by the tax authorities, which makes use of existing infrastructure. Most is assessed and collected automatically on a transaction-by-transaction basis from broker-dealers via an electronic settlement system (CREST). This has helped to lower the cost of compliance to the taxpayer (£50 million in 2008), administration cost (0.1 per cent of revenue collected – making it cheaper than value-added tax [VAT] and income tax), and the risk of under-reporting by broker-dealers. A full-time staff audit is conducted via assurance visits and office enquiry work. One incentive for compliance is in the form of linking tax payment to legal recognition of a change of share ownership.

Box 9.2 Brazil's Temporary Contribution on Financial Transactions, and Financial Operations Tax

Brazil has implemented two STTs in parallel in recent years: the Financial Operations Tax (IOF) since 1967, and the Temporary Contribution on Financial Transactions (CPMF) during 1996–2008. As shown in Figure 9.3, both (in particular the CPMF) have provided a stream of significant additional, stable and sustainable revenue, in absolute terms and relative to GDP.

Figure 9.3 Brazil's FTT revenues (1997 to 2010)



Source: IPEA 2011, Cagnin and de Freitas 2012: Table 1

The jump in revenue in 2000 followed an increase in the CPMF rate in 1999 (see below). The sharp drop in 2008 followed the termination of CPMF in that year, the impact of which was only partially offset by an expansion in IOF coverage. Nevertheless, the IOF contribution remains significant in size and as a tool of economic policy, as will be explained.

The benefits of the CPMF went well beyond raising additional financing for development; information generated by the CPMF helped the tax authorities to gauge the extent of tax evasion, based on large differences revealed in the scale of transfers and declared income. The authorities were able to use this information to recover significant amounts of tax due, equivalent to a massive 50 per cent of CPMF revenue (IPEA 2011). Brazil's experience with domestic FTTs therefore provides very useful examples of how some developing countries might begin thinking about implementing similar taxes with a currency component.

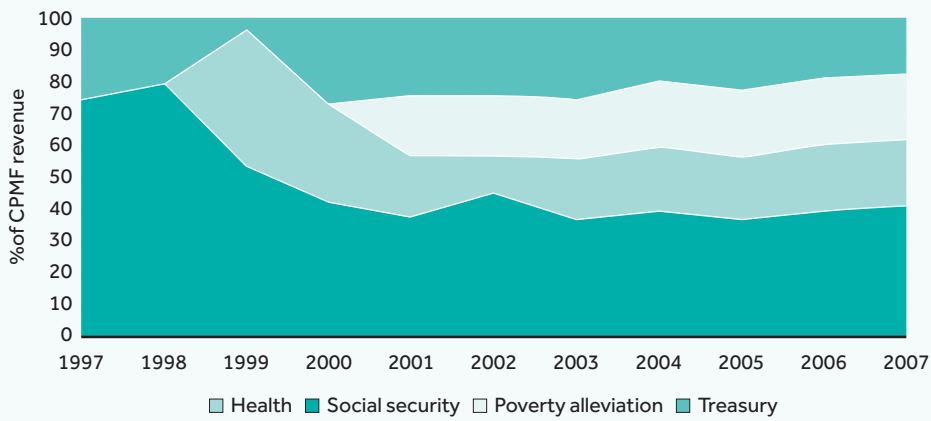
Objectives and development contribution: The motivations for each tax are very different. The CPMF was created to provide revenue exclusively for social spending including health (50 per cent), social

(continued)

Box 9.2 Brazil's Temporary Contribution on Financial Transactions, and Financial Operations Tax (continued)

security (25 per cent) and poverty alleviation (25 per cent). In practice, however, the government reallocated approximately 20 per cent of CPMF revenue to the treasury to help to meet primary surplus targets. The actual allocations are shown in Figure 9.4.

Figure 9.4 Allocation of CPMF revenues (1997 to 2007)



Source: Adapted from Cagnin and de Freitas 2012: Table 3

Although falling short of its initial targets, an 80 per cent contribution to social sectors from a significant revenue suggests that the CPMF nevertheless remained strongly pro-poor. The Ministry of Health, for example, relied on it for around 30 per cent of its resources in most years during 1997–2007 (Cagnin and de Freitas 2012: Table 2). However, in spite of its strong pro-poor credentials, CPMF was open to criticism as people on low incomes were obliged to pay the same rate as others. Hence recent discussions in congress about reintroducing it have suggested that people on low incomes be exempt from paying.

In contrast, the IOF was introduced and is used actively as a governmental instrument to influence financial behaviour, in particular to help mitigate currency appreciation and capital market speculation. Its revenues are shared between the federal government, states and municipalities. A share of these revenues

(continued)

Box 9.2 Brazil's Temporary Contribution on Financial Transactions, and Financial Operations Tax (continued)

(18 per cent) is required to be spent on education. IOF therefore has a creditable directly pro-poor component, although this is not nearly as significant as the CPMF's pro-poor agenda was, either in absolute or relative terms.

Which instruments are subject to the taxes? The CPMF was levied on all financial transactions or transfers, including withdrawals from checking or saving accounts by the general public.

The IOF covers three categories: loans and credit originating from financial and non-financial institutions; forex (spot) transactions; and securities (stocks, corporate bonds, securities options and futures, and forex futures, options and derivatives).[3] Various exemptions exist. However, Brazil has implemented several changes to its coverage (and rates – see below) as a means to deal with currency appreciation (JP Morgan 2011, Forbes 2012a, Bloomberg 2012a, Tax News 2012). In June 2013, for example, Brazil reduced the IOF tax rate from 6 per cent to 0 per cent on funds entering Brazil for investment in fixed income assets to stem the depreciation in the exchange rate.

In which territories does the tax apply? The IOF applies and the CPMF applied to transactions that occur in Brazil only.

At which stage is the taxation collected? The IOF is paid upon settlement, when foreign currency is converted into domestic currency.

Who is taxed? The purchaser is liable under the IOF. It is charged on capital inflows (purchases of the domestic currency by non-residents) and outflows (purchases of forex by residents).

What amount is taxed? The IOF is based on the amount of foreign currency converted into domestic currency.

What is the tax rate? The CPMF was launched with a low rate of 0.25 per cent, which was increased in 1999 to 0.38 per cent. In spite of this increase, the level was considered to be low enough to prevent negative effects on the tax base. The rate therefore remained low, stable and, with infrequent changes, predictable over time.

As reflected in its objectives, the IOF is managed entirely differently from the CPMF, with rates varying by instrument and for inflows and outflows. As a monetary policy tool the rates tend to be much higher than for other FTTs (including the CPMF itself), and these are adjusted

(continued)

Box 9.2 Brazil's Temporary Contribution on Financial Transactions, and Financial Operations Tax (continued)

frequently as needed (and without recourse to congress) based on changing circumstances.[4] For example, various changes were made during 2012 in response to quantitative easing in developed countries. Furthermore, in 2011 the tax on international credit card operations was increased from 2.38 per cent to 6.38 per cent to reduce the amount of spending by Brazilians abroad as a consequence of increased tourism abroad.

Brazil's management of the IOF would suggest that it has been successful in helping to rebalance capital inflows away from shorter-term, more destabilising, flows (witnessed by a decline in portfolio equity) and towards longer-term, more sustainable, types (with FDI remaining reasonably stable). For example, in November 2011 the IOF on foreigners investing in Brazilian equities was reduced from 2 per cent to 0 per cent, and the IOF on foreigners investing in infrastructure-related bonds with a duration of greater than four years was reduced from 6 per cent to 0 per cent.[5] The IOF has also helped to mitigate exchange rate appreciation. However, the frequency of changes – especially during times of global uncertainty – means that coverage as well as rates are not always predictable, although this would appear to be outweighed by the benefits of the tax.

How is the tax assessed and collected? Administration of the IOF is based on self-assessment. Financial institutions authorised by the Central Bank collect the tax, and they are responsible for maintaining records and registering them with the Central Bank, making tax avoidance difficult. These banks are obliged to tax each transaction and remit revenue to government on the third business day following the end of a ten-day cycle, and file a monthly tax return. The tax authority audits this tax as part of its wider audit of bank activities. There is some evidence of avoidance, for example through investors disguising short-term capital as FDI, offshore derivatives trading in underlying Brazilian instruments and issuing bonds with options clauses.

9.1.4 Instrument assessment

Table 9.5 Domestic financial transaction tax assessment

Draft principle	Rating	Description
ADDITIONALITY	High	✓ FTTs are proven to generate additional revenue in larger and more advanced developing countries, which has been tied to development spending and economic stabilisation.
NATIONAL OWNERSHIP	High	✓ Tax can be tailored to meet national economic or development needs. ✓ National capacity: the country has the capacity to design and amend the tax according to need.
INTERNATIONAL ALIGNMENT AND HARMONISATION	Medium	✓ The instrument is aligned to national development strategies and economic planning. ✓ National capacity: the tax makes use of existing legal frameworks, and institutional arrangements within the government and the financial sector. ✗ Legislation and FTT design need to be flexible in order to track financial innovation and avoid the development of loopholes/ reduce the risks of non-compliance.
RESULTS AND ACCOUNTABILITY	Medium	✓ National capacity: where they exist (generally in more advanced economies), centralised electronic assessment, clearing and settlement systems or implementation via the financial sector (using existing bank supervision practices and reporting requirements) would enhance transparency and accountability. ✗ National capacity: where these do not exist, LICs in particular may need to build capacity to ensure they have the aforementioned appropriate assessment and collection systems in place.

(continued)

Table 9.5 (Continued)

Draft principle	Rating	Description
PREDICTABILITY & SUSTAINABILITY	Medium	✓ Taxes have provided a steady stream of revenue over time. ✓ Taxes are predictable if rates and coverage remain constant over time or are changed infrequently with awareness creation. ✓ If used in support of monetary policy, taxes can help to increase longer-term sustainable flows and reduce shorter-term speculative flows and hence promote economic and financial stability. ✗ Predictability to investors is affected if government changes coverage and rates on an ad hoc and frequent basis. This may impact on the sustainability of flows to the country. ✗ Ceteris paribus, revenues can be pro-cyclical.
PRO-POOR	Low	✗ There is no implicit guarantee that revenues will be tied to development. ✗ Rates may not include exemptions for low-income operators.
DISBURSEMENT	High	✓ Tax may be due upon agreement or settlement and collected with high frequency (including transaction by transaction).

9.2 Domestic carbon tax

9.2.1 About

A carbon tax is an environmental tax levied on the carbon content of fuels (coal, petroleum and natural gas) in order to correct the market failure in carbon pricing, and reduce CO_2 emissions.

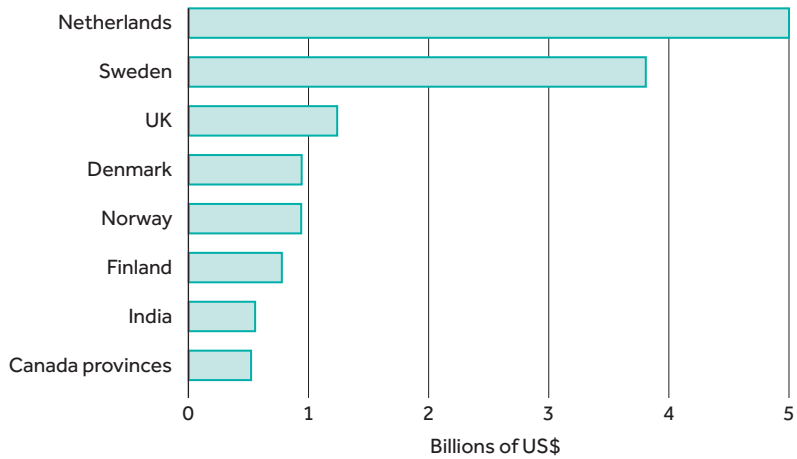
A carbon tax works through the price mechanism directly, and has the potential to raise significant amounts of revenue. In contrast, carbon trading schemes cap emissions at a certain level via the exchange of permits. Each type of instrument has its own strengths and weaknesses. A carbon tax it is easier and cheaper to administer via existing institutional arrangements (trading schemes are complex and require new arrangements), it is more predictable and stable as the price would be known and it has the potential to be applied economy-wide. The emissions reductions resulting from a tax are unknown, but such a tax would inevitably send signals to producers and consumers to adjust their behaviour. Data on revenues are scarce, but they are likely to be pro-cyclical as they are tied to levels of economic activity.

There is growing interest in carbon taxes within the Commonwealth including the UK (since 2001), the Canadian provinces of British Columbia and Quebec (since 2008 and 2007 respectively), and India (since 2010). Australia and South Africa each passed legislation in 2011 to launch carbon taxes, although Australia subsequently abolished its carbon tax in July 2014. New Zealand has operated an emissions trading scheme since 2008. These taxes have been generating significant revenue, as shown in Figure 9.5. The variable rates and tax bases across countries would suggest that there is huge scope for scaling up and rolling out a carbon tax more widely.

Revenues are used in different ways including to support climate change strategies or supplement budget revenue. However, little of the carbon tax revenue raised by developed countries has been used to support development in developing countries.

The impact of taxes on CO_2 emissions is extremely difficult to assess because other mitigation measures and economic growth are influencing factors. Nevertheless, countries with long-established taxes have seen CO_2 emissions fall quite substantially, for example Sweden's CO_2 emissions reduced by 9 per cent during 1990–2006, and Denmark's by 15 per cent per capita during 1990–2005 (NREL 2009: 19–20).

Figure 9.5 Annual carbon tax revenues (various years, US$ billions)



Note: The Netherlands' revenue includes all environmental taxes of which carbon tax is the main source. Revenue from Canada's provinces aggregates revenue raised by British Columbia and Quebec. India's amount is an estimate.

Source: National Renewable Energy Laboratory (NREL) 2009; and (for India) Source Watch 2012

The above discussion considers carbon taxes in isolation, but a carbon tax needs to be seen as part of a wider strategy for tackling climate change, including other environmental taxes, investment, subsidies and public spending, as on its own it is unlikely to have the desired results. The following discussion raises a few of these broader issues for consideration.

Firstly, while a country may begin to produce less carbon (for example, emissions from the EU and the USA have fallen in recent years [Global Carbon Project 2012]) its carbon footprint may increase. The UK finds itself in this position as it imports most goods from high-emitting China, which in effect enjoys an export subsidy (The Economist 2012). This necessitates complementary areas of action in the UK at the domestic level.

One way to address this challenge is to tax carbon imports from high-emitting countries. While this would place the burden on the consumer, import taxes would help to remove the 'subsidy' on exports from high-mitting countries, thereby addressing a market failure. It could be implemented unilaterally without recourse to long and complex international negotiation, and would not necessarily affect domestic producers (to the extent that their imported inputs are not taxed). However, such a tax would impact on imports from developing countries by making them more expensive and less competitive, and potentially risk retaliatory measures.

Another option is to heavily subsidise expensive renewable energy sources and the design and production of more efficient lower-cost technologies. This would require substantive government intervention. The UK Energy Act 2013, for example, aims to move the UK away from polluting fossil fuels and towards a low-carbon economy, while maintaining a stable electricity supply. The estimated cost of this is £110 billion over ten years (BBC 2012).

At the global level, application of a global carbon tax remains elusive and a highly charged international political issue. Most of the countries mentioned above are developed, and better able to afford the introduction of carbon taxes. Furthermore, many developing countries take the view that the developed world should pay developing countries for cleaner growth, given that the current environmental crisis is principally the result of high-polluting activities in developed countries. A global carbon tax is briefly discussed in section 12.3.2.

Developing countries may find themselves with little choice but to take a greater lead in cutting their own emissions and investing in new technology, as inaction could have a great cost to themselves. India accounted for 8 per cent of the increase in worldwide carbon emissions during 2010–11, which is small compared with China's 68 per cent, but still significant (Climate Policy Initiative 2013: ii). The rate of increase is also highest in these two countries, with India's emissions growing by 9.4 per cent in 2010 and 7.5 per cent in 2011, compared with 10.4 per cent and 9.9 per cent in China (Global Carbon Project 2012). Both countries are experiencing or expected to experience growing environmental challenges domestically that will need to be addressed. Indeed, China in response to domestic air pollution problems is piloting sub-national carbon-trading schemes. India introduced a carbon tax on coal produced or imported into India. In 2014 this was doubled from 50 to 100 Indian rupees per ton. The revenue raised is earmarked to fund clean energy and environmental projects.

Furthermore, climate change will disproportionately affect developing countries. Estimates show that baseline global warming will lead to a reduction in agricultural output per hectare of 16 per cent at the global level. This decline is much greater for developing countries, with the effects strongest closer to the Equator. Under the scenario of unabated global warming, India could see a fall of 38 per cent, South Africa 33 per cent, and Nigeria 19 per cent compared with a 2 per cent fall in Canada by the 2080s (Cline 2008). Sea level rise is already also placing small island states in a highly precarious position, an issue on which the Secretariat has long been advocating by raising global awareness and giving a voice to these countries (for example, see Commonwealth Secretariat 2008).

However, were China and India to reduce their emissions by 30 per cent by 2020, their manufacturing output could drop by 6–7 per cent, with an even greater fall in their manufacturing exports (Mattoo and Subramanian, cited in The Economist 2013). Therefore, developing countries will face high costs whether they choose to address the issue or not.

9.2.2 First considerations

Eligibility: Any country may consider implementing a domestic carbon tax.

A carbon tax would only be worthwhile for countries that already emit sufficiently high carbon emissions. Countries would need to adapt institutional arrangements to administer the carbon tax, which may pose a challenge for the Commonwealth's poorest and smallest developing countries that are capacity and resource constrained.

Tax design varies according to national circumstances, requiring several careful considerations which are now outlined in Table 9.6..

The decision on whether or not to implement a carbon tax would also need to be weighed against the potential costs to wider development policy, for example the impact on local business and jobs, and the extent to which the most vulnerable and poorest members of society could be protected from the negative impacts of the tax.

9.2.3 Operation

A carbon tax involves the same considerations as any other tax. A country should seek to minimise its administration costs, maximise compliance, minimise negative impacts on the poorest and consider where to channel revenues to climate change adaptation and mitigation strategies.

Table 9.6 Domestic carbon tax: considerations and options

Consideration	Options
Planning and integration	In deciding whether or not to implement a carbon tax, a country should ensure that the tax fits with existing carbon-reduction measures including other environmental taxes, subsidies and public spending. Existing taxes might already tackle CO_2 emissions even if this is not their primary motivation, for example the congestion charges (UK), natural resource extraction levies (forestry in Cameroon) and industrial pollution taxes (petroleum in Kenya). A country might also implement non-tax measures which impact on CO_2 emissions and should be considered in light of a potential carbon tax, such as enhanced soil management (Kenya); enhanced organic farming standards (Uganda); provision of renewable energy technology to rural households (Bangladesh); and bike-sharing and electric vehicle charging (London) (WRI 2011). The taxes may also be tied to regional or international initiatives, e.g. European countries (Finland, Sweden, UK) implementing national carbon taxes are also signatories to the EU Emissions Trading Scheme.

(continued)

Table 9.6 (Continued)

Consideration	Options
Administrative arrangements	A carbon tax would work through existing institutional arrangements, administered by the tax authority in association with environmental/energy agencies or departments, planning and finance departments, and working with and across relevant line ministries. In practice, such agencies or departments are heavily under-resourced in many developing countries, leading to major revenue shortfalls (e.g. Tanzania's forest and fisheries sectors (UNEP 2010: 17)). A fundamental prerequisite is to ensure relevant agencies are strengthened, and clear lines of communication and demarcation of responsibility are made between them, as part of a whole-of-government approach to tackling the issues.
Defining the tax base	The tax base should ideally be defined by the fuels and their sources, and apply to each greenhouse gas (GHG)-emitting entity based on the amount of GHGs they emit. In practice, tax bases vary considerably across countries. The tax base is especially difficult to define in many developing countries, as there is limited capacity to measure and monitor emissions. As a first step, a country might first undertake a study to determine the fuels it wishes to tax, based on scale or intensity of CO_2 emissions (see Arndt et al. 2011 for the South African case).[6] Secondly, basing the tax on proxies instead of actual emissions would be more practical (if less precise) for developing countries. A country may decide to apply the tax 'upstream' (on fuel producers at the point of production or import) or 'downstream' (on emitters at the point of fuel use). Upstream would be simpler and easier with fewer taxable entities. However, downstream would have the advantage of sending a more direct message to consumers.
Setting rates and exemptions	A country should set the tax at a level high enough to discourage environmentally damaging behaviour and to raise revenues to support climate change mitigation and adaptation. Rates vary greatly across and within countries. Quebec charges C$3.20 per metric ton of CO_2, while Finland charges US$30. Sweden charges different rates for standard users (US$105) and industrial users (US$23). The UK charges different rates for electricity, natural gas supplied by a gas utility, liquid petroleum gas, and others based on the energy content of each. India targets coal. Exemptions similarly vary, with some countries offering more concessions for industry than for households and non-commercial activities. South Africa is considering allowances for businesses exposed to international trade (KPMG 2012). Conversely, the UK exempts domestic users and non-business use by charities (HMRC 2011).

(continued)

Table 9.6 (Continued)

Consideration	Options
Phasing in the tax	Wide variations in rates and exemptions raise questions as to whether these taxes are properly correcting for the market failure in carbon pricing. In order to increase tax efficiency, concessions and phasing-in strategies should ideally be transparent and temporary (except towards the poorest, as discussed below). The pace of introduction may be a concern for developing countries too fast could compromise support, too slow would limit impact. There are several ways of dealing with this; one option is to introduce the tax at a low rate and increase it over time such as in British Columbia where the rate tripled from C$10 in 2008 to C$30 in 2012, with flexibility to adjust depending on whether GHG emissions targets are being met. South Africa is considering a similar approach, introducing the tax with an initial rate of US$16 per tonne of CO_2, which would increase at a rate of 10 per cent per year to US$28 by 2019/20 (KPMG 2012; UNDESA 2012). Another option is to offer refunds in the early stages, then lower them gradually each year (such as in Denmark).
Role of incentives	Ideally, a system should operate without the need for incentives of any kind. However, in practical terms, various kinds of incentives will have a role to play. South Africa is establishing benchmarks for each sector; companies emitting less CO_2 for each unit of output will receive an additional tax-free allowance. Those exceeding their limits will have these allowances reduced (KPMG 2012). The UK offers a heavily reduced rate (35 per cent of the main rate) to energy-intensive businesses that have entered into a climate change agreement with the government (HMRC 2011). A tax applied upstream on fuel producers could be supported by tax credits to encourage them to develop and adopt carbon capture and storage technology.[7]
Frequency of tax collection	To benefit as quickly as possible from the revenues, developing countries should collect revenue reasonably frequently, for example quarterly. However, this may pose capacity-related challenges, depending on resources available to ensure timely and regular compliance. SMEs may also find complying with high frequencies a high burden compared with larger enterprises. Countries may therefore ask emitters above a certain liability threshold to submit more frequent returns, and build in greater flexibility for lower emitters. The UK, for example, requires companies to submit quarterly returns for its Climate Change Levy if their emissions liability exceeds £2,000 per year, but will consider annual returns for those whose liability is £2,000 or less (HMRC 2011: 23–4).

(continued)

Table 9.6 (Continued)

Consideration	Options
Protecting the poorest	The tax burden will fall upon producers and consumers to varying extents, and a disproportionately large share of the burden will fall on the poorest. This runs counter to national development and poverty reduction strategies, and may be further exaggerated if there is an ad hoc system of exemptions in place, and if the tax base is not defined clearly according to need. Carbon intensity studies can assist a country to identify the probable impacts on the poorest in order to plan how to protect them. South Africa found that carbon intensity is high for exports but low for major employing sectors, and that middle-income households are the most carbon-intensive consumers. This means that its tax would affect export earnings but should not disproportionately affect workers and poorer households (Arndt et al. 2011). Measures to protect the poorest include tax relief or transfers, subsidised access to energy-dependent services, recycling the revenue through VAT (sales tax) and temporary concessions to allow time to adjust. British Columbia provides rebates including a low-income climate action tax credit and a small business rate cut.
Green spending	Revenues may be pro-cyclical as they are tied to levels of economic activity, and hence may decline during downswings. A share of revenues would ideally be linked to the national climate change strategy and moving towards a 'green economy' in the longer term. Ideally, developed countries would also channel a growing share of their carbon tax revenues to tackling climate change adaptation and mitigation in the poorest developing countries. This would require a firm commitment on the part of the revenue-raising government, as there is no implicit guarantee that funds would otherwise be used for such initiatives. In practice, many jurisdictions do channel some revenue to environmental objectives, but this is for domestic use with very little funding climate change adaptation and mitigation in the poorest countries. The UK funds energy efficiency initiatives (HMRC 2011), Quebec pays into a green fund which supports GHG reductions and improvements in public transport, India supports clean energy technology and environmental remediation such as forest regeneration and cleaning up pollution (Legal Plant 2011), Denmark uses 40 per cent of revenues for environmental subsidies with the rest returned to industry in some form, Sweden channels funds to the general budget and the Netherlands uses funds to support income tax cuts (NREL 2009: 5, 8). Studies suggest that women and girls – disproportionately vulnerable to the negative impacts of climate change in developing countries – have largely been excluded from climate change finance policies and programmes (WEDO 2011).

(continued)

Table 9.6 (Continued)

Consideration	Options
Monitoring and verification	Countries should have monitoring and verification systems in place, supported by accurate and timely data, to establish whether emissions are declining, and hence whether the tax is effective. The UNFCCC and the Kyoto Protocol require participants in the carbon market to report on their emissions reductions. Some countries require entities to report on emissions (e.g. large entities in the USA) and the voluntary Carbon Disclosure Project has elicited responses in some countries, including South Africa. In practice, data are a major challenge, and as such the use of proxies may be considered (e.g. based on the type of installation and product). Even with reliable data, the task of assessing the impact of a tax is challenged by other factors that impact on carbon emissions, such as economic growth and the existence of other mitigation policies. Countries therefore tend to look at the effect of a broad range of measures on emissions, and many have seen reductions over a relatively short period.
Compliance	The tax would need to be legally enforced, and supported by realistic penalties, in order to promote compliance. This would be greatly assisted by building or reinforcing financial and technical capacity in the relevant agencies, and ensuring that laws are updated as required. Developing countries may also consider awareness creation – especially of the private sector – to explain why the tax is necessary, how it is being applied, and how it fits in with the wider tax system. This is especially important in countries where businesses perceive the tax system to be opaque.

Box 9.3 summarises some recent developments in Commonwealth countries.

Box 9.3 Recent developments with carbon taxes in selected Commonwealth countries

India

India's tax targets coal (both imported and produced) as this accounts for at least half of its electricity generation. The tax is intended to help India to meet its voluntary target to cut CO_2 emissions intensity (emissions per unit of GDP) by 25 per cent from 2005 levels by 2020. Revenues raised are earmarked to fund clean energy development and environmental projects. In addition to the tax, India sets emissions levels for 563 of the country's biggest polluting companies, allowing businesses to trade carbon certificates with trading. This scheme is due to commence in 2014 (The Guardian 2011).

South Africa

South Africa became one of the first developing countries to announce the introduction of a carbon tax to reduce its GHG emissions and assist in the global effort to curb climate change. South Africa has committed to a 34 per cent reduction in CO_2 emissions by 2020 and a 42 per cent reduction by 2025, subject to international assistance. This would involve a 90 per cent reduction in electricity sector emissions by 2025, as these contribute over half its total emissions, via the use of coal (UNDESA 2012). Introduction of the tax has been postponed to 2016. The tax will be phased in from 2016 and the government is considering proposals for a carbon offset scheme to help companies lower their carbon tax liability. Some politicians and influential business representatives are opposing it, as they fear that it will damage economic growth (Business Day 2013).

9.2.4 Instrument assessment

Table 9.7 Domestic carbon tax assessment

Draft principle	Rating	Description
ADDITIONALITY	High	✓ The tax would be a source of significant additional revenue. ✓ Revenues are not classifiable as ODA.
NATIONAL OWNERSHIP	Medium	✓ The instrument is aligned to national climate change adaptation and mitigation strategies. ✓ National capacity: the country has the capacity to design and amend the tax, and tailor it to economic or development need. ✗ National capacity: implementation requires strong capacity not just in the revenue collection agency, but also in environmental agencies and line ministries, which is likely to be a challenge in many developing countries.
INTERNATIONAL ALIGNMENT AND HARMONISATION	High	✓ Plans may be in place to use the tax as a step towards an emissions trading scheme. ✓ National capacity: the tax makes use of existing institutional arrangements (hence it is easier in theory to administer than an emissions trading scheme).
RESULTS AND ACCOUNTABILITY	Low	✗ National capacity: quality data are likely to be a major challenge, especially in developing countries, requiring capacity-building in monitoring and validation.
PREDICTABILITY & SUSTAINABILITY	Medium	✓ Taxes can provide a steady stream of revenue over time. ✓ Taxes are predictable if the introduction is phased, e.g. starting from low to high. ✓ Revenues can contribute to the general budget if not required for climate change projects. ✗ Revenues are pro-cyclical. ✗ There is scope to adjust rates and the tax base on an ad hoc basis in response to non-climate change considerations, for example to suit certain sectors or industries.
PRO-POOR	Low	✗ Incidence would hit the poorest operators hardest, necessitating the introduction of pro-poor exemptions. ✗ There is no implicit guarantee that revenues will be tied to national climate change and development strategies.
DISBURSEMENT	High	✓ Emitters above a certain level can be charged more frequently (e.g. quarterly), while those below this level may be charged less frequently (e.g. annually).

9.3 Curbing illicit flows

9.3.1 About

In recognition of the fact that ultimately development resources must come from the recipient country itself, there has been a renewed emphasis in recent years on domestic revenue mobilisation in developing countries. One important challenge is curbing the estimated US$946.7 billion in resources flowing out of developing countries through illicit financial flows (GFI 2013).

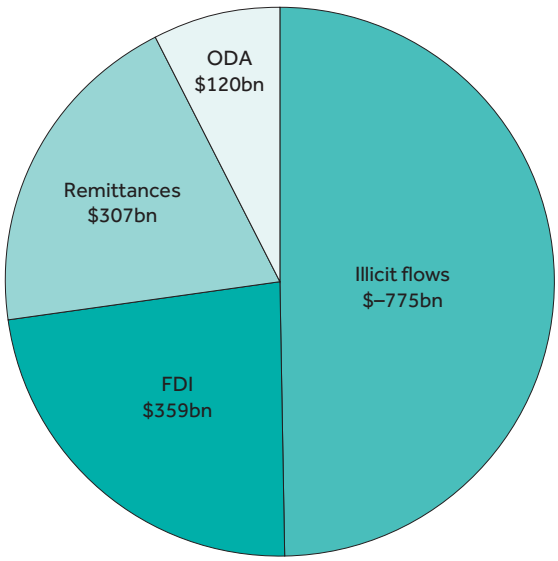
Illicit financial flows (IFFs) pertain to the cross-border movement of money that is illegally earned, transferred or utilised. IFFs include practices such as tax evasion, corruption, terrorist financing, money-laundering, counterfeiting, fraud, false invoicing, extortion and bribery. IFFs have long been a concern for developing countries, due to their negative impacts on development, as they constitute a heavy drain on domestic resources which could otherwise be invested in the developing countries from which they originated.

Whilst curbing IFFs is not in itself a source of innovative development finance, it is included here because it is an important focus of the Leading Group on IFD, of which the Commonwealth is a member. More importantly, reducing these outflows can generate significant new and additional resources for development. As shown in Figure 9.6, in 2009 illicit capital flows were estimated to be equivalent to all of the combined value of FDI, remittances and ODA, and thus has the potential to dwarf other forms of capital flows to developing countries such as FDI, remittances and ODA.

Tackling IFFs requires international co-operation as well as domestic political will.

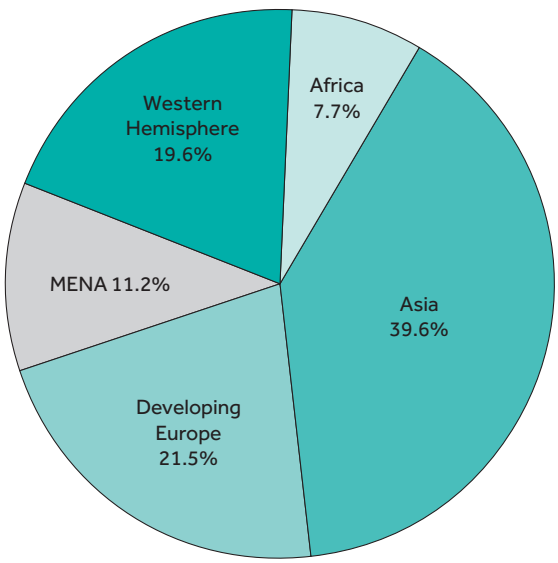
Illicit flows are very difficult to measure.[8] It is estimated that developing countries lost US$946.7 billion in 2011 due to IFFs, a 13.7 per cent increase from 2010 (GFI 2013). Globally, illicit financial outflows averaged 4 per cent of GDP. In its most recent report, GFI estimates that during the period 2002–2011 developing countries lost a total of US$5.9 trillion in IFFs and that during this period the losses increased at an average rate of 10.2 per cent per annum (GFI 2013).Table 9.3 shows that Asia accounts for the largest volume of IFFs.

Figure 9.6 Capital flows to and from emerging markets (2009, US$ billions)



Source: Kar and Freitas 2011

Figure 9.7 Regional percentage of 2002 to 2011 cumulative illicit financial flows



Source: GFI 2013

Three Commonwealth countries feature in the list of the top ten countries with the highest level of cumulative IFFs during the period 2002–2011: US$370 billion left Malaysia, US$344 billion left India and US$142 billion left Nigeria. The poorest Commonwealth countries also suffer significant losses. For example, during the same period GFI estimates that Bangladesh lost US$12.4 billion; Cameroon US$5.9 billion; Malawi US$5.3 billion; Lesotho US$1.3 billion; Uganda US$7.3 billion; Tanzania US$4.4 billion; and Zambia US$19.3 billion. In Commonwealth countries it is estimated that 70 per cent of these flows arise from trade mispricing (the deliberate over invoicing of imports or under invoicing of exports) usually for the purpose of tax evasion. The top five Commonwealth countries in terms of trade mispricing on average are Malaysia, India, South Africa, Nigeria, and Trinidad and Tobago. The sheer size of these estimates suggests that several Commonwealth countries can mobilise significant tax revenues through reforming customs and trade protocols to detect and curtail trade mispricing, especially as these figures are likely to be under estimates (GFI 2012, Commonwealth 2013c).

It is noteworthy that these top five Commonwealth countries have relatively large extractive industries, sectors in which Africa's IFFs are highly concentrated. Global financial liberalisation has helped facilitate an increase in these flows. IFFs are also concentrated in the destination countries; the main recipients of IFFs from African countries are developed countries (especially the United States, European states, Canada, Japan and Korea) and emerging economies such as China and India (UNECA 2013). This illustrates the transnational character of IFFs, and the need for national, regional and international action to address this challenge.

A lack of transparency and supervision of cross-border flows are at the heart of the problem. High levels of intra-company trade create extensive scope for trade mispricing, enabling companies to report profits in low-tax jurisdictions. Governments are also seeking more sharing of information on companies using offshore companies, to ensure that they pay their fair share of taxes and do not utilise offshore centres for corrupt practices, including ill-gotten gains. Complex commercial transactions between government agencies and foreign investors also provide opportunities for corruption. This last issue is a particular problem in relation to natural resource investments, and it is notable that resource-rich countries in Africa score poorly on the Resource Governance Index (RGI), a measure of the level of disclosure in the natural resource sector.

Another factor to be addressed is the lack of resources and limited enforcement capacity of tax administrators in several developing countries. This problem is magnified when tax evasion takes on an international dimension. The need to build capacity and share information are seen as key components in the fight against tax evasion.

The revenue generated by curbing illicit financial flows may be counter-cyclical if it helps a country to recoup lost revenue during shocks, but it may also be pro-cyclical, with amounts increasing with the level of economic activity.

9.3.2 First considerations

Eligibility: Any country for going a significant amount of revenue relative to domestic revenue due to illicit flows could consider this measure.

9.3.3 Operation

Various initiatives exist to highlight the problem of IFFs and attempt to influence international standards to increase financial transparency. Measures are far-ranging and fall under umbrella initiatives of the G8 and G20, such as the automatic exchange of information between countries and disclosure on the beneficial ownership of companies. However, substantive actions still need to be taken in these areas, and other areas also need to be addressed, including trade mispricing, the harmonisation of anti-money laundering policies and country-by-country company reporting (GFI 2013a).

An example of a recently emerging response from Africa is provided by the African Union (AU) and UNECA, which inaugurated their High Level Panel on Illicit Financial Flows in South Africa on 12 February 2012. The panel is hosted by UNECA, and a consultative workshop composed of experts defines its strategic objectives and goals. The AU and UNECA will use the panel to determine the nature, pattern and level of illicit outflows; assess long-term development impacts; sensitise key stakeholders; and advocate for remedial mechanisms.

The panel is chaired by HE Mr Thabo Mbeki, former president of South Africa, and vice chaired by UNECA. There are eight other members from within and outside Africa from the public and private sector and research and advocacy organisations (UNECA 2012). The initiative was organised in consultation with the above-mentioned Task Force on Financial Integrity and Economic Development.

The Task Force on Financial Integrity and Economic Development was borne out of the Leading Group on Innovative Financing for Development, and is a consortium of governments and NGOs guided by a co-ordinating committee that includes various NGOs and advocacy organisations.[9] It advocates the following measures to reduce illicit flows, many of which fit into the remits of agencies charged with boosting global financial stability in the wake of the global financial and economic crisis:

- Transfer pricing: parties conducting cross-border sales to certify that there is no trade mispricing, and that the transaction is priced using the OECD arm's-length principle. This would be executed by the OECD and World Trade Organization;
- Country-by-country reporting: full disclosure by multinationals of data on where they operate, number of staff, payments to governments, profits made and accounting information. This would be executed by the International Accounting Standards Board;

- Beneficial ownership: confirmation of beneficial ownership in all banking and securities accounts, and automatic cross-border exchange of tax information on personal and business accounts. This would be executed by the Financial Action Task Force and individual countries;
- Automatic exchange of tax information, as per the European Savings & Tax Directive. This would be executed by the EU and UN Committee of Experts on International Cooperation in Tax Matters; and
- Harmonising predicate crimes, requiring that predicate offences for a money laundering charge are harmonised at the most restrictive level, and codified. This would be executed by the Financial Action Task Force.

Regional initiatives are harmonising with the international financial architecture. For example, the 40 recommendations on anti-money laundering of the Financial Action Task Force (2003) are being taken forward in an African context, in bodies set up around the Financial Action Task Force standards, e.g. the Eastern and South African Anti-Money Laundering Group, and the Middle East and North Africa Financial Action Task Force.

9.3.4 Instrument assessment

Table 9.8 Curbing illicit flows assessment

Draft principle	Rating	Description
ADDITIONALITY	High	✓ The gains (to development) are potentially huge in absolute and relative terms. ✓ Revenues are not classifiable as ODA.
NATIONAL OWNERSHIP	Medium	✓ Domestic resource mobilisation is boosted. ✓ Government has full ownership of revenue gains. ✓ Extra revenues can be aligned to national priorities. ✗ National capacity: executing agencies are mainly international or regional. There is a lack of resources and limited enforcement capacity of tax administrators in many developing countries.
INTERNATIONAL ALIGNMENT AND HARMONISATION	Medium	✓ National capacity: works within mandates of international organisations. ✓ There is no guarantee that revenues go towards development.
RESULTS AND ACCOUNTABILITY	Medium	✓ It promotes more accountability and transparency in the tax system and in trade and business arrangements. ✗ National capacity: illicit flows are very difficult to measure.
PREDICTABILITY & SUSTAINABILITY	Medium	✓ Revenues are generated on an ongoing basis. ✓ Could be counter-cyclical if it helps a country to recoup lost revenue during shocks. ✗ Could be pro-cyclical with amounts increasing with the level of economic activity. ✗ Amounts may move with economic (and political) cycles.
PRO-POOR	Medium	✓ There is the potential to boost domestic revenue and hence development expenditure. ✗ There is no guarantee that funds would be used towards development goals.
DISBURSEMENT	High	✓ Fast gains can be made by stopping illicit outflows from taking place.

Notes

1 Australia, Bangladesh, Barbados, Botswana, Dominica, Fiji, Ghana, India, Jamaica, Kenya, Malawi, Malaysia, Malta, Mauritius, Namibia, Nigeria, Pakistan, Singapore, South Africa, Sri Lanka, Swaziland, Tanzania, Trinidad and Tobago, UK, Zambia and Zimbabwe.

2 Non-Commonwealth countries implementing a type of STT include G20 countries (Argentina, Brazil, China, France, Germany, Indonesia, Italy, Japan, Russia, South Korea, Turkey, and USA), and non-G20 countries (Chile, Hong Kong, Switzerland, and Taiwan).

3 Although its base includes foreign currency, it is considered a STT rather than currency transaction tax (IMF 2011a; Beitler 2010) as it applies only to the conversion of foreign into domestic currency from inward investment rather than all trades in the wholesale forex market.

4 Owing to the number of recent changes, the current rates are not mapped here. However, they are recorded in relevant legislation (http://www.receita.fazenda.gov.br/legislacao/legisassunto/iof.htm).

5 http://masterclassbrazil.com/managing-a-business-in-brazil/taxes/iof-financial-operations-tax/

6 The South African carbon intensity study looked at industries, products and households. At the industry level it measured tons of CO_2 against the value of gross output for economic sectors, and at the product level against the value of final demand.

7 Carbon capture and storage technology aims to prevent the release of CO_2 into the atmosphere by capturing it at source, transporting it, and storing it, for example in the ground or oceans.

8 Different measures exist, each of which faces data quality and reporting challenges. For example, transactions in narcotics and contraband goods are omitted, and there is discussion as to whether or not certain items such as misinvoicing should be included. The World Bank's Residual Method defines illicit flows as the residual of the extent to which a country's sources of funds exceed their reported uses: illicit flows = (increase in foreign debt + increase in FDI) – (financing of current account deficit + additions to the country's reserves). The Hot Money Narrow Method adjusts for trade misinvoicing.

9 Christian Aid, The European Network on Debt and Development (Eurodad), GFI, Global Witness, Tax Justice Network, Tax Research LLP, Transparency International and the Leading Group itself.

Chapter 10

Insurance

Insurance-based mechanisms represent a growing area in innovative financing for development, and one in which Commonwealth developing countries have been playing a leading role. Although they do not necessarily contribute additional revenue streams for development, they do aim to improve the effectiveness of development finance. Examples include weather index-based insurance schemes in operation in India, Kenya, Malawi and Tanzania among other developing countries, and regional catastrophe insurance schemes such as the Caribbean Catastrophe Risk Insurance Facility (CCRIF).

Weather index-based insurance (WII) and the CCRIF are both examples of parametric insurance schemes, whereby policies pay out on the basis of the expected loss based on measured parameters (e.g. a rainfall index for WII and the strength of an earthquake or hurricane wind speed for CCRIF) rather than the actual value of the loss. This allows for ex ante management of climate and natural catastrophe risks, transparent and low settlement costs, and, most importantly, the fast disbursement of funds.

The schemes outlined on WII in this section look at the micro level, where farmers or groups of farmers can insure against weather-related risks. At the macro level, this section outlines the CCRIF as an example of a multi-country pooled risk catastrophe scheme, as it was the first regional scheme to be established backed by traditional finance and capital markets. It should be noted, however, that the pooling of country catastrophe risk is starting to be replicated in other regions such as in Africa[1] and the Pacific[2] but due to the infancy of these schemes they have not been covered in detail here.

There may be scope for further innovation, for example by scaling up existing arrangements, rolling out to other regions such as Asia, pooling across regions to facilitate scaling-up and adapting it to new sectors such as agriculture. As indicated, there is already a wealth of Commonwealth developing country experience that can be drawn upon to encourage this process. This is explored further in Chapter 12.

10.1 Weather index-based insurance

10.1.1 About

WII aims to provide fast, automatic payments to smallholder farmers in developing countries who are severely affected by agricultural production risks, such as droughts or floods that are not typically covered by traditional crop insurance.[3] WII schemes operate in over 17 developing countries, including six Commonwealth countries (India, Malawi, Tanzania, Kenya, Rwanda and Zambia). Most schemes are in a pilot phase, thus impact is difficult to assess at present.

As will be shown, private companies, local NGOs, government agencies and multilateral organisations each have a role to play in WIIs. Payouts may be counter-cyclical as they relate to weather indicators only. They can be disbursed quickly and automatically, without the need to file individual claims, which is thought to reduce transaction costs and hence premiums. However, experiences in India and Malawi[4] suggest a greater need for farmer awareness and increased education on insurance and finance in order to increase the effectiveness of WII. In addition, when funded by donors, funds count as ODA (OECD 2011b), so WII does not necessarily provide additional development finance at the global level.

10.1.2 First considerations

Eligibility: As most schemes are in the pilot phase, it is difficult to precisely indicate eligibility.

The scheme may benefit developing countries with a significant number of smallholder farmers who are vulnerable to weather risk. However, several prerequisites are necessary for successful implementation (IFAD 2011 and World Bank 2011):

- Good data: Consistent daily historical data (ideally 30 years' worth) are needed for proper actuarial analysis of weather risk and sound agronomic data are needed to assess crop vulnerability.
- Suitable infrastructure: A dense, secure and high-quality weather station network is required. Where there are insufficient weather stations, this may pose

challenges to scaling-up. However, several organisations such as the International Fund for Agricultural Development (IFAD) are considering the use of satellite data, which would dramatically reduce the weather infrastructure constraints for developing countries;

- A sound regulatory environment.
- The existence of partners, stakeholders, interested parties and a champion willing to play a co-ordinating role.

10.1.3 Operation[5]

- WII is provided by agencies such as the World Bank to farmers, farmer associations, processors etc. against pre defined and measurable adverse climatic conditions in a given area, e.g. whenever rainfall or temperature levels are so high or low as to decrease crop yields (or in the case of livestock insurance, decrease the feed for livestock).[6]
- Payments[7] are triggered according to parameters stipulated in the insurance contract,[8] supported by weather data from a specific monitoring reference weather station. However, a key challenge for WII is *basis risk*, which occurs when the weather recorded by the local weather station varies from the actual conditions experienced by farmers affected by micro-climates, and who are based away from the station. This can result in a payout not being triggered even though particular farmers face adverse weather conditions that necessitate a payout.
- Structures can vary depending on the legal framework, product design, institutional capacity and interest in any given country, as illustrated in Table 10.1.

Table 10.1 Stakeholders and their responsibilities within a WII scheme[9]

Category	Potential stakeholders	Responsibility or role
Insurer	Insurance companies, insurance associations	• Underwriting risk • Designing contracts • Marketing
Reinsurer	Reinsurance companies, hedge funds	• Risk transfer capacity
Agribusinesses and financial partners	Agricultural banks, rural service organisations, NGOs, monetary financial institutions (MFIs), processors, input suppliers, agribusiness	• Clients • Agents for marketing and education • Collecting policies and premiums
Farmers	Farmers' associations, co-operatives	• Clients
Government departments	Meteorological services; insurance regulators; ministries of finance, planning and agriculture; research and specialist institutes	• Providing data, agronomic information and research • Assisting in contract design • Maintaining weather infrastructure • Regulating products
Donors	Multilateral organisations, foundations	• Technical assistance • Financing key investments

- The WII contract is designed and underwritten by the insurer. However, as insurers normally have limited presence in rural areas, distribution is organised through a party with existing links to farmers or farmer groups, such as a bank, processor, co-operative or monetary financial institution.
- Developing country governments are usually responsible for maintaining the weather infrastructure and regulation of WII schemes.
- As shown in Table 10.2, many existing WII schemes are integrated into an existing development programme and bundled into a package linked with credit, inputs or contract farming. This can make the scheme more attractive to farmers and other stakeholders, and make it easier to sustain and eventually scale up.

Table 10.2 Selected WII schemes in Commonwealth developing countries

Country	Product description	Structure and operation	Scale[10]
India (2003)	Rainfall index insurance for smallholders growing various crops.	BASIX (a microfinance institution) launched this scheme through the insurer ICICI Lombard, with technical assistance from the World Bank and IFC. WII contracts are linked to crop loans that BASIX provided to farmers.	150,000
India (2004)	Rainfall and temperature index insurance for smallholders growing crops.	This index insurance scheme was designed and provided by Agriculture Insurance Company of India (AIC) – a government-funded public insurance company. Insurance is provided with or without a loan.	1 million
Malawi (2004)	Rainfall insurance for groundnut and maize smallholders.	The pilot was launched by the National Smallholder Farmers' Association of Malawi (NASFAM) and two lenders (Opportunity International Bank and Malawi Rural Finance Corporation). Technical assistance provided by Insurance Association of Malawi and the World Bank. The two local lenders provide loans to smallholders who agree to purchase WII (covering the cost of seeds and insurance premiums). Farmers sell their yield to NASFAM, which in turn pays them after deducting loan repayments and accounting for any payouts.	1700
Kenya (2009)	Rainfall index insurance for smallholders for crops and livestock.	Index-based crop insurance pilots have been implemented by financial institutions, risk managers, input suppliers, public and private extension companies, government ministries and the Kenyan weather agency.[11] Various public and private institutions, with technical assistance from DFID and other partners, have also implemented the first pilot WII scheme for pastoralists to help them manage drought-related livestock mortality.	500+

(continued)

Table 10.2 (Continued)

Country	Product description	Structure and operation	Scale[10]
Tanzania (2011)	Rainfall index insurance for smallholders.	The pilot is being launched by a consortium led by NGO World Vision Tanzania, within an existing World Vision Tanzania project. Farmers will be able to access a loan supplied by the public agency Small Enterprise Development Agency in order to purchase farm inputs with the support of Farm Concern International (an agriculture extension services provider). The loan is bundled together with WII provided by the micro-insurer MicroEnsure.	Unknown

10.1.4 Instrument assessment

Table 10.3 WII assessment

Draft principle	Rating	Description
ADDITIONALITY	Low	✗ Mechanisms aim to improve the effectiveness of development finance rather than create new revenue streams (donor funding counts as ODA). ✗ There is no analysis as to whether this is a cost-effective way of diversifying and funding these risks compared with official funds that provide compensation under adverse weather conditions.
NATIONAL OWNERSHIP	Medium	✓ There is potential for local stakeholders to drive the initiative. ✓ There is flexibility to accommodate different stakeholders at the national level. ✓ A menu of options allows adaptation to country needs. ✗ National capacity: there is heavy reliance on international technical assistance if local capacity is not sufficiently developed to implement complex WII schemes.
INTERNATIONAL ALIGNMENT AND HARMONISATION	High	✓ Donor financial and technical support complements wider development programmes. ✓ National capacity: many programmes are bundled into existing development programmes.
RESULTS AND ACCOUNTABILITY	Medium	✓ The schemes are supported by contracts and tied to measurable indicators. ✗ Index products do not align with the traditional definition of insurance, and without strict regulation, buyers of the product will not have their interests protected by law. ✗ National capacity: weaknesses in weather data and monitoring may pose problems.
PREDICTABILITY & SUSTAINABILITY	Medium	✓ Potentially lower premiums may result from reduced transaction costs. ✓ Payouts which relate to weather indicators only are counter-cyclical. ✗ Experience has shown a high dropout of farmers who do not receive payouts, either because of a good growing season or as victims of basis risk (India, Malawi).[12] ✗ Farmers may not purchase insurance during downturns due to liquidity constraints.
PRO-POOR	Medium	✓ The schemes are targeted at smallholders largely consisting of the rural poor. ✗ Poor, cash-strapped farmers may not be able to afford premiums.
DISBURSEMENT	Medium	✓ In theory, the use of weather station data would facilitate rapid payment. ✗ In practice, the payment trigger may not activate if farmers are affected by micro-climatic changes not registered by the monitoring station.

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10.2 Caribbean Catastrophe Risk Insurance Facility

CCRIF
The Caribbean Catastrophe Risk Insurance Facility

10.2.1 About

The CCRIF provides a form of compensatory finance via a fast-disbursing, parametric regional insurance pool or a joint reserve mechanism that provides immediate liquidity to Caribbean governments in the face of natural catastrophes, thus reducing the economic impact of the latter. It is thus a counter-cyclical instrument.

The CCRIF was established in May 2007 at the request of the Caribbean Community and Common Market (CARICOM), and operates under the laws of the Cayman Islands. It was developed with funding from Japan, and capitalised from a Multi-Donor Trust Fund (MDTF) supported by Canada, the EU, the World Bank, the UK, France, the Caribbean Development Bank (CDB), Ireland and Bermuda, together with membership fees paid by participating governments.

The CCRIF board includes one member country representative (appointed through CARICOM), one donor representative (appointed through the CDB) and three technical experts appointed by CARICOM and the CDB. The board is responsible for strategic decisions, with technical advice from the facility supervisor (currently Caribbean Risk Managers Ltd), which performs front office functions. The insurance manager (currently Sagicor Insurance Managers Ltd) manages the CCRIF and performs back office functions.

There may be scope for enhanced engagement between CCRIF and a wider range of officials from its members, including those from disaster risk management agencies and decision-makers in finance and planning ministries. Such enhanced engagement could include determining procedures for appointing the board; setting the objectives of the technical co-operation budget; discussion on the loss model; the parametric nature of coverage including new perils; the inherent basis risk; and the role that CCRIF coverage can play in a broader risk management plan (World Bank 2010b, ix).

Since 2007, the CCRIF has paid out to the value of US$32 million, following three earthquakes and five tropical cyclones. Funds were paid out to seven member countries, including four Commonwealth member states: Saint Lucia, St Vincent and the Grenadines, Barbados and Dominica.[13] This amount appears small even

considering the fact that the recipients are small states, but the CCRIF is included in this toolkit on the grounds that it is relevant to most Commonwealth developing countries, and has the potential for replication and scaleability.

Initiatives such as the CCRIF are especially important for many developing countries and small states, because other sources of compensatory instruments tend to be slow at disbursing resources, which means that the immediate liquidity provision of such schemes should be as big as possible. However, the resources are unlikely to be additional, as donor contributions are classifiable as ODA (OECD 2011b).

The CCRIF is currently monitoring activities by the World Bank and other agencies, with a view to determine how it can provide index-based agricultural coverage via governments or to farmers.

10.2.2 First considerations

Eligibility: The CCRIF is a regional initiative and therefore open only to certain countries in the Caribbean region.

The facility targets small developing states vulnerable to natural catastrophes. As the insurance is index based, high catastrophe-monitoring capacity is a prerequisite.

10.2.3 Operation

Table 10.4 CCRIF: considerations and options

Consideration	Description
Reserves	The CCRIF works as a mutual insurance company, or joint reserve mechanism, with revenues coming from annual country contributions, and a MDTF held by the World Bank. The MDTF receives payments from eight donors (including Canada, the UK, and the CDB) towards CCRIF's operating expenses, including reinsurance and payouts. This frees up country contributions to build reserves and reduces the need for expenditures on reinsurance. Country contributions are set at a level that covers expected losses and operating costs, and allows for net reserve growth.
Risk pooling	The CCRIF's reserve base allows it to retain some country risk, thus lowering costs and the amount of reinsurance needed in order to secure enough capital to assure full payment of claims after a major disaster. A stronger reserve base also smooths the cost of risk transfer, which is highly variable and cyclical in the commercial reinsurance market, providing benefits to its members of greater premium stability. Pooling or aggregating country-specific risks is also designed to reduce the cost of individual insurance premiums. However, region-wide catastrophes mean that many of the CCRIF's members can be affected in a given year. The benefits of pooling would increase if the facility covered more countries or even regions, as risk would be more diversified.

(continued)

Table 10.4 (Continued)

Consideration	Description
Parameters	There is flexibility to design the parameters of the cover: countries can decide what to cover (earthquakes, tropical cyclones, excess rainfall), the frequency and severity of the catastrophes they wish to cover, and can tailor the premium they wish to pay to their access to other sources of finance, and the speed with which they can access this finance following the disaster. The CCRIF's 'parametric' policies pay out on the basis of the expected loss based on a measured parameter of the hazard event, rather than according to the actual value of the loss. This measurement, made by an independent agency, allows for transparent, low settlement costs and quick-disbursing contracts. A weakness is that parametrics are difficult to design for smaller category events. Reinsurance and pricing may be expensive: the World Bank (2010b) has recommended that the CCRIF consider whether its reserves are now at a level that would support higher risk retention and/or further reduction of the premium rate. In responding to a change in the premium rate, members would need help to decide whether to increase their coverage (holding the premium payment constant), or maintain coverage (reducing premium payment). Scope was also identified to readjust CCRIF's investment strategy to match asset and liability maturities better and to facilitate investment in fewer liquid assets that could give a higher return.
Coverage	Maximum coverage is US$100 million for each catastrophe, and is capped at 50 per cent of total estimated direct losses above a deductible amount. This proportion is believed to be sufficient to fulfil the CCRIF's objective of meeting participants' immediate liquidity needs until other sources of funds can be mobilised for their longer-term relief and reconstruction. However, it should be noted that indirect losses can also be significant.
Premiums	Once the country has decided on the type of insurance to purchase, the CCRIF calculates the average annual loss (AAL), and sets the premium as a multiple of the AAL in order to cover the combined cost of AAL, operating costs and reserve growth. As countries pay in direct proportion to the risk covered by the facility, there is no cross-subsidisation. Annual premiums typically vary from US$200,000 to US$4 million for coverage ranging from US$10 million to US$50 million. The CCRIF's reserves grew thanks to relatively low payouts during the second season of operation, strengthening its risk-bearing capacity. The CCRIF passed on part of this gain to its members by implementing a fall in the premium rate by 10 per cent. This enabled its members to increase their coverage while paying the same premium amount (World Bank 2010b).
Information and procedures	Governments are not obliged to provide detailed asset values and other information prior to the commencement of the insurance programme, and only one form has to be signed during the entire claims process (Samuel 2011). However, members perceive the need for increased transparency in procedures for appointing the board, operational policies, functioning of risk model and principles followed in setting the budget and determining the scope of activities (World Bank 2010b). A potential weakness relates to monitoring. Countries need to have comprehensive systems in place for the facility to be fully efficient. For example, catastrophes might hit in places that are not adequately monitored, in which case the mechanism would not come into effect.

10.2.4 Instrument assessment

Table 10.5 Caribbean Catastrophe Risk Insurance Facility assessment

Draft principle	Rating	Description
ADDITIONALITY	Low	✗ Funds are from donors (largely ODA), and beneficiary countries.
NATIONAL OWNERSHIP	High	✓ There is regional ownership and representation on the board, and beneficiary countries pay into the facility. ✓ A menu of options gives flexibility to adapt insurance policy to needs. ✓ National capacity: countries have the capacity to implement the policy.
INTERNATIONAL ALIGNMENT AND HARMONISATION	High	✓ The facility complements wider donor and national initiatives to tackle climate change and adaptation, and disaster risk reduction. ✓ National capacity: the facility works with existing institutional arrangements.
RESULTS AND ACCOUNTABILITY	Medium	✓ Parameters are in place to trigger payments. ✗ Parameters may be quite high. ✓ The use of set parameters is transparent. ✗ National capacity: high catastrophe monitoring capacity is a prerequisite.
PREDICTABILITY & SUSTAINABILITY	High	✓ The use of reserves and reinsurance from international capital markets help to ensure sustainability, provided that reinsurers do not go out of business. ✓ The insurance pool helps to diversify risk. ✓ Payouts follow a natural disaster so are counter-cyclical.
PRO-POOR	Medium	✓ The facility is cost-effective for small, poor and vulnerable economies. ✗ Members contribute according to risk exposure rather than income level. There is no cross-subsidisation.
DISBURSEMENT	High	✓ Quick disbursement of funds is facilitated by a parametric model.

Notes

1 The African Risk Capacity scheme was launched on 14 May 2014. It is an extreme weather insurance scheme designed to help African countries reduce their reliance on external assistance in the event of drought.

2 A Pacific regional pilot scheme was launched in January 2013 and is funded by the government of Japan. Five countries participate in its first phase: The Marshall Islands, Samoa, Solomon Islands, Tonga and Vanuatu. It provides US$45 million of earthquake, tsunami and tropical cyclone catastrophe cover. In January 2014, Tonga was the first Pacific country to benefit, receiving a payout of US$1.27 million towards recovery from Cyclone Ian.

3 Index-based insurance is not a substitute for crop insurance, which covers other production-related risks.

4 Experiences in Malawi based on Commonwealth Secretariat consultation with Chavula Adams, principal agrometeorologist; weather and climate services; and the Department of Climate Change and Meteorological Services, Government of Malawi.

5 For further information, the 'Weather Index-based Insurance in Agricultural Development: A Technical Guide' (World Food Programme [WFP] and IFAD 2011) deals with project design and management, and describes an integrated approach that addresses various constraints relating to access to finance, improved seed, inputs and markets (http://documents.wfp.org/stellent/groups/public/documents/communications/wfp242409.pdf). The World Bank's Agricultural Risk Management Team's 'Designing Index Based Weather Risk Management Programmes' is available at (http://www.agrisktraining.org) or in CD format upon request.

6 A limit is set for each measured parameter (for example cumulative rainfall) at which a maximum payment is made. The period of insurance is stated in the contract and coincides with the crop growth period.

7 Payments can be made in a lump sum or incrementally (e.g. a dollar amount per millimetre of rainfall above or below the trigger).

8 As stated by Skees (2008), setting appropriate sales closing dates or multi-year contracts is necessary in order to avoid the risk of intertemporal adverse selection. For example, in Mongolia, lenders could use information about emerging problems as early as 7–8 months before the actual event, in order to restrict lending to farmers where there are indications of impending drought.

9 Adapted from World Bank (2011).

10 Estimated number of beneficiaries (Burke et al. 2010)

11 Technical support from Financial Sector Deepening Kenya (an independent trust to support financial market development), the Rockefeller Foundation and the World Bank.

12 Basis risk occurs when the measured variable at the measurement site differs from that on the individual farmer's field.

13 The following Commonwealth countries are currently members of the CCRIF: Antigua and Barbuda, the Bahamas, Barbados, Belize, Dominica, Grenada, Jamaica, St Kitts and Nevis, Saint Lucia, St Vincent and the Grenadines, and Trinidad and Tobago.


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Chapter 11

Vertical Funds

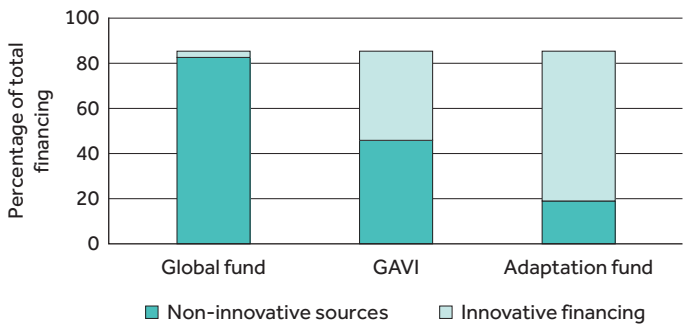
Vertical funds have become major channels for delivering international aid over the last decade, increasing in number and size, and in their country and development sector reach. Many Commonwealth developing countries benefit from their support. Of the vertical funds covered in this toolkit, 21 Commonwealth developing countries receive support from the GAVI Alliance; 27 from the Global Fund to Fight AIDS, Tuberculosis and Malaria; 6 from the Adaptation Fund; and 5 from the Global Digital Solidarity Fund. This again highlights a tremendous basis for experience-sharing between Commonwealth and other developing countries.

Several vertical funds have been established for over a decade: GAVI was established in 2000, the Adaptation Fund in 2001, and the Global Fund in 2002, but, despite this, in the literature vertical funds and innovative finance are often seen as natural partners. Indeed, some vertical funds such as the Adaptation Fund depend heavily on innovative sources of finance. For others, such as the Global Fund, the amounts derived from innovative sources are relatively small, as shown in Figure 11.1.

The positive characteristics of vertical funds include that they primarily make innovative use of existing donor funds. Furthermore, they effectively target development priorities; many, such as GAVI and the Global Fund, target health, and some, such as the Adaptation Fund, target the environment and education. They can raise additional funds at the national (if not global) level if a country successfully taps into them to raise resources that it would not have otherwise attracted.

Being focused and results-driven, vertical funds can be highly effective in meeting their objectives, and strong performance in high-profile development areas can make

Figure 11.1 Financing sources of selected vertical funds



Source: Adapted from data on fund websites

them popular with the public, political leaders, and CSOs. Some of the funds, such as GAVI and the Global Fund, are also signed up to the Paris Declaration, and are members of the Leading Group on IFD.

However, focusing on development priorities as mentioned above (HIV/AIDS, TB and malaria, or immunisations) can also be a disadvantage, as this could leave other aspects of health service provision in developing countries relatively underfunded, as more resources are poured into the former. Furthermore, the fact that funds are results driven can be a weakness as well as a strength, as performance-related criteria have the potential to undermine the predictability and sustainability of funding.

Other limitations include the fact that vertical funds generate relatively little in the way of additional funding at the global level, and cannot therefore be relied upon to plug global development financing gaps. This is true for funds dependent on non-innovative sources (such funds primarily use ODA), but also, rather less intuitively, for those funds that have been more successful in tapping into innovative sources. This is because the innovative mechanisms that they use can themselves depend on official contributions, which are again classifiable as ODA.

Furthermore, countries can come to rely on finance from vertical funds: the Global Fund in Ghana, for example, has accounted for over 70 per cent of Ghana's expenditure on anti-HIV/AIDS since 2005. The recent crisis in funding for the Global Fund, owing to a shortfall in donor support, suggests that vertical funds may not be as sustainable and predictable as hitherto believed. As will be seen, potential vulnerabilities in funding exist in both non-innovative and innovative sources.

In addition, several vertical funds have not signed the Paris Declaration, which challenges efforts to enhance country ownership, alignment, harmonisation, mutual accountability, and donor consistency. Country ownership and alignment is weak for those funds whose delivery mechanisms bypass recipient government institutions and mechanisms, although it must also be noted that some funds aim to strengthen national health systems as well.

Application procedures are often complex, and significant resources are required to complete them. However, action is being taken to harmonise applications under the Health System Funding Platform, a collaborative effort by the GAVI Alliance, the Global Fund and the World Bank, with facilitation by the WHO, aimed at simplifying country access to new and existing funds for health system strengthening. Arguably, the adoption of this initiative could be accelerated in order to boost the capacity of national health systems as a matter of priority.

Related to this, the proliferation of funds, many of which may generate very small amounts (for example, there are presently at least 20 climate funds), brings associated management costs, and meeting minimum accountability standards places pressure on scarce resources. This raises the need at country level to target those few funds that have the potential to raise large amounts, have greater impacts and have less

complex governance structures and rules for disbursement. At the global level, there is a case for reducing the number or greatly increasing the co-ordination of these various initiatives on a development sector basis, in order to address the high level of fragmentation. UNDESA, for example, has proposed that the health mandate of the Global Fund be widened, with the other health-related vertical funds consolidated under it. The choice of the Global Fund is based on its fairly inclusive and transparent governance structure (UNDESA 2012a: xvii–xviii). There would appear to be an even greater need to identify a correspondingly suitable umbrella body or arrangement under which the rapidly proliferating smaller climate funds might be consolidated. Learning lessons from the experiences of the health and climate change funds, it may also be timely to consider similar optimal institutional and co-ordination requirements for the other development sectors, as initiatives to raise innovative financing in those sectors gather momentum.

In the case of climate change finance channelled through vertical funds, there is a heavy bias in funding towards mitigation, which receives 75 per cent of funds as opposed to the 20 per cent allocated to adaptation. This is in spite of political commitments to achieve equity between them. While GHG reductions can help to reduce vulnerability in the long term, the LDCs and small island developing states (SIDS) need immediate scaled-up support for adaptation.[1]

There is also inequitable distribution of vertical funds between developing countries, with emerging economies such as Brazil, China and India being the biggest beneficiaries. These trends are again of particular concern for Commonwealth LDCs, SIDS and other small states, given their disproportionate need for adaptation and limited scope for mitigation actions (Commonwealth Secretariat 2013: 7–8, 35).

Thus, while there are undeniably many benefits to vertical funds, at the global level the additional funding that they provide to pre-existing development finance is limited, and care is needed in selecting the right funds to approach, and in ensuring to the greatest extent possible that they work within, and ideally help to reinforce, national systems and development plans.

The next section evaluates a selection of three vertical funds in more detail, demonstrating how vertical funds can apply to different development sectors and how they make use of innovative financing. Two of these funds relate to health and one to the environment.

11.1 The GAVI Alliance

11.1.1 About

The GAVI Alliance was established in 2000, and is based in Switzerland and the USA. GAVI aims to save children's lives and protect people's health by improving access to various immunisations, including against pneumococcus, yellow fever, measles, and rubella, and improve health systems in poor countries. By 2010, 300 million children were immunised and 5 million deaths were prevented (GAVI 2011a). As of 2013, 72 countries were benefitting, 20 of which were Commonwealth countries (see below). Certain features determine that GAVI is counter-cyclical – long-term commitments, advance market commitments (AMCs) and frontloading help reduce vulnerability to economic downturns – and others make it a-cyclical – eligibility for funding is linked to income per capita rather than economic trends.

11.1.2 First considerations

Eligibility: Governments from countries with a GNI per capita of less than US$1,550 as of 2013 can apply. Countries 'graduate' from support when their GNI per capita reaches US$1,550, but may apply for further support under some circumstances (GAVI Alliance 2013: Table 1).

GAVI may not be suitable for aid-dependent countries without the financial means to sustain vaccine coverage and costs after GAVI funding ceases; or for poorer countries with weaker health systems and capacities (Isenman et al. 2010). The latter group may be unable to deliver short-term results, which are a pre-requisite for GAVI funding, and which would pose a challenge to predictability and sustainability. However, these are likely to be among the countries that would need GAVI's help the most.

11.1.3 Governance

GAVI is a PPP of multilateral, public, CSO and private sector participants. Its broad representation makes it reasonably inclusive, although ownership by domestic

governments is constrained by its centrally driven mandates and lack of field presence (Isenman et al. 2010).

The board is responsible for strategy and policy-making. It has four permanent members (the Gates Foundation, UNICEF, WHO and the World Bank); 18 rotating members (five developing country governments, five donor governments, a research and technical institute, an industrialised country vaccine industry, a developing country vaccine industry and a CSO); and nine unaffiliated members whose purpose is to bring independent scrutiny to decision-making.

The secretariat is responsible for day-to-day operations including fundraising, approvals and disbursements, and legal and financial issues.

The Independent Review Committee (technical experts predominantly from LICs and MICs) is responsible for reviewing country applications and progress reports, and making recommendations to the board (Sridhar and Tamashiro 2009).

11.1.4 Operation

Application process: Countries apply to GAVI, and applications are subject to assessment by the Independent Review Committee. Applications may undergo multiple revisions prior to approval (50 per cent of successful proposals are approved at first submission). GAVI estimates that the process from application to approval for health system strengthening takes 3.7 months on average, with grant disbursement 1.5–2.5 months after approval. The process can be burdensome to countries, and additional to their existing plans, which may compromise ownership in poorer countries that do not have the capacity to draft applications, and must thus rely on external support (Isenman et al. 2010). GAVI, with the Global Fund, the World Bank and WHO, is developing the Health System Funding Platform to co-ordinate the flow of international resources and the application process.

Applicants are required to provide co-finance, which is calculated on a per-dose basis and is variable according to income group, as Table 11.1 shows for the period from 2013.

GAVI disburses to finance ministries. Health ministries are responsible for implementing projects with help from UNICEF (vaccine procurement and technical assistance), WHO (guidance, quality assurance and control of vaccines, and technical support) and the World Bank (assistance to develop sustainable financing for health systems and immunisation services).

Delivery begins after manufacturers have entered into a supply agreement with UNICEF and their vaccines have been deemed eligible by WHO under the AMC (see below).

GAVI's mandate targets immunisations, and this focus is delivering strong results (DFID 2011a). However, the prioritisation of immunisation over improvements in

Table 11.1 Co-financing requirements by country income group (from 2013)

Income group (no. of countries in group)	GNI per capita threshold	Countries	Co-financing requirement
Low-income country (36)	At or below US$1,025, the World Bank low-income threshold.	**Commonwealth (10):** Bangladesh, The Gambia, Kenya, Malawi, Mozambique, Rwanda, Sierra Leone, Tanzania, Uganda, Zimbabwe. **Non-Commonwealth (26):** Afghanistan, Benin, Burkina Faso, Burundi, Cambodia, Central African Republic, Chad, Comoros, Congo DR, Eritrea, Ethiopia, Guinea, Guinea-Bissau, Haiti, Korea D.R., Kyrgyz Republic, Liberia, Madagascar, Mali, Mauritania, Myanmar, Nepal, Niger, Somalia, Tajikistan, Togo.	US$0.20 per dose (no annual increase).
Intermediate-income country (19)	Above US$1,025 but below the GAVI eligibility threshold of US$1,550.	**Commonwealth (8):** Cameroon, Ghana, Lesotho, Nigeria, Pakistan, Papua New Guinea, Solomon Islands, Zambia. **Non-Commonwealth (11):** Cote d'Ivoire, Djibouti, Nicaragua, Lao PDR, Sao Tome and Principe, Senegal, South Sudan, Republic of Sudan, Uzbekistan, Vietnam, Yemen.	Begins at US$0.20 per dose and increases 15 per cent annually.
Graduating country (17)	Above the GAVI eligibility threshold of US$1,550.	**Commonwealth (2):** Guyana, Sri Lanka. **Non-Commonwealth (15):** Angola, Armenia, Azerbaijan, Bhutan, Bolivia, Congo Rep., Cuba, Georgia, Honduras, Indonesia, Kiribati, Moldova, Mongolia, Timor Leste, Ukraine.	Begins at 20 per cent of the projected price of the vaccine (in the year that GAVI support ends) and increases linearly over four years to reach the projected price.

Source: GAVI Alliance (2013: Table 1)

primary healthcare treatments may not be aligned to domestic health sector priorities, thereby causing fragmentation within the health system (Ryman et al. 2008; Sridhar and Tamashiro 2009).

Another area of support provided by GAVI is health system strengthening, which in itself is very positive and supportive of aid effectiveness principles. However, overall the work in this area has not delivered particularly strong results (DFID 2011a). The focus on short-term results over capacity-building may hinder long-term sustainability. For example, support in Nigeria is much lower and of a shorter duration than health systems strengthening support from other donors (Cambridge Economic Policy Associates 2010b). Nevertheless, there are positive experiences: Bangladesh noted improvements in district-level immunisation systems, coverage in remote areas, and in monitoring and reporting; and Nigeria witnessed improvements in planning, budgeting, data quality and accountability.

Countries submit annual progress reports to the Independent Review Committee, and are encouraged to do so via an online platform. The progress reports follow a template provided by GAVI to ensure consistency over time and across countries. The countries (via the Inter-Agency Coordinating Committees) are responsible for completing, checking and submitting the reports. Examples can be found on the country pages accessed via the country hub (GAVI Alliance, no date).

Submission of the annual report is a condition for continued GAVI support. The committee assesses the reports and provides recommendations for approval to the GAVI board. Applications are performance based (based on immunisation coverage). While this can encourage strong results, it can also challenge the sustainability and predictability and penalise the weaker and/or poorer countries struggling to meet the necessary targets (UNDP 2012: 28).

The rejection of Nigeria's application for Pentavalent vaccine and Pneumococcal Conjugate Vaccine support, for example, impacted its planning and budgeting, and diverted scarce resources from other much-needed areas. Furthermore, while reporting requirements do serve to increase transparency and accountability, the processes involved can lead to increasing transaction costs and fragmentation of national systems.

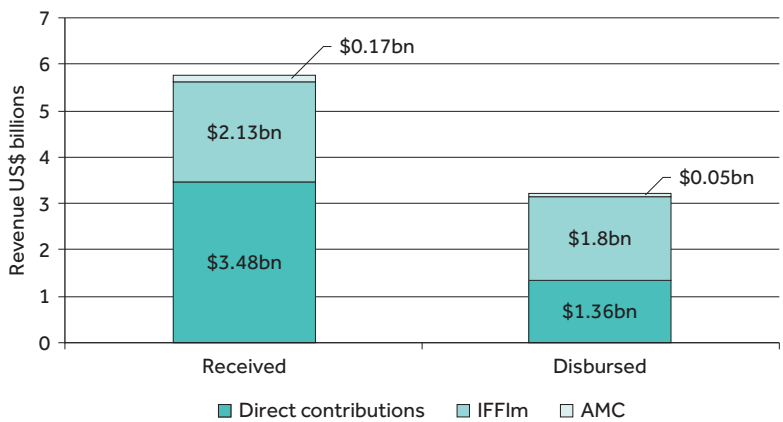
Results depend very much on the AMC delivering on its objective to reduce the price of vaccines. Experiences from Bangladesh and Nigeria show that GAVI needs to do more to make vaccine prices affordable (e.g. by supporting more emerging market suppliers), which would help to ensure that beneficiary countries are able to finance vaccines sustainably once donor support ends. Indeed, DFID (2011a) and Cambridge Economic Policy Associates (2010a) observed that procurement can be further strengthened, and prices could have been brought lower earlier. As a consequence, many aid-dependent LDCs may require long-term subsidies to maintain high levels of immunisation (Isenman et al. 2010).

11.1.5 Financing arrangements

GAVI is transparent in the amount and type of information it makes publicly available. Data on financing arrangements are available on the GAVI website in the form of summary and detailed reports. However, this is with a lag.

As shown in Figure 11.2, GAVI raised US$5.8 billion during 2000–11, of which 61 per cent was from 'traditional' donors and other sources, with the remaining balance from two 'innovative' sources: the International Finance Facility for Immunisation (IFFIm, 36 per cent) and AMC (3 per cent) (GAVI 2011b). GAVI launched a third innovative financing source – the Matching Fund for Immunisation – in 2011.

Figure 11.2 GAVI's funding sources in 2008 (US$ billions)



Source: GAVI 2011b

GAVI had disbursed US$3.2 billion (55 per cent) of its revenue by 2011. This comprised 39 per cent of the traditional revenues received, 89 per cent of IFFIm resources and 29 per cent from AMC.

Pledges for the period September 2011 to 2015 amount to US$6.7 billion, including 'traditional' contributions (US$4.8 billion), IFFIm (US$1.2 billion), and AMC (US$0.8 billion) (GAVI 2011b; 2011c).

DFID (2011a) found that GAVI's co-financing policy promotes sustainability/affordability for the poorest countries and is cost-effective. However, each of its funding sources has inherent and potentially very significant weaknesses (see Box 11.1 for further information).

Box 11.1 How GAVI is funded

GAVI is funded through a mix of traditional and innovative, public and private sources. Traditional sources amounted to 61 per cent of GAVI's total resources by 2011, of which 76 per cent were public funds, including grants from nine donor governments including four Commonwealth – Australia, Canada, South Africa and the UK – and 24 per cent private funds from foundations, corporations and individuals. GAVI's Matching Fund for Immunisation was launched in 2011.

Among the non-innovative sources, diversity in donor pledges increased when the Netherlands joined in 2009 and Australia in 2011. However, GAVI still depends heavily on the UK (48 per cent of current pledges) and France (28 per cent). Its funding would therefore be highly vulnerable to any policy change that led one of these two countries in particular, to scale back support, and, as recent Global Fund experiences have shown (see later), donor pledges come with no firm guarantee. Furthermore, this source of funding is predominantly in the form of ODA, and is therefore not additional at the global level.

Innovative sources of funding come from the IFFIm, AMC and Matching Fund. **IFFIm** (which provided 36 per cent of total GAVI funding from 2000 to 2001) is a UK-registered charity governed by its own board, whose administrative functions are supported by GAVI, and treasury functions are supported by the World Bank. It was established in 2006 at the initiative of the British government to accelerate the availability of predictable long-term funds for health and immunisation programmes through GAVI, encourage new producers and allow larger scale production to lower costs. It does this by 'frontloading' ODA commitments by issuing bonds in international capital markets. The bonds are up to 20 years in maturity, and are rated AAA (Fitch, Moody's, S&P). There are nine sponsoring countries, of which three are in the Commonwealth: Australia, South Africa and the UK. IFFIm's all-in cost of borrowing has usually been below the weighted average of IFFIm donors' borrowing costs. There is, however, a risk that this may rise should there be a downgrade in UK and European credit ratings. With current global financial and economic uncertainties, country credit ratings are no longer as assured as they once were. Donor government payments to meet bond interest and principal count as ODA (OECD 2011b), and therefore do not represent additional development financing.

(continued)

Box 11.1 How GAVI is funded (continued)

AMC (contributing 3 per cent of total GAVI funding from 2000–11) aims to encourage manufacturers to develop and produce new vaccines by reducing their investment uncertainty. To achieve this, donors commit upfront to a price for the vaccine, and manufacturers commit to providing that vaccine at a price affordable to developing countries. To finance the AMC, donors pay money to the World Bank (which assumes the financial risk), which then disburses to GAVI. The AMC was assumed to help decrease vaccine costs, and enable recipient countries to eventually afford immunisation without GAVI support. The above experiences show that in practice this has been difficult to achieve, and as a consequence there is the risk that recipient countries may be unable to finance immunisations in the longer term if vaccine prices remain high (Sridhar and Tamashiro 2009). As this funding includes donor support as donor governments pay for vaccines, it is counted as ODA (OECD 2011b) and is therefore not additional to pre-existing development finance available at the global level.

The Matching Fund is a new private sector programme designed to raise US$260 million for immunisation by 2015. DFID and the Gates Foundation have together pledged US$130 million to match contributions from corporations, foundations and other organisations, as well as from their customers, members and employees. It has so far attracted six private institutions, which have made significant pledges.

11.1.6 Instrument assessment

Table 11.2 The GAVI Alliance assessment

Draft principle	Rating	Description
ADDITIONALITY	Low	✗ A large share of funding is ODA, and is therefore not additional to pre-existing development finance.
NATIONAL OWNERSHIP	Medium	✓ Country co-financing requirements fostering a sense of ownership. ✓ Developing countries sit on the board, albeit on a revolving basis. ✓ Countries can decide their priorities. ✓ National capacity: national co-ordination mechanisms include all major stakeholders. ✗ Application and monitoring processes may be additional to existing systems. ✗ Prioritising immunisation may not be aligned to national priorities.
INTERNATIONAL ALIGNMENT AND HARMONISATION	Medium	✓ The Health System Funding Platform is intended to co-ordinate the flow of international resources and the application process. ✗ GAVI lacks in-country presence. ✗ National capacity: this platform may not yet be fully effective.
RESULTS AND ACCOUNTABILITY	Medium	✓ Delivery is results based, looking at short-term health impacts as well as longer-term systems strengthening. ✓ There is a comprehensive monitoring and evaluation framework. ✓ The GAVI board includes non-affiliated representatives. ✓ Country applications and reports are subject to independent review. ✗ A results-based approach may penalise weaker or poorer countries. ✗ More focus is needed on longer-term results (systems strengthening). ✗ National capacity: application and monitoring procedures are burdensome and costly.

(continued)

Table 11.2 (Continued)

Draft principle	Rating	Description
PREDICTABILITY & SUSTAINABILITY	Medium	✓ A mix of financing sources promotes sustainability. ✓ Long-term commitments, AMC and frontloading help reduce vulnerability to economic downturns and therefore GAVI is counter-cyclical. ✓ Eligibility for funding is linked to income per capita rather than economic trends, and is therefore a-cyclical. ✗ Financing sources have inherent vulnerabilities. ✗ Further and quicker reduction in vaccine prices is needed. ✗ Performance-based criteria means funding can stop suddenly. ✗ The focus on short-term results may hinder sustainability. ✗ Health system strengthening needs to be enhanced.
PRO-POOR	High	✓ Beneficiaries may be from poorer communities. ✓ There is evidence of support reaching remote areas.
DISBURSEMENT	High	✓ Disbursements are reasonably fast.

11.1.7 How to apply

Application processes are not detailed here as they are subject to change. However, it may be noted that applications are generally submitted by the health ministry, in consultation with the finance ministry and an Inter-agency Co-ordination Committee. In the past, these have required inclusion of multi-year health sector strategic plans and improvement plans. For the latest information visit www.gavialliance.org/support/apply/.

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11.2 Global Fund (and UNITAID)

Investing in our future
The Global Fund
To Fight AIDS, Tuberculosis and Malaria

11.2.1 About

The Global Fund was established in 2002, and is based in Switzerland. It aims to attract and disburse additional resources to prevent and treat HIV/AIDS, TB and malaria by reducing the price of treatments and providing insecticide-treated nets.

By the end of 2013, programmes supported by the Global Fund had administered antiretroviral treatment for HIV/AIDs to 6.1 million people, tested and treated 11.2 million people for TB, and distributed 360 million insecticide-treated nets to protect against malaria. The fund operates in 140 countries including 27 in the Commonwealth.[2]

In theory, the Global Fund's support is a-cyclical. However, its financing sources make it vulnerable to pro-cyclicality, as it is heavily reliant on official contributions. Indeed, some of these contributions were recently cancelled as a result of donors failing to meet commitments in the wake of the global financial and economic crisis. Contributions from the fund's innovative source, UNITAID's Solidarity Levy, which raises funds via a levy on airline tickets, may fluctuate with the number of flights, which is a factor of economic conditions. UNITAID is discussed here in terms of its contribution to the Global Fund, rather than as a separate mechanism.

11.2.2 First considerations

Eligibility: Eligibility varies by country income group (according to World Bank classification) and official disease burden data: LICs may access funds without limitation; lower MICs can apply but 50 per cent of efforts must focus on the most affected populations and involve high-impact interventions; and upper MICs can access limited funds for concentrated interventions if the disease burden is extreme, severe or high. Small island economies are eligible if they have a low or moderate disease burden.

The Global Fund requires that recipient governments contribute a certain proportion of their national disease programme budget to be eligible for Global Fund money.

The higher the recipient's income category, the greater the proportion must come from government.

The Global Fund may not be suitable for poorer countries with insufficient capacity to deliver required short-term results; and those without the capacity to complete the application process, which often requires external expertise – the 50 per cent rejection rate on applications may make the application cost difficult to justify (Isenman et al. 2010).

11.2.3 Governance

The Global Fund is a PPP of donor and recipient governments, CSOs, the private sector, foundations, and communities. It is signed up to the International Aid Transparency Initiative (Isenman et al. 2010).

The board is responsible for strategy, policy-making and mobilising resources. It has 27 members, 20 of which have voting rights. These include seven developing country representatives, eight donor country representatives, three CSOs (one developing country NGO, one developed country NGO, and one representing an affected community), one private sector representative and the Gates Foundation. The four non-voting members include key partners, namely WHO, the Joint United Nations Programme on HIV/AIDS (UNAIDS), the World Bank and a Swiss citizen (the fund is legally a Swiss Foundation).

The secretariat executes board policies, mobilises resources, provides strategic support, and oversees monitoring and evaluation.

The Technical Review Panel (TRP), an independent group of international experts, reviews grant proposals based on technical criteria and provides funding recommendations to the board.

The trustee (currently the World Bank) manages the money as instructed by the secretariat.

At the country level, the Country Coordinating Mechanism (CCM) is a partnership of all key stakeholders in a country's response to the three diseases. It does not handle Global Fund financing itself, but is responsible for submitting grant proposals, nominating entities to administer funding, and overseeing grant implementation. In the optimal situation, the CCM would already exist in a given country, but if that is not the case, a country can create a new entity.

11.2.4 Operation

In 2011, the Global Fund experienced an extensive reform process after reports of grant mismanagement in some key recipient countries led to the cancellation of the eleventh funding round. In addition to establishing new leadership and overhauling grant administration and accounting procedures, it also implemented a new funding model. The new funding model, piloted in 2013, became fully operational in 2014,

and moves away from the previous rounds-based system to one that allows countries to apply on a rolling basis.

During the first ten years of the Global Fund's operation, proposals were submitted under the rounds-based system. Under this mechanism the Global Fund issued a call for proposals each year, proposals were submitted and reviewed by the TRP, which recommended which proposals should be funded, and the board made final decisions on funding. Proposals either succeeded or failed. Over 50 per cent of applications failed during the first ten years, and paperwork and proposal preparation entailed high transaction costs, even in cases where the country had already won a significant number of grants and performed well, such as in Ghana. This was especially burdensome for countries like Sierra Leone, which have weaker human and institutional capacities.[3]

The new funding model seeks to address some of these difficulties. Under the new funding model, funding is awarded for a three-year allocation period, aligned with the Global Fund's three-year replenishment cycle. At the beginning of an allocation period, the fund allocates available funding to countries based on a formula[4]. Some money is placed in an incentive stream, for which countries may compete. Proposals can be submitted at any time during each three-year allocation period. The Global Fund provides guidance to applicants before proposals are developed, and rather than submit finished proposals, applicants submit concept notes, which are prepared by the CCM. As before, the TRP reviews each concept note, though it may be involved more than once during the application process, and the Global Fund board makes final decisions on funding.

Grant implementation is carried out by principal recipient(s), who sign an agreement with the Global Fund and are designated by the CCM to receive the funds and implement programmes directly or via other agencies. The Global Fund disburses to the principal recipient(s) via the trustee (currently the World Bank). The target length of time between commitment and disbursement is nine months, but in practice this has been between nine and eleven months (Sridhar and Tamashiro 2009). Principal recipient(s) can be a multilateral, public, civil society or private sector organisation. They are tasked with the financial and programmatic responsibility for the grant, and can request additional disbursements based on demonstrated progress. The CCM oversees and monitors progress during implementation.

Principal recipients must regularly report on spending and results to country-level independent consultancies called Local Fund Agents, contracted by the Global Fund. Reporting standards, however, are judged to be high (DFID 2011b). As funding is performance based, this can affect sustainability and predictability, as experienced by Sierra Leone when its round four malaria grant was cancelled. This highlights that poor performance (especially where capacity is an issue) may be better addressed through remedial actions, including capacity strengthening, in order not to penalise well-performing sub-recipients, or the country as a whole.

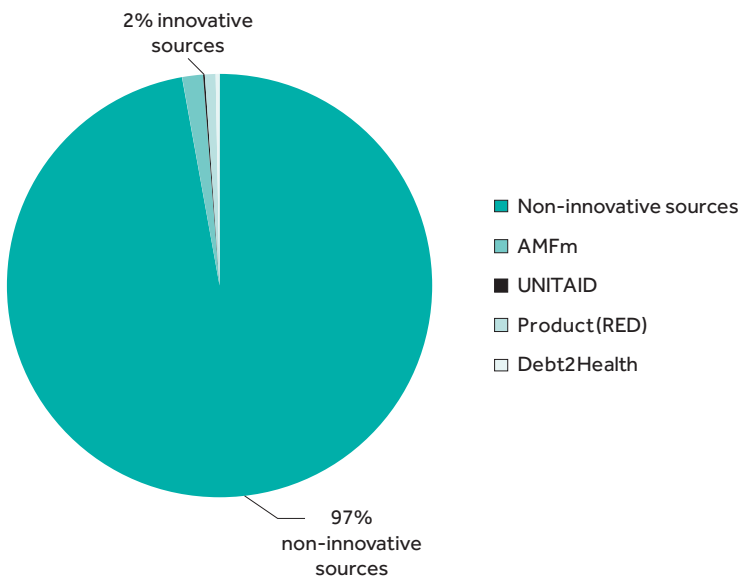
Global Fund support focuses specifically on HIV/AIDS, TB and malaria, and is in line with country need. While this enables the Global Fund to target its efforts, the disadvantage is that the fund might be too focused and not fully aligned with country priorities. As a result, other important diseases might be neglected, as has been the case in Ghana and Sierra Leone. There have thus been calls for the Global Fund to take a more flexible approach in allocating funds to other health areas. The results-based approach may also penalise weaker and/or poorer countries (UNDP 2012: 28) and sub-sectors performing relatively well.

There has been progress in capacity-building (such as Ghana's TB programme), which assists sustainability, but concerns have been raised that in Ghana's case no assistance was given to domestic pharmaceutical companies to scale up and become drug providers, and more focus on longer-term results in strengthening systems has been called for. Finally, while operating through the CCM entails a degree of country-level ownership, there have been concerns over limitations to how the beneficiary country can steer key aspects of the process, for example through negotiating drug costs (which proved difficult in Ghana). Ownership and alignment may also be challenged by the performance requirements and rapid pace of expected disbursement, which may lead to a supply-driven health agenda rather than an integrated strategy that strengthens the underlying health delivery system (Sierra Leone).

11.2.5 Financing arrangements

The Global Fund has raised US$30 billion during 2002–13 in a series of regular funding rounds that were intended to improve predictability. By the end of 2013, the fund had disbursed 77 per cent of this amount.[5]

Figure 11.3 Global Fund revenue by source (in per cent and US$ billion)



Source: Global Fund pledges and contributions data, 2014

Box 11.2 How the Global Fund is financed

Until 2013, 98 per cent of the Global Fund had been funded from around 50 developed and developing country governments including Commonwealth countries (Australia, Canada, South Africa, Uganda and the UK), organisations, foundations and individuals. As this funding came from traditional donors, it was not additional to pre-existing development finance. A major cause of concern has been the cancellation of the 11th funding round in November 2011, owing to the failure of donors to commit sufficient funds, which affected projects from 2011 to 2013. This led the Global Fund to instead establish a Transitional Funding Mechanism for currently supported essential services, which closed on 31 March 2012, and develop a new funding model consistent with its Strategy 2012–2016, to begin in 2014.

'Innovative' sources of funding amounted to only 2 per cent of Global Fund financing until 2013, and was not fully additional to pre-existing development finance. Sources include the Affordable Medicines Facility- malaria (AMFm), Debt2Health, Dow Jones Global Fund Index, Product (RED), and UNITAID (a separate mechanism, which in turn raises funds via innovative mechanisms).

AMFm (hosted and managed by the Global Fund) seeks to boost access to affordable, effective anti-malarial medicine by negotiating a price with manufacturers; subsidising this for first-line public, private and NGO buyers; and expecting these buyers to pass on a share of the subsidy to patients so the latter can buy the medicines. The Roll Back Malaria Partnership intervenes in this programme on the ground. As of 2013, AMFm had received US$485 million[6] from the Gates Foundation, UNITAID, Canada and the UK, and delivered US$310 million in co-payments (Global Fund 2013).

Official contributions count as ODA so additionality to pre-existing development finance at the global level is limited, but those from private foundations are additional (OECD 2011b). Phase one of AMFm involved nine pilots in eight countries, of which five were in the Commonwealth: Ghana, Kenya, Nigeria, Tanzania and Uganda. The programme has been effective in reducing consumer prices. For example, in 2010 importers paid up to 80 per cent less than in 2008–2009 for artemisinin-based combination treatments. However, Africa Fighting Malaria (2011) found that, while prices had dropped, as

(continued)

Box 11.2 How the Global Fund is financed (continued)

of 2011 this had benefited only four countries – Ghana, Kenya, Nigeria and Tanzania – whose demand accounts for 80 per cent of total production capacity, thereby increasing the risk of shortages for non-AMFm participants (Tren et al. 2011).

Product (RED) is the largest private sector donor to the Global Fund, delivering US$246 million since 2006 to support HIV/AIDS projects in sub-Saharan Africa, including in five Commonwealth countries: Ghana, Lesotho, Rwanda, South Africa and Zambia. Recognised brands partner with (RED), and use the Product (RED) licence to develop (RED) goods and services. Half of the profits received from each (RED) product are allocated directly to the Global Fund, with no overheads taken. Because Product (RED) raises private funds, it is additional to ODA, although the amounts raised are very small compared with the Global Fund's total funding.

Debt2Health converts official debt at a discount for highly indebted, disease-burdened countries: an official creditor cancels bilateral debt, in exchange for which the beneficiary country pays a portion of the debt to the Global Fund (75 per cent to date), and the Global Fund disburses back to the beneficiary country through its usual channels. Six agreements have been signed to date, two of which involve Commonwealth countries.[7] The debt cancellation and conversion parts of the swap are classifiable as ODA (OECD 2011b) and therefore do not provide additional funds to pre-existing development finance at the global level.

The Dow Jones Global Fund 50 Index SM, launched at the Frankfurt Stock Exchange in December 2010, is the flagship of a new index series that will track companies supporting the Global Fund. A share of licensing revenues will go to the Global Fund. However, no funds have been generated to date.

UNITAID was founded by five countries (including the UK) in 2006 to boost access, primarily by LICs, to HIV/AIDS, malaria and TB treatments by negotiating low prices for drugs and the development of new medicines, and transferring funds to partners including the Global Fund for delivery.[8] Hosted by WHO and operating through a UN trust fund, it has its own board, consisting of: five founding countries (Brazil, Chile, France, Norway and the UK); Spain; one African country; one Asian country; two CSOs; one foundation; and the WHO.

(continued)

Box 11.2 How the Global Fund is financed (continued)

Currently, six Commonwealth member countries are UNITAID members: Cameroon, Liberia, Mauritius, Namibia, South Africa and the UK, two of which (Cameroon and Mauritius) implement the Solidarity Levy. Three other Commonwealth members (Kenya, Mozambique and Nigeria) are in discussions about joining (UNITAID 2013a).

As of 2012, UNITAID had raised US$2 billion, mostly from innovative sources. Two-thirds (67 per cent) is from the Solidarity Levy on air tickets, which is a very small tax (usually US$1–2) added to outbound air tickets in participating countries, paid at the point of purchase, and collected by the airlines. Cameroon, with a domestic levy of €1 and an international levy of €4, contributed US$1.4 million to UNITAID between the time of initial implementation in 2011 until the end of 2012, and Mauritius contributed US$8.7 million between 2007 and the end of 2012. France is the largest contributor overall, raising US$1.1 billion over 2006–12, setting different rates for domestic/ inter-European and international flights, and for economy and business/ first-class passengers. Other implementing countries include Chile (US$24 million raised since 2006), the Republic of Congo (US$1.1 million raised since 2011), Madagascar (US$30,000 since 2009), Mali (US$0.9 million since 2010), Niger (US$0.3 million since 2007), and the Republic of Korea (US$35 million since 2006) (UNITAID 2011b).

UNITAID assesses the Solidarity Levy to be economically neutral, equitable and transparent, with no negative effects on air traffic, airline jobs or profitability; administratively simple and cost effective; and a negligible burden on passengers who have generally responded positively to it. UNITAID also claims that it generates revenue additional to ODA (UNITAID 2013a). While this would presumably be the case if levied in aid recipient countries, in donor countries if the money raised from the levy is used for development purposes, the OECD classifies it as ODA (OECD 2011b, 8), and therefore not additional. Given that France presently provides a substantial share of revenue from the levy, then most revenue should be classed as ODA and is therefore not additional. However, if more developing countries join the initiative and begin raising money directly via their own levies, this would increasingly become an additional source of development finance as well as a move towards greater self-sufficiency.

Another innovative source of UNITAID funds is Norway's CO_2 tax, which contributes 7 per cent. Remaining funding comprises funding

(continued)

Box 11.2 How the Global Fund is financed (continued)

from donor governments (23 per cent of funding) and the Gates Foundation (3 per cent of funding).

UNITAID has also begun to receive funds from MASSIVEGOOD,[9] an innovative mechanism founded in 2010 by the Millennium Foundation, which collects a voluntary micro-donation from airline ticket purchases from private individuals or corporations.

In summary, although some of UNITAID's funding is from private sources, the majority comes from official sources, and is therefore not additional at the global level. Funds from air ticket levies and voluntary levies may also be pro-cyclical.

11.2.6 Instrument assessment

Table 11.3 Global Fund (and UNITAID) assessment

Draft principle	Rating	Description
ADDITIONALITY	Low	✗ The Global Fund is heavily dependent on ODA.
NATIONAL OWNERSHIP	Medium	✓ Developing countries sit on the board, albeit on a revolving basis. ✓ Support is largely aligned with national priorities. ✓ National capacity: the co-ordination mechanism of all major stakeholders works through existing arrangements where possible. ✓ National capacity: some progress in building capacity has fostered a sense of ownership. ✗ There is a lack of flexibility to address other health priorities. ✗ Countries have limited influence in some key areas. ✗ National capacity: the application process is tedious and additional to existing plans, although this may be improved by the new funding model. ✗ National capacity: ownership may be lower in poorer countries that do not have the capacity to, draft applications, for example, thus relying on external support.

(continued)

Table 11.3 (Continued)

Draft principle	Rating	Description
INTERNATIONAL ALIGNMENT AND HARMONISATION	Medium	✓ The Global Fund supports health sector-wide approaches. ✗ There is no in-country presence, although the fund uses local agents. ✗ National capacity: monitoring procedures are burdensome and costly to countries.
RESULTS AND ACCOUNTABILITY	Medium	✓ Delivery is primarily based on short-term results. ✓ Monitoring and evaluation frameworks are comprehensive. ✓ The Fund is a signatory to the International Aid Transparency Initiative. ✓ Assessment is independent and with high reporting standards. ✗ National capacity: the results-based approach may penalise weaker and/or poorer countries and sub-sectors performing relatively well. ✗ National capacity: more focus is needed on longer-term results (systems strengthening). ✗ National capacity: processes can be burdensome.
PREDICTABILITY & SUSTAINABILITY	Medium	✓ Funds are operational for several years with three-year allocation periods. ✓ In theory, Global Fund support is a-cyclical. ✗ In practice, vulnerability in funding from donor and innovative sources (hit by the global economic downturn) make it susceptible to pro-cyclicality. However, this may be cushioned by the new funding model. ✗ Performance-based criteria means that funding can stop suddenly. ✗ Benefits may be skewed to a small number of countries. ✗ The process may become supply driven. ✗ The strengthening of health systems needs to be enhanced.
PRO-POOR	High	✓ Activities benefit the poorest communities.
DISBURSEMENT	Low	✗ Disbursements have tended to lag.

11.2.7 How to apply

Visit the website for further information: www.theglobalfund.org/en/fundingmodel/single/applicationmaterial/

For further information and guidance on the application process, see the Aidspan guides at: www.aidspan.org/page/guides-global-fund

11.3 Adaptation Fund

11.3.1 About

The Adaptation Fund was established as one of three funds under the UNFCCC as part of the Marrakesh Accords (2001) to support efforts in developing countries to adapt to the effects of climate change. The others two funds were the Least Developed Countries Fund (LDCF) and the Special Climate Change Fund (SCCF).[10]

The Adaptation Fund's sole purpose is to finance adaptation action and programming in developing countries party to the Kyoto Protocol (which includes all Commonwealth countries with the exception of Canada). It therefore helps, to a limited extent, to redress the heavy imbalance towards funding for mitigation, mentioned at the start of this chapter. Although it is relatively small compared with other funds, the Adaptation Fund is included in this toolkit because it addresses adaptation, which is of critical concern to Commonwealth developing countries, and because of its reliance on innovative finance. Table 11.5 shows how the Adaptation Fund fits into the broader climate funds architecture.

The Adaptation Fund became operational in 2009. It aims to help developing countries undertake climate change adaptation projects consistent with their development goals, by monitoring diseases affected by climate change, building capacity, and strengthening or establishing national and regional centres and networks for rapid response to extreme weather events. Of at least 20 climate funds in operation at the moment, it is one of the few that raises resources from an innovative component; most of the others rely exclusively on government budgets. The Adaptation Fund has approved projects in 17 countries, of which six are Commonwealth countries: Maldives, Mauritius, Pakistan, Samoa, Solomon Islands and Tanzania. It is too early to assess the results, but it can already be observed that amounts raised to date have been very small, making it one of the smallest climate funds, and innovative sources have fallen short of expectations. In addition, donor funding may be vulnerable to pro-cyclicality, declining in times of recession.

11.3.2 First considerations

Eligibility: the fund is open to developing countries party to the Kyoto Protocol and vulnerable to the effects of climate change. These include low-lying and other small island states; those with low-lying coastal, arid and semi-arid areas or areas liable to flood, drought and desertification; and those with fragile mountainous ecosystems. LDCs that cannot access the LDCF are given priority over those that can.

Table 11.5 Climate funds (assumed as of July 2013*)

Fund	Type	Administered by	Focus	Date operational	Amount pledged (US$ million)	Amount approved (US$ million)	Disbursed (US$ million)
Adaptation Fund	Multilateral	Adaptation Fund board	Adaptation	2009	341	184	58
Amazon Fund (Fundo Amazônia)	Multi-donor national	Brazilian Development Bank	Mitigation	2009	1,032	226	79
Clean Technology Fund	Multilateral	World Bank	Mitigation	2008	4,936	2,340	219
Congo Basin Forest Fund	Multi-donor regional	AfDB	Mitigation	2008	186	75	20
Forest Carbon Partnership Facility	Multilateral	World Bank	Mitigation	2008	459	42	16
Forest Investment Program	Multilateral	World Bank	Mitigation	2009	611	70	2
Global Environment Facility (GEF) Trust Fund - Climate Change Focal Area (GEF 4)	Multilateral	GEF	Adaptation Mitigation	2006	754	982	957
GEF Trust Fund - Climate Change Focal Area (GEF 5)	Multilateral	GEF	Adaptation Mitigation	2010	1,077	453	31
Global Climate Change Alliance	Multilateral	EC	Adaptation Mitigation	2008	385	324	137
Global Energy Efficiency and Renewable Energy Fund	Multilateral	EC	Mitigation	2008	170	77	0
Green Climate Fund (GCF)	Multilateral	GCF - to be confirmed	Adaptation Mitigation	Not yet operational	6	0	0
Indonesia Climate Change Trust Fund	Multi-donor national	National Development Planning Agency	Adaptation Mitigation	2010	21	10	5

UK International Climate Fund	Bilateral	UK government	Adaptation Mitigation	2011	4,640	721	0
International Climate Initiative	Bilateral	German government	Adaptation Mitigation	2008	1,082	904	0
Australia's International Forest Carbon Initiative	Bilateral	Australian government	Mitigation	2007	190	126	32
Japan's Fast Start Finance - private sources	Bilateral	Japanese government	Adaptation Mitigation	2008	15,000	10,826	0
Least Developed Countries Fund	Multilateral	GEF	Adaptation	2002	605	442	133
MDG Achievement Fund – Environment and Climate Change thematic window	Multilateral	UNDP	Adaptation Mitigation	2007	90	90	90
Norway's International Climate and Forest Initiative	Bilateral	Norwegian government	Mitigation	2008	1,608	305	284
Pilot Program for Climate Resilience	Multilateral	World Bank	Adaptation	2008	1,155	364	15
Scaling-Up Renewable Energy Program for Low Income Countries	Multilateral	World Bank	Mitigation	2009	480	58	1
Special Climate Change Fund	Multilateral	GEF	Adaptation	2002	259	170	111
Strategic Climate Fund	Multilateral	World Bank	Adaptation Mitigation	2008	n/a	n/a	n/a
Strategic Priority on Adaptation	Multilateral	GEF	Adaptation	2004	n/a	n/a	n/a
UN-REDD Programme	Multilateral	UNDP	Mitigation	2008	173	158	124

* Data on the Climate Funds Update website are undated. They are assumed to be recent.

Source: Adaptation Fund website; Climate Funds Update (2013)

Countries with national capacity to implement are likely to experience greater ownership and sustainability than those with less capacity, which may have to rely on multilateral implementing entities.

11.3.3 Governance

The World Bank is the interim trustee and the Global Environment Facility is the interim secretariat. The Adaptation Fund has engaged with civil society on project design and implementation matters.

11.3.4 Operation

Eligibility: Eligible developing country parties to the Kyoto Protocol may submit project proposals directly to the secretariat via accredited National Implementing Entities (NIEs), Regional Implementing Entities (RIEs), or Multilateral Implementing Entities (MIEs). Proposals must be signed off at the national level by an authority recognised by the government. In principle, leadership by an NIE is a strong advantage, as it can enhance ownership (through direct access) and alignment. The reality, however, is somewhat different (see below). Proposals are subject to review by an Accreditation Panel appointed by the board. At the board's 12th meeting in December 2010, concerns were raised over the lack of transparency in project decisions, as there remain difficulties in establishing operational and objective criteria for the allocation of funds (UN 2011b).

NIEs or MIEs are responsible for financial management, monitoring, and reporting via annual status reports and terminal evaluation reports. Overcoming national capacity constraints is a major challenge, evidenced by the fact that most approvals have been given to MIEs led by agencies such as the UNDP, UNEP, and WFP, rather than to NIEs.[11] As of March 2014, the Adaptation Fund had committed significantly more funds to MIEs (with US$190 committed, and US$83 million disbursed), than to NIEs (US$36 million committed and US$15 disbursed). There is also the risk that, with the desire to scale up adaptation activities quickly, the board will revert to relying on MIEs unless significant resources are established to support NIE capacity-building efforts (Heinrich Boell Stiftung and ODI 2010). This does not bode well for ownership, and the problem may become more acute given some of the funding challenges highlighted in the next section.

For all countries and the subset of Commonwealth countries, the ratio of disbursements to approvals is presently less than one third. Jamaica, Mauritius and Samoa are at or close to their US$10 million cap. Only Rwanda and Jamaica have NIE-led projects, while the others are led by MIEs (most are led by UNDP). This might reflect institutional capacity constraints in the majority of these countries.

The Adaptation Fund was ranked 17th of 72 institutions in the 2012 Aid Transparency Index, and is the first climate fund to join the International Aid Transparency Initiative (ODI 2013: 6).

11.3.5 Financing arrangements

The Adaptation Fund was worth US$341 million as of January 2013. Regarding plugging climate change financing gaps, the Adaptation Fund is tiny, and it is dwarfed by several of the other climate funds, as shown in Table 11.2.

Almost two-thirds of the funding is innovative, generated from a 2 per cent levy on certified emission reductions (CERs) issued by the Clean Development Mechanism (CDM). The CERs can be traded and sold, and used by industrialised countries to meet a part of their emission reduction targets under the Kyoto Protocol. The CDM stimulates sustainable development and emission reductions, while giving industrialised countries some flexibility in how they meet their emission reduction limitation targets.

The remaining balance of funding is from voluntary contributions, originating primarily from European donor governments (in particular, Spain, Sweden, Germany and the UK), whose contributions are classifiable as ODA, and are therefore not additional to pre-existing development finance. More recently, contributions have been sourced from private agents. The innovative financing part of the Adaptation Fund has underperformed. At the outset, high CER prices were anticipated, and the 2 per cent levy on these was forecast to deliver US$160–950 million by 2020. Owing to carbon price volatility, the amounts generated by the levy have been towards the lower end of this range.

The 149 developing countries signatory to the Kyoto Protocol are eligible to access the Adaptation Fund. This very large constituency, combined with the Adaptation Fund's small size, has meant that the amount an individual country can receive has been capped at a modest US$10 million. The aim is to prioritise support to particularly vulnerable countries, but this has proved very difficult in the absence of a global agreement on the factors that make countries vulnerable. Owing to these difficulties, disbursement has been on a first come, first served basis (ODI 2013: 7–8).

As of March 2014, the Adaptation Fund had approved US$225 million worth of projects in 34 countries, of which it had disbursed US$97 million. Eight Commonwealth countries have benefited so far, with approvals of US$43 million and disbursements of US$13 million, as shown in Table 11.6.[12]

For project details, and an impression of the kinds of paperwork involved, visit the Adaptation Fund website to download documents, proposals and concept notes (Adaptation Fund 2013a and 2013b).

Table 11.6 Adaptation Fund – funded projects (as of March 2014)

Country	Project	Implementing agency	Approved amount (US$ million)	Disbursed amount (US$ million)	Year approved
Seychelles	Ecosystem-based Adaptation	UNDP	6.5	1.3	2014
Rwanda	Reducing Climate Change Vulnerability in Northwest Rwanda through Community Based Adaptation	Ministry of Natural Resources	10.0	3.2	2013
Sri Lanka	Addressing Climate Change Impacts on Marginalized Agricultural Communities living in the Mahaweli River Basin	WFP	8.0	2.8	2012
Jamaica	Enhancing the Resilience of the Agricultural Sector and Coastal Areas to Protect Livelihoods and Improve Food Security	Planning Institute of Jamaica	10.0	3.5	2012
Mauritius	Climate Change Adaptation Programme in the Coastal Zone	UNDP	9.1	0.9	2011
Pakistan	Reducing Risks and Vulnerabilities from Glacier Lake Outburst Floods in Northern Pakistan	UNDP	3.9	2.6	2010
Papua New Guinea	Enhancing Adaptive Capacity of Communities to Climate Change-related Floods in the North Coast and Islands Region	UNDP	6.5	1.7	2012
Samoa	Enhancing Resilience of Samoa's Coastal Communities to Climate Change	UNDP	8.7	1.5	2011
Solomon Islands	Enhancing Resilience of Communities in Solomon Islands to the Adverse Effects of Climate Change in Agriculture and Food Security	UNDP	5.5	3.1	2011
Tanzania	Implementation of Concrete Adaptation Measures to Reduce Vulnerability of Livelihood and Economy of Coastal Communities of Tanzania	UNEP	5.0	0.7	2011

Source: 'Funded Projects', Adaptation Fund website

11.3.6 Instrument assessment

Table 11.7 Adaptation Fund assessment

Draft principle	Rating	Description
ADDITIONALITY	High	✓ Two thirds of funds originate from innovative tax-based sources that are not classified as ODA.
NATIONAL OWNERSHIP	Medium	✓ Developing countries constitute the majority on the board and can decide funding priorities. ✗ The need to scale up activities could necessitate focus of MIEs rather than NIEs. ✗ National capacity: in theory, NIEs can lead projects, but in practice most approved projects are led by MIEs, necessitating capacity-building for NIEs.
INTERNATIONAL ALIGNMENT AND HARMONISATION	Medium	✓ Direct access in principle can help ensure proper harmonisation with national systems, plans and priorities. ✗ Procedures, documents and review criteria are separate from those of other donors and funds. ✗ National capacity: national agencies are used in few countries.
RESULTS AND ACCOUNTABILITY	Medium	✓ The fund has principles of transparency and openness. ✗ Fiduciary standards for NIEs focus solely on financial management and not on social and environmental safeguards. ✗ National capacity: there remain difficulties in establishing operational and objective criteria for the allocation of funds.
PREDICTABILITY & SUSTAINABILITY	Medium	✓ The levy on CER sales makes funding predictable and a-cyclical. ✗ The cap of US$10 million per country and overall shortage of funds are significant concerns. However, there is huge potential to scale up. ✗ Donor contributions may be pro-cyclical (declining in recession).
PRO-POOR	High	✓ The fund aims to help developing countries directly.
DISBURSEMENT	Low	✗ Disbursements have tended to lag.

11.3.7 How to apply

The Adaptation Fund board accepts and considers project and programme proposals throughout the year on a rolling basis. For further information visit www.adaptation-fund.org/page/apply-for-funding

Notes

1 Climate change adaptation projects address agriculture and food security, disaster risk reduction, infrastructure, land and water management, and coastal resilience. Therefore, there is some overlap between these and what are considered to be 'development' projects.

2 Bangladesh, Belize, Botswana, Cameroon, Fiji, Gambia, Ghana, India, Jamaica, Kenya, Lesotho, Malawi, Malaysia, Maldives, Mauritius, Mozambique, Namibia, Nigeria, Pakistan, Papua New Guinea, Rwanda, Sierra Leone, Solomon Islands, South Africa, Sri Lanka, Uganda, and Zambia.

3 Experiences from Ghana and Sierra Leone are from a report by the United States Agency for International Development (USAID 2007) which presented country experiences based on consultations with key stakeholders including health ministries and government officials, NGOs, health advisors and multilateral organisations.

4 The allocation formula is based on the income category of recipient countries and the disease burden.

5 By the end of 2013, the Global Fund had disbursed a total of US$23 billion (www.theglobalfund.org/en/about/fundingspending/#disbursed).

6 Global Fund Pledges and Contributions data, 2014.

7 Australia-Indonesia, and Germany-Pakistan (www.theglobalfund.org/en/innovativefinancing/debt2health/).

8 Other UNITAID beneficiaries include the Clinton Health Access Initiative, Ensemble pour une Solidarité Thérapeutique Hospitalière En Reseau, the Foundation for Innovative New Diagnostics, the Global Drug Facility, i+solutions, Roll Back Malaria Partnership, Stop TB Partnership, UNICEF and WHO.

9 MassiveGood also supports the Spanish Red Cross.

10 LDCF was established to support preparation and implementation of National Adaptation Programmes of Action (NAPAs) in response to urgent and immediate adaptation needs. As of June 2012, expenditures were US$537 million, approximately US$128 million (or 23.8 per cent) of which has been received by Commonwealth LDCs. The LDCF represents a critical source of funding for the

initial development of NAPAs and sensitisation/capacity-building around adaptation planning in many LDCs.

The SCCF supports adaptation and technology transfer for developing country party members of the UNFCCC. As of July 2012, US$189 million had been mobilised for 45 projects and 3 programmes, with only approximately US$35 million (or 18.5 per cent) of this going to 9 Commonwealth countries, 5 of which are the largest Commonwealth recipients of climate finance (Commonwealth Secretariat 2013, 14–15).

11 www.adaptation-fund.org/funded_projects

12 Other beneficiary countries include: Argentina (two projects), Cambodia, Colombia, Djibouti, Egypt, Lebanon, Mauritania, Georgia, Cook Islands, Uruguay, Madagascar, Mongolia, Maldives, Turkmenistan, Ecuador, Eritrea, Nicaragua, Senegal and Honduras.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Section 4

New and Potential Developments

Overview

The previous section introduced a range of instruments and mechanisms assessed through the lens of the Commonwealth draft principles on IFD, drawing on both Commonwealth and non-Commonwealth experience. A striking observation from this preliminary assessment is that while these instruments might have positive impacts on development, not all of them provide additional funding beyond ODA. They are also presently limited in terms of their application across countries and development sectors.

This chapter aims firstly to stimulate thinking and promote discussion about how some of these instruments and mechanisms might be adapted to provide additional finance across a wider range of countries and development sectors, especially in the smallest, poorest, and most vulnerable Commonwealth countries. Secondly, it seeks to inform about potential new mechanisms that are currently under consideration. In considering the adoption or adaptation of existing instruments and mechanisms, the next chapter summarises the key issues arising from Section 3, and raises a series of questions that decision-makers in Commonwealth developing countries, as well as other stakeholders, may wish to consider and discuss among their peers.

Chapter 12

Adapting Existing Instruments and Mechanisms

This chapter selects some of the instruments and mechanisms included in Section 3 that could potentially be adapted to other development sectors and Commonwealth developing countries, and raises points for stakeholder consideration. It is not intended to be exhaustive, but rather identifies those mechanisms that have had a demonstrated impact, and are sufficiently diverse as to merit consideration in their own right.

12.1 Bonds

12.1.1 Diaspora bonds

A country may issue bonds targeted at its diaspora as a means to raise stable finance. Preferably this finance would be raised at a discount (if a country can persuade its investors to accept a 'patriotic discount'). There is a strong element of national ownership, and revenues raised may be channelled towards development goals in line with a national development plan. India, Sri Lanka and South Africa have issued diaspora bonds and Nigeria is planning to issue a diaspora bond later in 2014. There is tremendous scope to explore the possibilities of diaspora bonds across a wider range of countries as a means to generate additional finance. One aspect that merits further exploration is whether and how these might be adapted for small states. Another aspect is the extent to which diaspora bonds might be a useful first step for relatively inexperienced developing countries seeking to launch a series of targeted bonds in international markets.

For consideration

Regional diaspora bond issues could be of great interest to Commonwealth small island states in the Caribbean (marketing to the UK and North America), and in the Pacific (marketing to Australia and New Zealand), and possibly among subregional groupings of small states in Africa.

In considering this, the following issues would need to be explored further:

- Would the size and wealth of the diaspora support a bond?
- Would the diaspora be willing to invest in a regional as opposed to a national bond? If so,

(continued)

For consideration (continued)

- What impact might this have on the patriotic discount? Is a patriotic discount viable, or should close-to-market rates be offered?
- Who would issue the bond?
- Which countries should participate?
- What other terms and conditions should be offered (maturity, currency, minimum subscription etc.) in order to attract investors?
- Who should manage the issue?
- Where should the bonds be issued? Should they be registered on international exchanges?
- How should the bond be marketed?
- How should revenues and debt service be divided among participating countries?
- Which development sectors should benefit? Should these be based on national priorities, or pooled to fund regional initiatives?
- Is there a role for a multilateral or regional development bank?
- What other targeted constituency bonds might be viable (e.g. Islamic bonds, low-carbon bonds and development bonds)?

12.1.2 GDP-linked bonds

A form of state-contingent debt, GDP-linked bonds provide an important means for developing countries to boost their financial and macroeconomic resilience to shocks (CCLs are another). They tie payments on sovereign debt to the rate of economic growth and are designed so that debt service is higher when economic growth is higher and lower when growth is low or negative. They have a number of advantages over conventional debt:

- From the borrower's perspective, they can provide additional fiscal space and can help the borrowing country to stabilise public spending by adjusting debt service upwards under conditions of favourable growth, and downwards with less favourable growth, reducing the likelihood of default and debt crises and facilitating more rapid recovery after a downturn. In addition, they are a suitable

option for developed countries (such as Portugal, Greece and Ireland) as well as developing countries.

- From an investor's perspective, GDP-linked bonds help lower their risk of exposure to default, may yield higher payments than conventional bonds and provide a means of portfolio diversification.
- Finally, there are a number of system-wide positive externalities, as GDP-linked bonds also have the potential to improve the functioning of the international financial system by fostering greater country self-insurance, reducing contagion risks, and reducing reliance on large-scale official sector support programmes to resolve crises. The impacts of the above mean that international institutions would be less likely to witness further debt crises, and contagion risks would be lowered.
- Despite its obvious advantages, the GDP-linked bond market has not developed. There are a number of challenges which must be overcome to address this, including the accuracy and timeliness of GDP data, market illiquidity and difficulty in pricing the instruments. The questions below are designed to help stimulate discussion on the possible role of the international community in encouraging this kind of financial innovation to address the two main issues of illiquid markets and pricing difficulties, with respect to GDP-linked bonds.

For consideration

- How can GDP data be made as timely, accurate and transparent as possible? What role is there for international organisations such as the IMF and the UN in building capacity to compile better and timely data, and in endorsing country data?
- Is there a role for independent verification of GDP data?
- How can potential moral hazard arising from the use of GDP data be overcome?
- Can multilateral and regional development banks play a 'market maker' role to generate sufficient scale and market liquidity in order to enable bonds to be actively traded, thereby minimising the issuance premium?
- What role can multilateral and regional development banks play in underwriting risk?

(continued)

For consideration (continued)

- What possibilities are there to co-ordinate issuance between a group of countries to generate sufficient scale and liquidity?
- What role could the international community, for example the G20, multilateral and regional development banks play in helping overcome co-ordination problems?
- Could the multilateral and regional development banks introduce this innovation into their lending to help establish this precedent?
- What role could the international community, for example the G20, multilateral and regional development banks, play in developing a draft model GDP-linked bond contract for discussion to help ensure standardisation?

12.1.3 Sovereign bonds issued in international markets

Issuing US dollar-denominated Eurobonds on international markets is establishing itself as an innovative source of financing for developing countries in Africa in particular, although Caribbean countries have been doing this for longer. Amounts raised are quite substantial, varying between US$0.5 billion and US$1 billion, and objectives relate mostly to large-scale development goals in infrastructure, budget support and (in Gabon's case) to pay off Paris Club creditors early. Interest rates are commercial, and issuing countries (except Namibia) have sub-investment grade ratings. The bonds have been very favourably received, and many have been heavily oversubscribed. The experiences of the countries above in issuing or considering issuing would suggest that the bonds are highly pro-cyclical.

Advantages of the bonds include that they provide long-term finance that can be used for development, they do not come with external conditionalities and they may be issued at rates lower than bonds issued in domestic currency. Disadvantages include exchange rate depreciation and volatility, which can make repayments more expensive and planning unpredictable; amounts borrowed are significant and will have to be repaid to commercial borrowers; there is no guarantee that prices will not plummet after a bond issue, which will significantly impact on yield; and they are more expensive than concessional loans and grants.

International investors may appreciate their higher returns, in spite of their mainly sub-investment grade ratings; the opportunity to invest excess liquidity; and seeing money spent on stimulating long-term growth rather than current spending.

For consideration

- Can additional funds be obtained more cheaply elsewhere?
- Will the country be able to service the debt?
- If a country decides to pursue the path of a Eurobond, does it have natural resources or otherwise well-regarded political stability and economic prospects that would attract investors?
- What impact might a country's credit rating have on the issue only? Among African issuers, so far only Namibia has had an investment grade rating.
- What development objectives should the funds be linked to?
- How much should be raised for a debut bond?
- What requirements are necessary for listing on J.P. Morgan's Emerging Bond Index (EMBI)?
- What technical support might be necessary, and where and how might this be sourced?
- What interest rate should be offered?
- Where might the bonds be listed?

12.1.4 Green bonds

International and regional development banks are issuing green bonds to raise additional finance for environmental, climate change adaptation and mitigation projects, to which developing countries may apply. The funds raised are additional as they do not qualify as ODA (OECD 2011). The bonds target private investors that wish to integrate environmental and climate change concerns into their investment decisions.

These bonds have generated significant additional resources by tapping into the private sector in a relatively short space of time. They are also aligned with the climate change strategies of beneficiary countries and donor governments. However, they presently tend to serve the needs of wealthier developing countries, and projects benefitting from the revenues raised by green bonds tend to be large scale.

For consideration

- How might green bonds be rolled out to benefit poorer (e.g. IDA-only) countries?
- Might they viably support smaller-scale mitigation and adaptation projects?
- Would the regional development banks be best placed to initiate this?

12.1.5 Blue bonds

Just as multilateral development banks pioneered the concept and issuance of green bonds to raise additional private sector finance to increase investment in climate-related projects, consideration could be given to the issuance of 'blue bonds' to mobilise private finance to investment in securing ocean health (International Sustainability Unit 2014). The development of the green bond market was pioneered by multilateral and regional development banks, which played a critical catalytic role by using their credit rating to help overcome some of the challenges associated with market perception, liquidity and scale. The rapidly developing green bond market sets a precedent for the issuance of other thematic bonds. The questions below are designed to help stimulate discussion on the possible role of the international community in developing a blue bond market.

For consideration

- In an oceans context, do bankable projects exist that are able to generate a financial return on investment as well as a social and environmental return?
- Could individual fishery projects be aggregated in order to reach scale and reduce transaction costs?
- Who are the potential bond issuers – governments or multilateral or regional development banks?
- What role can multilateral and regional development banks play in underwriting risk?
- Is there a role for certification?

12.2 Loans and guarantees

12.2.1 Official sector CCLs

Another form of state-contingent debt, CCLs seek to help countries sustain growth and priority development spending in the face of shocks by suspending debt service. Although they are not necessarily additional as they qualify as ODA (OECD 2011b), they have a number of obvious benefits. These include the automatic suspension of debt-servicing without the need for time-consuming negotiations to secure access to new finance facilities; the provision of more fiscal space, which allows for more counter-cyclical fiscal policy and reduces the costs of unnecessary adjustment thereby protecting growth; and the provision of flexibility ex ante which helps reduce the likelihood of costly crises and disruptive debt crises, defaults and debt restructuring.

Despite these advantages, the application of this innovation remains limited. Since 2012, the Commonwealth, in collaboration with the UNDP and in close liaison with the AFD, has been undertaking studies and facilitating regional discussions to explore the feasibility and desirability of this innovation from both the lender's and borrower's perspective (Commonwealth Secretariat 2013a). Initial findings are that Commonwealth developing countries were not aware of this kind of innovation but found the concept very attractive, and were keen to deepen knowledge and awareness as well as engage in further dialogue. Lenders also found the concept appealing and recognised the obvious benefits, but identified a number of design concerns and possible limitations. These included concerns around trigger design and availability of data; the need for widespread adoption to be effective in terms of scale; liquidity risks; increased administrative burden; moral hazard; and difficulty in designing ex ante instruments that tailor support to meet actual needs.

Possible future adaptation of CCLs

Feedback on the general utility of CCLs was unanimously positive among African, Caribbean and Pacific officials and international and regional organisations consulted. They recognised their country-driven approach, predictability, the flexibility offered by a floating grace period, and their relative simplicity. Discussions also yielded several constructive proposals for enhancing and adapting CCLs in future, including:

- Making more information available on the costs of accessing payment holidays. To date this has been free for LDCs, but this could change if the CCL is adapted to borrowers other than LDCs.
- Greater flexibility to accommodate changes to a country's risk factors, which might arise from a change in the structure of the economy.
- At present AFD uses exports for triggers, but is considering using other triggers such as imports and inflation. In the Caribbean, since tourism is the main income earner as opposed to commodity exports in Africa, the triggers would

need to reflect risks to the tourism industry. The Caribbean is also vulnerable to natural disasters so the triggers could relate to parametric triggers for hurricanes, for example.

- African countries would like to see greater flexibility in the CCL with respect to a change in risk factors. If, for example, a country strikes oil two years after successfully negotiating a CCL that has a trigger linked to tourism earnings, it would want to adjust the trigger from tourism to oil prices, as oil would have become the main income source, hence oil price volatility would be the major risk to sustainable growth and debt service repayment.

In order to realise the potential of CCLs, they would need to be introduced at scale across the system.

The questions below are focused on stimulating debate amongst the international community to explore CCLs further. Although the questions are very much focused on official sector lending, there is huge potential to explore this innovation in sovereign borrowing from the private sector, and this is flagged in the questions. Indeed, recent research by the Bank of Canada has also proposed the introduction of state-contingent bonds (sovereign cocos) (Bank of Canada 2013).

For consideration

- What steps might be taken to encourage multilateral, regional development banks and bilateral donors to introduce this innovation in their official lending or to scale existing CCLs in the case of the AFD?
- Could the OECD, G20 or G7 countries co-ordinate and introduce CCLs in their borrowing, thereby helping to reach a critical mass to set a precedent and achieve market liquidity? The adoption of collective action clauses (CACs) by the G10 and major emerging market economies sets the precedent and demonstrates that the international community can reach agreement and implement changes in debt contracts.
- Which disbursement triggers should be used and, related to this, what data are available to support this?
- What grace periods and maturities would be most appropriate?
- Does further awareness need to be raised among lenders and potential beneficiary countries?

12.2.2 Contingent credit facilities

Contingent credit facilities are another source of counter-cyclical finance. As with CCLs, they are focused on ensuring that development gains are protected in the event of a crisis. They differ from CCLs in the sense that they are available but not yet drawn down, whereas CCLs are already on the books of the debtor country. The IADB is introducing such facilities through its DSL and CCLND. These are available to borrowing member countries, many of which are Caribbean small island states, as well as larger countries in mainland Latin America. In theory, this could be broadened to other countries and regions.

For consideration

- What steps might be taken to encourage multilateral and bilateral donors to introduce or scale up existing facilities?
- What disbursement triggers should be used?
- What grace periods, maturities and drawdown periods would be most appropriate?
- How concessional should the facilities be?
- How can the speed of disbursement be enhanced?

12.2.3 Guarantees

Guarantees aim to encourage private sector investment in developing countries by mitigating risks that are of concern to lenders and achieve better leverage, maturities and financing costs. They cover against a wide range of risks. They are available to both LICs and MICs and usually require a counter-guarantee from the borrowing government. They mainly target infrastructure projects. A range of guarantees are provided by the World Bank, AfDB, ADB and IADB. These include:

- partial risk guarantees (PRGs), which ensure payment if a government or public entity fails to perform its contractual obligations for a private sector project;
- partial credit guarantees (PCGs), which cover private lenders against all risks for a specific period of the debt term for a public investment. They are designed to lower the cost and extend the maturity of debt; and
- policy-based guarantees (PBGs), which cover a portion of debt service on a loan or bond by sovereign government from private foreign creditors in support of agreed structural, institutional and social policies and reform.

It is clear that the use of guarantees can leverage and attract additional private finance. The World Bank is one of the leading proponents of the use of guarantees. By the end of 2011, it had approved 28 guarantees representing an exposure of US$1.4 billion, which have leveraged US$12 billion of private resources for projects worth US$28 billion (World Bank 2011e). Official agencies and private institutions are also considering establishing global or regional guarantee facilities to support infrastructure projects in developing countries. GuarantCo, for example, established by bilateral donor group PIDG, offers partial guarantees for debt from private infrastructure projects and companies, public utilities and municipalities.[1]

An increasing emphasis and exploration of how best to use public money to leverage private investment can be anticipated. Listed below are some questions for consideration to explore this potential.

For consideration

- What is the scope for guarantees provided by development banks to be used for first-time issuers of GDP-linked bonds or to boost future-flow remittance securitisation?[2]
- What is the scope for expanding the use of guarantees beyond large infrastructure projects and beyond sovereign borrowers?
- How might domestic investors benefit as well?
- Is there scope for introducing guarantees that can protect investors against service failures in areas such as power, customs and licensing, that discourage private investment in sub-Saharan African countries (such as those described by Gelb 2006)?

12.3 Public revenue

12.3.1 Financial transaction taxes

Domestic financial transaction tax

FTTs in a developing country context are motivated by the need to raise revenue for development and promote financial and economic stability. FTTs come in several varieties. Countries that have implemented some form of a domestic financial transaction tax include as many as 26 Commonwealth countries, including the UK,[3] and at least 16 others – both G20 and non-G20 (IMF 2011a: Table 1; Grabel 2005 in Beitler 2010: Table 3.1a).[4]

Securities and currency transaction taxes are receiving most attention in the context of reducing financial volatility and generating development finance. If designed well, domestic FTTs can generate huge additional and sustainable revenues for development, and contribute to macro-stabilisation. In theory, an FTT on exchange-traded transactions is easier to administer than one on OTC transactions, but this may apply to many low-income countries to a very limited extent only, owing to their relatively underdeveloped capital markets. With respect to forex transactions, these share many of the same considerations, depending on whether they are OTC or exchange based.

For consideration

- Which instrument or range of instruments could be used? If a combination of instruments should be used, how should composition be determined?
- In addition to an underlying asset, which instruments that may be used as close substitutes (and their derivatives) should be targeted?
- How can the coverage of the tax be adapted to keep pace with financial innovation?
- How can the challenges of capturing applicable OTC transactions across borders be addressed? What kind of co-ordination might be required with other countries, for example with others that impose an FTT?
- When should the tax be applied – when a transaction is settled (cash rule), entered into (accrual rule) or some combination (hybrid rule)?
- Should the tax apply to the buyer or seller, or should it be shared between both?
- Should certain actors be exempted? If so, which ones?
- What amount should be taxed? Should it be based on the total amount exchanged (the 'consideration')? What consideration should be made about whether flows are gross or net?
- What rate should be applied in order to generate meaningful amounts? How important are risks of non-compliance? Is the rate intended to avoid market distortion or influence the composition of capital inflows?

(continued)

For consideration (continued)

- Should the rate apply to inflows, outflows or both?
- Should the rate be based on a percentage of the transaction or should it be a flat rate?
- How can the amount due be assessed accurately?
- How might it be collected?
- What systems are needed to implement the tax? What related capacity issues need to be addressed? How?
- How can the implementing country pre-empt or mitigate non-compliance risks related to under-reporting, migrating transactions to non-taxable jurisdictions, and substituting non-taxed for taxed assets?

International financial transaction tax

Current international debates on FTTs centre on various proposals for more widely adopted FTTs, what design these should take, and what revenues should be used for, including whether they should be earmarked for development or go to general revenue. Some of the proposals relate to a global tax, others to regional-level taxes. The general consensus is that a small amount (somewhere between 0.005 and 0.1 per cent) could generate potentially huge revenues. A tax of 0.005 per cent, for example, might generate over US$30 billion per year (Schmidt 2008 cited in Ocampo and Griffith-Jones 2011). Three of the proposed examples are the FTTs proposed by the G20 and the EU, and the Robin Hood Tax.

In his report to G20 leaders in 2011 on innovative finance, Bill Gates proposed a G20 FTT. The proposed G20 FTT would entail a 0.1 per cent tax on equities and a 0.02 per cent tax on bonds, estimated to raise US$48 billion from G20 member states, or US$9 billion if applied to larger European countries alone. The tax was not endorsed. Different opinions exist within the G20 on whether or not to implement such a tax and what its proceeds should be used for (Reuters 2011; Gates 2011).

The proposed EU FTT, initially proposed by the European Commission in 2010, has been a controversial proposal. The proposed FTT would tax financial transactions between financial institutions at a rate of 0.1 per cent on the exchange of shares and bonds and 0.01 per cent on derivatives, if just one of the financial institutions resides in a member state of the EU FTT. It is estimated that it could raise up to €57 billion each year, and will be paid based on the location of the financial institution. The adopted text confirms that the additional revenue generated will be used 'for specific policy purposes, such as development aid and fighting climate change' (European Parliament 2012). In May 2014, the EU moved closer to the implementation of FTT

as ten countries agreed to seek a progressive tax on equities and some derivatives by January 2016. The FTT may however be subject to future legal challenge by other EU countries who have not agreed to an EU FTT such as the UK if it adversely affects their economies.

The proposed Robin Hood Tax has three strands. The first is an FTT of 0.05 per cent on transactions in stocks, bonds, foreign currency and derivatives, thus its coverage would be wider than the original Tobin Tax proposal. This first strand is estimated to raise £250 billion per year globally, and could be applied at the global, regional or national level. The second strand is a flat-rate bank levy on large financial institutions. The third strand would be an financial activities tax on excess profit and remuneration that would amount to a value-added tax on the financial sector. This would be projected to raise up to US$93 billion across the OECD (Robin Hood Tax).

For consideration

- Should an international FTT be introduced?
- At what rate should the tax be set and on what transactions?
- Should revenue be earmarked for development, allowed for general budget revenue, or some combination?
- How should such a tax be implemented?
- Can developing countries implement this tax? If yes, what challenges might be encountered, and how might they be met? If not, why not?

12.3.2 Market-based climate financing

A carbon tax is an environmental tax levied on the carbon content of fuels (coal, petroleum and natural gas) in order to correct the market failure in carbon pricing and reduce CO^2 emissions. It is part of a wider strategy for tackling climate change, including other environmental taxes, investment, subsidies and public spending. It works through the price mechanism directly, and has the potential to raise significant amounts of revenue. Carbon trading schemes, on the other hand, cap emissions at a certain level via the exchange of permits.

There is growing interest in carbon taxes within the Commonwealth, with implementation in the UK, some Canadian provinces, and India. South Africa is planning to launch in 2016. Australia launched its carbon tax in 2012, but this was repealed in July 2015. New Zealand has operated an emissions trading scheme.

Two major strands of the international debate for raising climate finance centre on the implementation of a global carbon tax or trading scheme and levies on international aviation and maritime fuels.

Proposed global carbon tax

At the UN Climate Change Conference in Copenhagen in 2009, developed countries agreed a goal of raising US$100 billion per year by 2020 to support climate change mitigation and adaptation activities in developing countries. In order to meet this challenge, the UN Secretary-General's High-level Advisory Group on Climate Change Financing (AGF) has proposed a carbon price of US$20-25 per ton of CO_2 equivalent in 2020, which could generate:

- US$30 billion via the auction of emission allowances and domestic carbon taxes in developed countries (assuming up to 10 per cent of total revenues is allocated to international climate action);
- US$10 billion from carbon pricing international transportation (assuming no net incidence on developing countries and earmarking between 25 and 50 per cent of total revenues);
- US$10 billion from other instruments such as the redeployment of fossil fuel subsidies in developed countries, or some form of financial transaction tax;
- US$10-20 billion in private net flows;
- US$10 billion net transfers from increased carbon market flows; and
- US$11 billion leveraged by multilateral development banks from these new funds.

Direct budget contributions from existing public sources are expected to remain important in the long-term, and multilateral agencies and bilateral programmes would be necessary to assist national action in the context of the Copenhagen Green Climate Fund, and a possible Africa Green Fund (AGF 2010).

For consideration

- Is a global carbon tax a good idea? Why/ why not?
- Is it viable for developing countries to implement? If it is, how would it be implemented? If not, why not?
- What form should it take?
- Who should pay the tax?
- Who should collect the tax?
- How should revenues be allocated across regions or countries?

Proposed levies on aviation and maritime sectors

Levies on international aviation and bunker fuels are the subject of international interest as they currently face no excise tax to reflect their environmental externalities, and they provide a potentially rich source of finance to address climate change. A globally implemented carbon charge of US$25 per ton of CO_2 could raise US$12 billion from aviation, US$26 billion from shipping, and reduce CO_2 emissions by 2020. Even allowing 40 per cent of this amount to be channelled back to developing countries (e.g. tourist destinations) by way of compensation, would leave US$23 billion for climate finance or other uses. Possible administrators include the International Civil Aviation Organization and the International Maritime Organization (IMO) (IMF 2011).

There is active and ongoing debate around promoting the maritime sector's contribution to financing climate change adaptation (see, for example, Leading Group on IFD 2013), with several concrete proposals suggested. The IMO has tabled a range of potential market-based mechanisms that would encourage the industry to invest in more fuel-efficient ships, and simultaneously generate finance for climate change mitigation and adaptation in developing countries.

Proposals range from contribution schemes for all CO_2 emissions from international shipping (collectable by fuel oil suppliers and paid into a global fund) to more narrowly targeting emissions from ships that do not meet efficiency requirements,[5] emission trading systems, and schemes based on a ship's operational and design efficiency. Among the mechanisms under consideration, the IMO believes a greenhouse gas fund could generate US$4– 4 billion, a Leverage Incentive Scheme US$10–87 billion, a Port State Levy US$40–18 billion, a vessels efficiency system US$5–18 billion, an emissions trading scheme supported by Norway and France US$28–87 billion, and a rebate mechanism US$17–23 billion (IMO 2011a).

How market-based mechanisms for the maritime sector would be implemented is of vital interest to the Commonwealth's poorest, smallest and most vulnerable countries, and small island states and developing countries in particular. Of direct relevance therefore, is the discussion on rebate, and other mechanisms that seek to ensure that the needs and circumstances of this group of countries are properly accounted for.

The mechanism proposed by the International Maritime Emission Reduction Scheme (IMERS), for example, would impose a direct levy on the fuel consumption (rather than the GHG emissions) of each ship above a predetermined size, regardless of its flag or owner nationality, and this would be based on an average carbon price established by the largest economy-wide emission reduction scheme. In line with UNFCCC equity principles, its rebate mechanism would entitle developing countries to receive (or forgo) annual rebates, and would channel revenue from developed countries to climate change action (UNFCCC Annex II). The rebate mechanism's incidence, based on 2007 data, would fall most on industrialised countries that were

original members of the OECD (53 per cent), high-income economies in transition (6 per cent), other high-income countries (10 per cent), LDCs (1.1 per cent), non-high-income SIDS (0.5 per cent), and other countries (29 per cent). Clearly without the rebate mechanism, a levy would hit the poorest countries disproportionately hard given their relatively greater dependence on seaborne imports (IMERS 2012).

The IMERS proposal recognises that such levies could be similarly applied to aircraft, and the rebate mechanism itself could be combined with other carbon pricing proposals, such as the greenhouse gas fund and emissions trading system.

For consideration

- Are such schemes a good idea?
- What should be their scope of coverage, e.g. all CO_2 emissions, or just those from ships that do not meet efficiency requirements?
- What mechanism or combination of mechanisms might work best?
- How can rebates for the smallest, poorest and most vulnerable countries be best ensured?
- How should they be organised and run?
- Can this be replicated for aircrafts?

12.3.3 Curbing illicit flows

Illicit flows include practices such as tax evasion, corruption, terrorist financing, money-laundering, counterfeiting, fraud, false invoicing, extortion and bribery. Initiatives to curb these flows aim to increase domestic resource mobilisation for development.

Illicit flows have long been a concern for developing countries because of their negative impacts on development. They constitute a severe drain on the resources of developing countries which could otherwise have been invested in the developing countries from which they originated. They starve developing countries of much needed tax revenue, which in turn has regressive impacts on poverty reduction efforts by depriving countries of money that could be spent on public services. They also provide a channel for the wealthiest in these countries to further enrich themselves by sending their money offshore.

Co-ordinated action to curb illicit flows in the South is relatively new. The challenge is very large, but the benefits are potentially great in terms of generating

additional, domestically generated and owned resources that could be used towards development objectives.

For consideration

- What more can be done to curb illicit flows in the South?
- How does this fit with existing efforts to reinforce the international financial architecture?
- Which international forums should developing countries be involved in where they are not adequately represented already? What steps might be taken to increase the developing country voice within these forums?
- What mechanisms can be put in place at the national level to ensure that a significant share of the money recovered from illicit flows is channelled towards development?

12.4 Insurance

12.4.1 Adapting the Caribbean Catastrophe Risk Insurance Facility (CCRIF) and weather index-based insurance (WII)

The CCRIF is a regional insurance pool in the Caribbean which provides immediate liquidity to country governments following catastrophes. Since the establishment of the CCRIF, other regional insurance pools have come into existence. The Pacific Catastrophe Risk Insurance Pilot, arranged by the World Bank, was launched in January 2013 and currently has six Pacific island participants: Cook Islands, Marshall Islands, Samoa, Solomon Islands, Tonga and Vanuatu. The African Risk Capacity (ARC) Project, initiated by the African Union with assistance from the WFP, is a pan-African risk pool insuring members against severe droughts. The ARC was launched in 2014 and currently has five members: Kenya, Mauritania, Mozambique, Niger and Senegal.

Other sources of compensatory financing tend to be slow in disbursing resources, which means that the immediate liquidity provision by the CCRIF should be as large as possible. The scheme could also include larger economies with the capacity to contribute more. In this way it could allow for cross-subsidisation. Exposure to large region-wide catastrophes (meaning many members may be affected in a given year) would mean that the scheme would work better if it covered several regions.

Using a similar mechanism, WII is a micro-level insurance pool which provides individual farmers with payouts in the event of adverse weather conditions, to insure

against agricultural production risks. India, Kenya, Malawi and Tanzania operate weather-based insurance schemes.

For consideration

The mechanisms used by the CCRIF, Pacific Catastrophe Risk Insurance Pilot and ARC, could be used for a wider range of natural disasters and economic shocks: the CCRIF and Pacific Catastrophe Risk Insurance Pilot could be adapted to cover against agricultural production risks resulting from adverse weather conditions, similar to WII but on a macro scale, and the ARC could broaden coverage beyond droughts to include other climate-related risks. In addition, the membership of all three could be broadened to include more countries from their respective regions. Finally, such schemes could be considered by new regions with similar characteristics and facing similar challenges, such as in Asia and the Indian Ocean. In fact, the ADB has recently proposed that the CCRIF model be examined as part of an enhanced disaster risk management strategy comprising innovative and traditional finance (ADB 2013: 146).

- Which other development sectors might benefit from an insurance pool? Would insurance be the most appropriate way of managing risks in these sectors?
- Is there an existing network of weather or catastrophe data collection?
- Are there sufficient countries available to participate in the pool?
- Would pooling across regions help in scaling up?
- What would be the appropriate governance structures within and across regions to make this work?
- Which preferably regional but also international partners might play a supporting role in financial and technical support?

12.5 Innovative financing mechanisms used by vertical funds

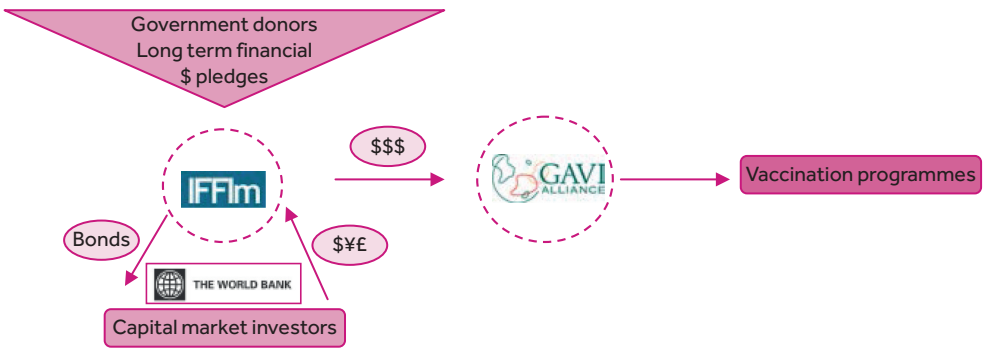
Vertical funds have become major effective channels for delivering international aid over the last decade, increasing in number and size, and in their country and development sector reach. As many as 21 Commonwealth developing countries receive support from the GAVI Alliance, 27 from the Global Fund and 6 from the Adaptation Fund. These funds make use of traditional as well as innovative finance.

Although much of their resource tends to be classifiable as ODA and therefore not additional on the global level, some of the innovative mechanisms they use, such as the frontloading of donor funds, AMCs and matching funds, can be highly effective and are innovative uses of ODA. This section looks at how these mechanisms might be further developed and ends with a brief discussion on how the issue of fragmentation of vertical funds may be dealt with.

12.5.1 Making greater use of frontloading

Frontloading (as practiced under IFFIm) aims to accelerate the availability and predictability of funds for the GAVI Alliance, and thereby enable developing countries to make long-term decisions about immunisation programmes. It does this by converting long-term donor commitments into immediate cash through the sale of 'vaccine bonds' in international capital markets. IFFIm believes it has proved popular with institutional and individual investors that want a market-based return and an ethical investment opportunity. As illustrated in Figure 12.1, the process appears to operate reasonably simply, with the World Bank as treasury manager.

Figure 12.1 How IFFIm funds the GAVI Alliance



Source: adapted from IFFIm

For consideration

- What other sectors might benefit from the front loading of ODA commitments?
- What structures would need to be in place for viable replication of frontloading to other development sectors? For example, would a new implementing body need to be established akin to IFFIm? Would the World Bank be an appropriate treasury manager? Are there executive mechanisms in place that this could support?

(continued)

For consideration (continued)

- Would donors be willing to frontload more of their pledges without detracting from their commitments elsewhere? If so, would they be willing to commit higher amounts of ODA in order to avoid reducing future aid flows and to avoid damaging consequences for developing countries in the future?
- Would there be enough demand for the bonds from different investors?

12.5.2 Adapting the Advance Market Commitment (AMC)

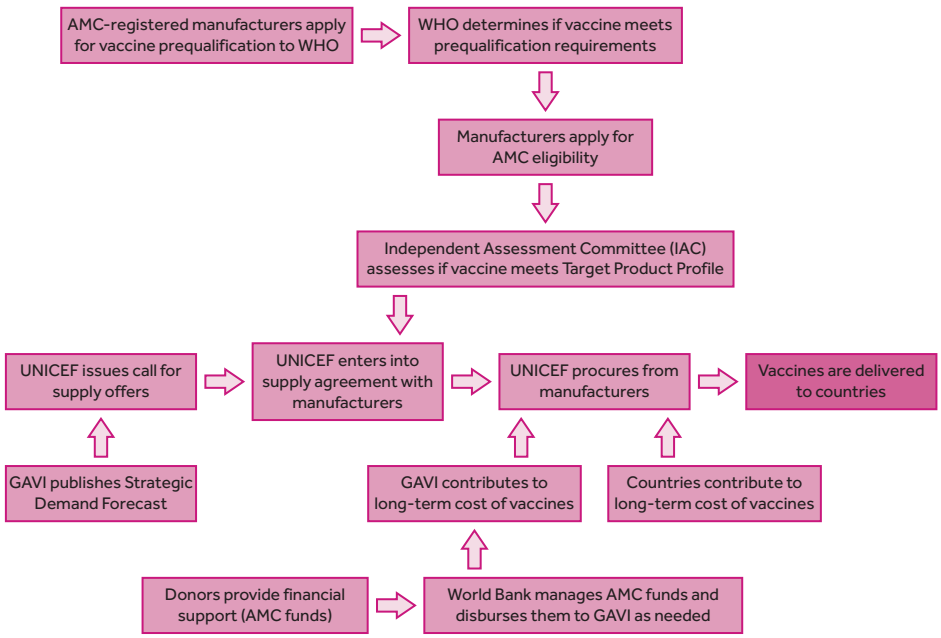
The AMC contributes to GAVI by accelerating the development and manufacture of vaccines for developing countries at affordable prices. It requires donors to commit funds to guarantee vaccine prices, and manufacturers to commit to providing the vaccines at a price affordable to developing countries in the long term. The first AMC was piloted in 2009 with a collective commitment of US$1.5 billion from five donor governments including Canada and the UK, and the Gates Foundation. GAVI endorsed a budget of up to US$1.3 billion for 2010–15 to help fund the cost of vaccines.

For consideration

Other development sectors may benefit from AMCs. Addressing food insecurity, for example, may be a priority in order to encourage businesses to make long-term investments in developing necessary seeds and techniques to increase food production and productivity.

- What other development sectors have the potential to benefit from AMCs?
- What structures would need to be in place for viable replication? If the AMC were applied to food security, which agencies might perform the equivalent functions of UNICEF, WHO and the World Bank?
- Is there an appetite among donor countries to support a new AMC without compromising support for the existing one?
- Could reasonable terms be arrived at that would be acceptable to all interested parties?

Figure 12.2 How the AMC works



Source: adapted from GAVI Alliance

As shown in Figure 12.2, the arrangements are reasonably complex, as they rely on a number of stakeholders (including UNICEF, WHO and the World Bank) to perform particular functions.

12.5.3 Adapting the Matching Fund

The GAVI Matching Fund (www.gavialliance.org/funding/give-to-gavi/gavi-matching-fund/) is based on public and private sector donors setting aside funding to match contributions from corporations, foundations and other organisations, as well as from their customers, members and employees. The arrangements appear to be reasonably simple, and it does not involve the creation of new structures. It was launched in 2011, and is designed to raise US$260 million for immunisation by the end of 2015.

For consideration

The arrangement may prove to be an effective way of leveraging additional funds and mobilising private sector involvement. There would also appear to be no reason why such an arrangement could not be adapted easily to other development sectors, with a wider pool of donors participating.

(continued)

For consideration (continued)

- Which other development sectors have the potential to benefit from a matching fund?
- Which existing or potential mechanisms might benefit from this type of arrangement?
- Which donor countries might be willing to support it?

12.5.4 Adapting subsidies for essential goods and services

Under the Affordable Medicines Facility-malaria (AMFm), the Global Fund (www.theglobalfund.org/en/amfm/) boosts access to affordable, effective anti-malarial medicine by negotiating a price with manufacturers, subsidising this for first-line buyers; and expecting those buyers to pass on a share of their subsidy to patients who buy the medicines. Adaptation might potentially be complex, as this initiative is run by the vertical fund itself.

For consideration

A similar arrangement could be applied to addressing other diseases within the health sector. It could also be applied to other development sectors such as education, for example through subsidising the purchase of equipment, books and materials, or food insecurity, for example through subsidising the purchase of inputs and technical assistance.

- Which other sectors might this mechanism be applied to?
- What structures might be necessary for it to function, e.g. would it need to be part of a vertical fund (if a suitable one exists) or might a dedicated agency such as one within the UN system support it?
- What safeguards would need to be in place to ensure it does not compete with but instead seeks additional resources to those raised by AMFm?

12.5.5 Adapting private sector profit schemes for development

Product (RED) (www.joinred.com/red/) supports the Global Fund. Recognised brands partner with (RED), and use the Product (RED) licence to develop (RED) goods and services. Half the profits received from each (RED) product go directly to the Global Fund.

For consideration

Product (RED) targets AIDS/HIV-related projects in sub-Saharan Africa. There is no reason, however, why such a scheme could not be adapted to other development sectors or other developing countries, provided these adaptations sought additional funding. Businesses also benefit from the exposure their brands receive.

- Which other development sectors and countries might a wider private sector scheme be applied to?
- What structures are needed to establish the necessary platform? Could it be managed independently of but along similar lines to, or alternatively in direct co-operation with, Product (RED)?
- Which businesses might be targeted for their support in other development sectors that do not presently subscribe to Product (RED)?

12.5.6 Addressing fragmentation

As mentioned in Chapter 11, there is a case for consolidating the various vertical funds to reduce the problem of fragmentation and for creating or reinforcing platforms that ensure that the role and capacity of national-level agencies is boosted rather than sidelined. Consolidation could be on a development sector basis, such as UNDESA's proposal for health funds to be consolidated under the Global Fund.

For consideration

- Is consolidation on the basis of development sector the optimal option? What other options might exist?
- Would the Global Fund be a suitable umbrella for the other vertical health funds?
- What arrangements might be suitable for consolidation of the numerous climate change funds?
- What arrangements might be suitable for nascent initiatives in other development sectors?

Consolidation could apply to the proliferation of climate change funds (many of which raise relatively small amounts), and momentum is gathering to consolidate more funds in other development sectors.

Notes

1 Current PIDG members include: DFID, the Swiss State Secretariat for Economic Affairs, the Netherlands Ministry of Foreign Affairs, the Swedish International Development Cooperation Agency, the World Bank, Irish Aid and the Austrian Development Agency.

2 There are many ways of sending remittances, including cheque payments, wire transfers, and credit card payments. Each of these could, in theory, be securitised, although discussion tends to relate to diversified payment rights, which are the rights (but not the obligations) that a bank has in the payment orders that it receives to pay funds to beneficiaries (Hughes 2011: 2–3). The scale and relative predictability of remittance flows promise great benefits in securitisation. Securitisation in low-income African countries has hitherto been very limited, owing to weak financial sector development, a lack of experience with international banking, and capacity weaknesses in contract enforcement and creditor protection (AfDB 2010: 4–5).

3 Australia, Bangladesh, Barbados, Botswana, Dominica, Fiji, Ghana, India, Jamaica, Kenya, Malawi, Malaysia, Malta, Mauritius, Namibia, Nigeria, Pakistan, Singapore, South Africa, Sri Lanka, Swaziland, Tanzania, Trinidad and Tobago, UK, Zambia and Zimbabwe.

4 Non-Commonwealth countries implementing a type of securities transaction tax include G20 countries (Argentina, Brazil, China, France, Germany, Indonesia, Italy, Japan, Russia, South Korea, Turkey and USA) and non-G20 countries (Chile, Hong Kong, Switzerland and Taiwan).

5 As measured by the Energy Efficiency Design Index (EEDI). See IMO 2011b for further information.

Chapter 13

New Instruments under Discussion

There is an urgent need to fill the development financing gap. It is widely recognised that even if existing development finance commitments are met by the international community, new and additional resources will be needed to achieve the post-2015 development goals. Accordingly, the post-2015 financing framework will need to place a greater emphasis on innovative finance for development, and a more concerted effort to identify and leverage innovative finance at the national, regional and international levels is required. Although relatively small amounts of additional innovative finance have been mobilised and disbursed to date, there are a number of proposals in the international arena which have the potential to significantly fill the development financing gap should there be the political will. Using examples from the Commonwealth wherever available, this section outlines just some of the proposals currently under discussion for new development finance instruments that may have direct relevance to developing countries in the Commonwealth and elsewhere. These proposals include utilising the growth of sovereign reserves and sovereign wealth funds (SWFs) to fund development banks in the South; reforming special drawing rights (SDRs) for development; an international billionaire's tax; a global lottery; the De-Tax; development of the financial guarantee market; and the Tobacco Solidarity Fund.

13.1 Reserves, SWFs and development banks in the South

South–South financial links have become increasingly important relative to North–South financial links over the last decade. This trend has been reinforced by the global financial and economic crisis in 2008, and highlights the great scope for developing South–South solutions to meet development financing challenges.

Foreign exchange reserve holdings in developing and emerging economies reached US$6.2 trillion out of a global total of US$9.3 trillion in 2010 (IMF data). Foreign exchange reserves allocated to SWFs constitute a huge pool of funds that are being used by several developing countries towards economic stabilisation and long-term development. As SWFs often have a long-term operating horizon, there is increasing discussion that a small share of SWF assets can be channelled towards funding the creation of new, or the reinforcement of existing, regional and sub-regional development banks in the South.

13.1.1 Growth of reserves

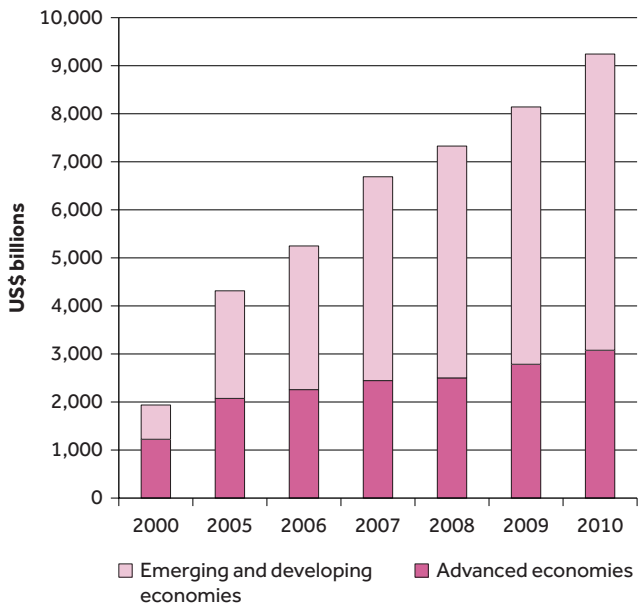
Foreign reserves accumulation is a widespread phenomenon of recent years, especially in emerging and developing economies whose reserves have grown over time to become much more significant than those held by advanced economies, as illustrated in Figure 13.1.

Most of the Commonwealth countries with the highest reserve levels have enjoyed general upward trends, as shown in Figure 13.2.

A country accumulates reserves for a variety of reasons linked to the nature of its economy and the status of its current and capital accounts. Firstly, non-commodity-based countries can use short-term current account surpluses as a counter-cyclical measure for times when its real export volumes fall, perhaps due to global business cycles, and commodity-based countries can do likewise when commodity prices decline. Secondly, non-commodity-based countries can use long-term current account surpluses as a means of building resilience, and non-renewable natural resource exporting countries do likewise as a means of wealth substitution. Thirdly, countries may accumulate reserves as a means to insure themselves against volatile and destabilising capital flows.

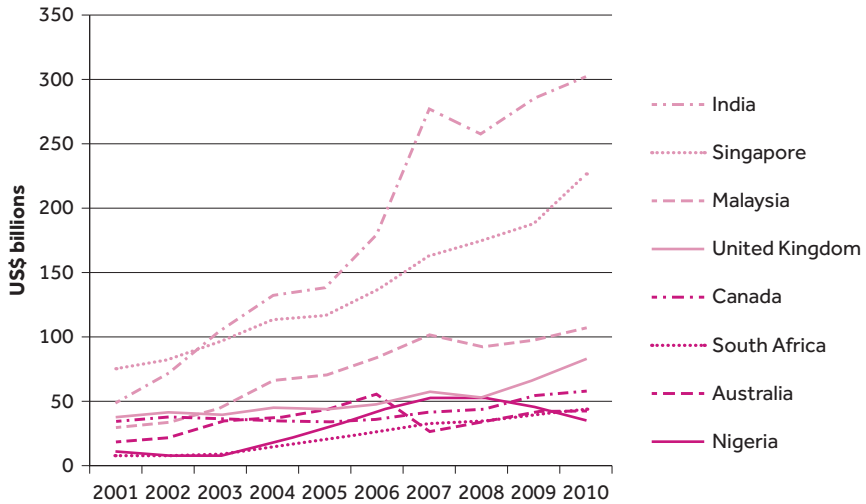
Reserve levels now often exceed immediate liquidity requirements, partly due to the growth and development of SWFs in the South.

Figure 13.1 World total in foreign exchange holdings (2000–10, US$ billions)



Source: IMF data

Figure 13.2 Total reserves held by selected Commonwealth countries (2001–10, US$ billions)



Note: Total reserves comprise holdings of monetary gold, SDRs, reserves of IMF members held by the IMF and holdings of foreign exchange under the control of monetary authorities.

Source: Adapted from World Bank (http://data.worldbank.org/indicator/FI.RES.TOTL.CD/countries)

13.1.2 Allocation of reserves to sovereign wealth funds

A share of reserves can be channelled towards SWFs. SWF assets have grown in developing and emerging economies, amounting to US$3.5 trillion of the global total of US$4.3 trillion in 2010 (SWF Institute, quoted in Griffith-Jones 2012b). The growth in SWFs is motivated by the need to save for the benefit of future generations once natural resources have been exhausted, and the need to moderate the impact of volatile fiscal revenues or foreign exchange receipts linked to trade.

Table 13.1 ranks SWFs in Commonwealth countries as of May 2012. Among the Commonwealth's developing country members, Asian countries dominate in the number and size of their SWFs, but there are two notably-sized SWFs in Africa, and one in the Caribbean. Most of these SWFs have been operational for several years, with Nigeria, Ghana and Papua New Guinea launching theirs most recently in 2011. The largest Commonwealth SWFs are non-commodity related. This contrasts with the global trend, in which oil- and gas-related SWFs have the largest assets.

Some of these Commonwealth developing country SWFs are illustrated briefly in Box 13.1.

Table 13.1 Sovereign wealth funds in Commonwealth countries (August 2014)

Country	Sovereign wealth fund name	Assets (US$ billion)	Inception	Origin
Singapore	Government of Singapore Investment Corporation	370	1981	Non-commodity
Singapore	Temasek Holdings	177	1974	Non-commodity
Australia	Australian Future Fund	95	2006	Non-commodity
Malaysia	Khazanah Nasional	40.5	1993	Non-commodity
Brunei	Brunei Investment Agency	40	1983	Oil
New Zealand	New Zealand Superannuation Fund	21.8	2003	Non-commodity
Canada	Alberta's Heritage Fund	16.9	1976	Oil
Botswana	Pula Fund	6.9	1994	Diamonds & minerals
Trinidad and Tobago	Heritage and Stabilisation Fund	5.5	2000	Oil
Nigeria	Nigerian Sovereign Investment Authority	1.4	2012	Oil
Kiribati	Revenue Equalisation Reserve Fund	0.6	1956	Phosphates
Australia	Western Australian Future Fund	0.3	2012	Minerals
Ghana	Ghana Petroleum Fund	0.07	2011	Oil
Papua New Guinea	Papua New Guinea Sovereign Wealth Fund	n/a	2011	Gas

Source: SWF Institute 2014a; retrieved 15 August 2014 from www.swfinstitute.org/fund-rankings/

Box 13.1 Features of selected Commonwealth developing country SWFs

Papua New Guinea's SWF aims to support economic stabilisation and long-term economic and social development by safeguarding the country's natural resource revenues. The SWF board will manage two funds including a Stabilisation Fund and a Development Fund (SWF Institute 2012b).

Nigeria established its SWF as a means to manage the excess profits from its crude oil sales. Its Sovereign Investment Authority will manage three funds including the Future Generations Fund, Nigerian

(continued)

Box 13.1 Features of selected Commonwealth developing country SWFs (continued)

Infrastructure Fund, and Stabilisation Fund, financed monthly from the country's oil and gas revenues. This arrangement replaces the Excess Crude Account, which was established in 2004 to help stabilise the budget (SWF Institute 2012c).

Trinidad and Tobago's Heritage and Stabilisation Fund (managed by the Central Bank) receives money from oil revenues separate from its foreign exchange reserves, and uses them to generate saving and investment income for future generations. This arrangement replaced the Interim Revenue Stabilisation Fund, which was established in 2000 to help stabilise the budget (SWF Institute 2012d).

Botswana's Pula Fund, established under the Bank of Botswana Act, is in contrast part of the country's foreign exchange reserves. The Pula Fund receives amounts in excess of what is expected to be needed in the medium term. The Pula Fund aims to secure a share of diamond export revenues for future generations by investing in public equity and fixed income instruments in industrialised and developed economies (SWF Institute 2012e).

Ghana's Petroleum Fund has been split into two funds: (1) the Ghana Heritage fund designed as a fund to save for the future generations of Ghanaians; and (2) the Ghana Stabilisation Fund to cushion the impact or sustain public expenditure in periods of low oil prices (SWF 2014b).

13.1.3 Proposal to finance development banks in the South[1]

To take advantage of the huge growth in reserves and SWF assets in the South, there is increased discussion that a small share of SWF assets is channelled towards the establishment of new, or the expansion of existing, regional and sub-regional development banks in the South. This proposal is being made by the South in the context of their long held frustration and concern over their lack of voice in existing multilateral and regional development banks, and the role of the dollar in the global monetary system. Southern-owned development banks would give a stronger voice to developing country borrowers, and to small and medium-sized developing countries, than is presently the case with multilateral and regional development banks. It would also foster a greater sense of regional ownership, alignment and control; allow for more timely and flexible disbursements of funds; allow for the pooling of developing country experience; help overcome information asymmetries;

and could better respond to regional needs such as cross-border infrastructure projects. Such development banks might also be better placed to respond to the needs of SMEs, which are presently overlooked by much development bank lending, and to working with national public development banks and commercial banks. With the SWF assets of developing and emerging countries totalling approximately US$3.5 trillion, a contribution of 1 per cent of their assets would raise US$35 billion towards paid-in capital for these development banks. Assuming that this capital could leverage annual loans to a ratio of 2.4 (based on the experience of the Latin American Development Bank), this would generate up to US$84 billion in additional annual lending (more than the total lending of the World Bank, AfDB, ADB, IADB and EIB to developing economies combined in their peak year of 2009). It should be noted, however, that this may understate the capital requirements for smaller or new development banks, as they would not have had the opportunity to accumulate sufficient complementary reinvested earnings which established development banks can leverage in addition to their paid-in capital. The proposal would mean that only 1 per cent of the SWF portfolio would be allocated to development banks. It would help SWFs to diversify into developing regions whose growth prospects are more favourable than those in developed regions, thus offering higher returns, and boost South–South synergies in investment and trade.

Another consideration, instead of creating development banks, is the creation of concessional facilities for LDCs in order to pre-empt future debt crises. Such facilities could offer counter-cyclical concessional finance and GDP-linked bonds to reduce the risk of debt burden (see Chapter 8). Financing such facilities might require channelling some existing grants from the South and from international grants, e.g. for climate change adaptation and mitigation, via these development banks.

In July 2014, leaders of the Brics countries (Brazil, Russia, India, China and South Africa) announced their agreement to establish a New Development Bank (NDB). The Bank will have an initial capitalisation of $100 billion, be based in Shanghai and have a rotating presidency, starting with India. The Brics countries also agreed to establish a Contingent Reserve Arrangement, effectively a $100 billion SWAP line amongst the five countries (Financial Times 2014b).

13.2 Reforming Special Drawing Rights for development

The IMF launched the SDR as an international reserve asset in 1969 to supplement its member countries' official reserves. Its value is based on a basket of four currencies (the US dollar, euro, yen and pound sterling). SDRs can be exchanged for freely useable currencies.

Issues have taken place irregularly and infrequently since. The second allocation took place during 1978–81 in response to uncertainty over the US dollar.

The third and by far the largest allocation took place in 2009 when the IMF issued the equivalent of US$250 billion as a response to the global financial crisis, increasing the amount of SDRs to the equivalent of US$328 billion. Among the beneficiaries were several developing countries that had joined the IMF after the second allocation. Some of these are Commonwealth members: Antigua and Barbuda, Belize, Brunei Darussalam, Kiribati, Mozambique, Namibia, St Kitts and Nevis, and Tonga. Although this was a positive development, SDRs were allocated to countries in relation to their quotas. This meant that wealthier countries benefitted the most, with only US$16 billion of the new allocation going to low-income countries.

There have been a number of proposals in recent years to make much greater use of the SDRs for addressing development and climate change challenges. In 2009 George Soros proposed using SDRs to establish a 'fast-start green fund' to finance climate change adaptation and mitigation.

NGOs have proposed that developing countries should benefit from more regular, targeted SDR allocations based on economic need rather than size, and that the conversion of these allocations into hard currency be subsidised at zero rather than market interest rates (Halifax Initiative 2010).

In 2011 a group of prominent economists lobbied the G20 to recommend that the IMF expand the use of SDRs. The proposal consists firstly of issuing the equivalent of US$240–390 billion in SDRs each year for three years, with the aim of reducing recessionary bias in the world economy. During downturns this would be non-inflationary, and it would reduce the need for countries to build up their own precautionary reserves and thereby reduce global imbalances. Secondly, a share of unused SDRs would be held by the IMF and treated as country deposits, which could be used to buy bonds from multilateral development banks to fund global public goods or development programmes. As these bonds would be issued at market rates, they would have to be combined with a grant element in order to be suitable for concessional lending. This would be part of a process to make the SDR the main or only mechanism for IMF lending (Stiglitz et al. 2011, Stiglitz 2011, Ocampo and Griffith-Jones 2011).

13.3 International billionaires' tax

UNDESA is proposing an annual 1 per cent lump sum levy on accumulated individual wealth holdings of US$1 billion or more, estimating that such a tax could have raised US$46 billion in 2012. This tax is not presently on any international agenda. The concept entails at least a part of the revenue being allocated to international development co-ordination or programmes in developing countries for the provision of global public goods. This would provide funds additional to ODA, and differs from other taxes discussed in this toolkit in that it targets stocks rather than flows or transactions.

The tax would target 1,226 individuals whose combined wealth amounted to US$4.6 trillion as of early 2012, giving them an average wealth of US$3.75 billion. Approximately one third of these individuals lived in the USA, a quarter in Europe, a quarter in the Asia-Pacific, 90 in other countries of the Americas, and 86 in Africa and the Middle East. The tax base for a billionaires' tax would fluctuate annually as individuals join or fall off the list. The amount collected would also fluctuate with the total level of wealth over time. There was a substantial drop in 2009, for example, although average wealth in the 20 years before the global financial crisis grew at 4 per cent per year (UNDESA 2012a: 12, 30, 44).

In theory, the tax would generate significant additional annual revenue that could be allocated to development. The tax would involve transferring money from the richest to the poorest. UNDESA believes that it would not be excessively onerous on the target group, and therefore argues that it therefore merits serious consideration.

There is presently no technical proposal for this tax, and a number of points, raised below, would need to be considered in order to make it viable.

Firstly, implementation would presumably be at the discretion of the individual countries concerned, through their existing tax arrangements, and countries would thus be required to become signatories to the scheme. Political resistance to this could be a potential challenge, with many countries likely to be averse to implementing such a tax unilaterally for fear that those taxed could move their residence and assets elsewhere.

Secondly, the majority of countries in which billionaires reside are rich. For example, the UK is fourth in Knight Frank's Top Ten Countries for Billionaires, and its billionaire population is forecast to rise by 85 per cent from 149 in 2012 to 276 in 2022. Similarly, Australasia's billionaire population is forecast to increase by 10 per cent from 41 to 45 over the same period (Knight Frank 2013: 9). The billionaires' tax would therefore require these countries to allocate and transfer a meaningful share of their tax revenue towards meeting development objectives in the poorest countries. However, as with other innovative taxes and levies, tax-raising countries are not prohibited from using such revenues for their own purposes or to meet existing ODA commitments, and this can lead to uncertainty and unpredictability in development finance.

Thirdly, implementation of the tax will become increasingly applicable to emerging economies over the coming decade and beyond. Asia, Africa and Latin America are forecast to see the fastest growth in the number of billionaires, as Table 13.2 shows.

In the Commonwealth, the tax would already be relevant to India, which features fifth in Knight Frank's Top 10 Countries for Billionaires. The number of billionaires in India is forecast to rise by 84 per cent from 122 in 2012 to 225 in 2022 (Knight Frank 2013: 9).

Table 13.2 Number of billionaires ranked by change by region

Region (ranked by change)	2011	2012	2022	Change (%) (2012–22)
1. Asia	496	543	1,191	119
2. Africa	25	35	75	117
3. Latin America	123	145	301	108
4. North America	487	586	1,146	96
5. Europe	672	708	1,115	57
6. Middle East	128	140	203	45
7. Australasia	36	41	45	10
Total	1,967	2,198	4,076	85

Source: Adapted from Knight Frank (2013: 9)

Fourthly, there is the risk of tax evasion and avoidance, especially if those targeted are not persuaded by the idea of a tax for development. Recent studies conclude that richer people have less compassion and a greater inclination to greed (Scientific American 2012). A recent survey in the USA found that the richest households gave a smaller share of their discretionary income to charities: households earning US$50,000–75,000 a year gave the biggest share (7.6 per cent), compared with 4.2 per cent for those earning US$100,000 or more, and only 2.8 per cent for those living in wealthier areas and earning US$200,000 or more (Chronicle of Philanthropy 2012). Relatedly, if the rich were subject to a wealth tax, this might impact negatively on their philanthropic giving. A Forbes/Credit Suisse global survey of 264 individuals with investable assets of US$1 million or more (including from the UK and India) found that 56 per cent of respondents stated that taxes impacted on their philanthropic giving. Prior to the last US election, for example, there was concern that philanthropic tax deductions would fall from US$5.12 million (double for a married couple) to US$1 million, and the estate tax would rise from 35 per cent to 55 per cent. Thus 59 per cent of US respondents believed that the outcome of the US elections would very significantly impact the tax policy, affecting both the climate and the level of philanthropic activity (Forbes 2012: 18).

Not all billionaires, however, are averse to taxes. 'Tax angels', such as JK Rowling and James Dyson, willingly pay their taxes in the UK (The Independent 2012); some billionaires, such as Liesel Pritzker Simmons, see philanthropy as conditional on the size of resources rather than the tax system or political situation (Forbes 2012: 18); and some high-profile billionaires, such as Bill and Melinda Gates, take an active interest in development issues.

Finally, such a tax need not be limited to billionaires. It may be worth considering extending UNDESA's proposal to 'centa-millionaires' (those with net assets of US$100

million or more). A centa-millionaires' tax could perhaps start at a lower rate, such as 0.25 per cent, rising to the proposed 1 per cent for billionaires (see Table 13.3).

Further research would be needed to estimate the amounts that this could generate, as estimates of the size of this group vary: Knight Frank's Wealth Report 2012 quotes 63,000 centa-millionaires worldwide, compared with Credit Suisse's estimate of 29,300 (2,700 of which have net assets above US$500 million). Nevertheless, both agree that the number has risen rapidly over the past decade. Knight Frank quotes a 29 per cent increase in numbers since 2006 – bucking the global downturn – and expects the number to rise even further with the emphasis shifting over time towards Asia. Among Commonwealth countries, Credit Suisse estimates there are 3,200 'Ultra High Net Worth Individuals' (net assets of US$50 million or more) in the UK, and 1,550 in India out of a global total of 84,500 (Credit Suisse 2012; Knight Frank 2012).

The pool of potential contributors to a centa-millionaires' tax is thus growing fast. Although wider than the scope of the taxes under discussion here, Table 13.4 shows that the number of 'High Net Worth Individuals' (those with net assets of US$30 million or more) in the Commonwealth is forecast to increase by 56 per cent in only ten years.

While the largest numbers of 'High Net Worth Individuals' are currently in the OECD countries and India, it is striking to note that the poorest African countries are forecast to lead the way in terms of change, with a tripling or quadrupling of numbers. This is followed by South Asia, with the rich nations at the foot of the table.

Striking, but perhaps slightly less surprising given the shifting emphasis towards Asia, is that by 2022 India will have overtaken the UK in its number of 'High Net Worth Individuals'. Also significant is the Eastern and Southern Africa region: Tanzania is forecast to overtake Kenya, and Zambia edges ahead of Uganda. The ranks based on number of individuals otherwise remain the same. It is also noted that no small island states in the Caribbean or Pacific feature in this list.

It would be interesting to establish how many of these Commonwealth country 'High Net Worth Individuals' are centa-millionaires and billionaires, and hence relevant to the proposed taxes under discussion here, as these are potentially a highly lucrative source of financing for development.

Table 13.3 Suggested tax for centa-millionaires and billionaires

Net assets (US$)	Tax rate (%)
0-100 million	n/a
100 – 500 million	0.25
500 million – 1 billion	0.5
1 billion +	1

Table 13.4 High Net Worth Individuals in Commonwealth countries ranked by change (2012–2022) and number

Country (ranked by change)	2012 Number (rank)	2022 Number (rank)	Change (%) (2012–2022)
1. Zambia	20 (14)	82 (14)	310
2. Uganda	20 (14)	81 (15)	305
3. Zimbabwe	16 (16)	61 (16)	281
4. Tanzania	118 (11)	329 (10)	179
5. India	8,481 (2)	17,032 (1)	101
6. Bangladesh	78 (12)	155 (12)	99
7. Sri Lanka	64 (13)	120 (13)	88
8. Kenya	142 (10)	248 (11)	75
9. Nigeria	529 (8)	809 (8)	53
10. Malaysia	828 (6)	1,249 (6)	51
11. Singapore	1,343 (5)	1,932 (5)	44
12. South Africa	828 (6)	1,149 (7)	39
13. UK	10,373 (1)	14,150 (2)	36
14. Canada	4,922 (3)	6,637 (3)	35
14. Australia	3,432 (4)	4,635 (4)	35
16. New Zealand	500 (9)	665 (9)	33
Total	31,694	49,334	56

Source: adapted from Knight Frank (2013: 9, 11, 13)

For consideration

- Would any countries be prepared to adopt a billionaires' (or centa-millionaires') tax unilaterally? Or would implementation of such a tax require the more complex procedure of seeking multilateral agreement? Which countries might be willing to take a lead in this process?
- What practical difficulties exist in arriving at an accurate picture of an individual's wealth in order to determine the amount of tax due?

(continued)

For consideration (continued)

- How might moral suasion be used to encourage billionaires and centa-millionaires to contribute? Seeking endorsement from billionaires who already willingly pay their taxes ('tax angels'), as well as those who are known to have an active interest in development issues, could be a useful starting point.
- Is it feasible for those poorest countries that have resident billionaires or centa-millionaires to implement such a tax? What assistance might they require in implementing it, and from whom?
- What formula might exist to ensure that a large part of the funds raised is used for development objectives? Or should this be left to the discretion of individual countries?
- What development objectives should the funds raised target? How might this be decided, and by whom (again at the national, regional or international level)?
- Might a pooled rather than country-level arrangement work, where the money is gathered into a central fund and the allocation and disbursement decided from there? If so, what existing international and regional bodies might be best suited to take on this role? And what kind of reinforcement (legal, institutional, financial, etc.) might they need in order to do this?

13.4 Global lottery

The creation of a global lottery is a relatively simple way to raise private finance for development. There are various options for how it could be established: an amalgamation of national lotteries, the development of a world lottery association, or the allocation of a percentage of finance raised by existing lottery organisations. The 2004 Euromillions Initiative is a good example of how quickly a regional lottery fund can develop. The UK lottery alone has raised £26 billion for good causes since 1994 – for every £1 that the public spends on lottery funds, 28 pence goes to the lottery's good causes. Currently Belgium is the only EU member state to earmark part of receipts (€18.3 million) from its national lottery to finance development co-operation. These funds are allocated to food security projects through the Belgian Fund for Food Security (EU 2012: 38).

For consideration

- Would it be advantageous for developing country lotteries to partner with developed country lotteries?
- If so, what practicalities need to be addressed in order to facilitate this?
- Who would co-ordinate a global lottery on an international level?
- How can more revenues raised from existing lotteries be allocated to development objectives?
- If more revenue can be channelled towards development, what formula might exist for allocating this among development sectors, regions and countries?
- Who would make decisions pertaining to this formula?
- How might developing countries apply for these funds, and to whom would they apply?
- What existing mechanisms can be used to channel and manage funds for development?

13.5 De-Tax

The De-Tax would raise funds by assigning a share of VAT revenues to development assistance. Governments would give one per cent of VAT revenues from businesses associated with the initiatives, and businesses would voluntarily give a share of their profit if they wished to co-finance development projects. It has been estimated that the De-Tax could raise US$2 billion annually if 26 countries participated (OECD 2011b). More information is needed on this scheme, as unfortunately the revenues are likely to count as ODA, and it would rely on a regressive tax that would hit the poorest hardest.

For consideration

- How can additionality be guaranteed in order to make this initiative worthwhile, i.e. how can donors be dissuaded from offsetting revenues raised against their existing ODA commitments?

(continued)

For consideration (continued)

- How can the De-Tax be implemented in such a way that it does not hit the poorest the hardest? For example, would it need to be redesigned (and, if so, how)? Or would a rebate scheme need to be established which reassigns credit to the poorest based on a formula?
- Would this initiative work better on a national level (with nationally set terms and conditions) or on an international level? The latter would require a degree of harmonisation – what are the challenges to this, and how might they be overcome?
- What formula might exist for allocating funds among development sectors, regions and countries?
- Who would make decisions regarding such allocation?
- How might developing countries apply for these funds, and to whom would they apply?
- What existing mechanisms can be used to channel and manage funds for development?

13.6 Ascending Markets Financial Guarantee Corporation

Ascending Markets Financial Guarantee Corporation (AMF; www.amfguarantee.com) is a financial guarantee insurance company focusing on developing countries. Its mission is to foster economic development, self-sufficiency and sustainability.

Its core business is to guarantee creditworthy, essential infrastructure and public service financing for both domestic and foreign investors. Guarantees to investors in local debt capital markets around the world include timely repayment in local currency of principal and interest for creditworthy bond issues and bank loans in microfinance, SME loan securitisations, consumer loans, agri-business, housing, health care, education, municipal and other sub-sovereign debt, infrastructure, clean energy and utilities.

The financial guarantees are rated A on the global scale when denominated in foreign currencies or AAA on the national scale when denominated in local currency. The financial guarantees help to mobilise some of the over US$5 trillion in developing country pension funds, insurance companies and banks for

investment in local development of roads, schools, hospitals, airports, ports and power, along with 'economic infrastructure' projects such as microfinance, housing and MSME financing. More local financing should help reduce dependence on official aid during a time of global economic constraint and should avoid the often dangerous mismatch of foreign currency-denominated debt with local currency-denominated projects.

AMF is soon to finalise its capital mobilisation with support expected from six development banks in the USA, Europe, Latin America and Africa, and two large global corporations, and is expected to launch in early 2015 (Triple Bottom Line Investment Group Conference USA 2013).

For consideration

- Do the guarantees fill a gap that current multilateral guarantee providers do not fill?
- Do any of the funds come from donors (which might limit their additionality)?
- How do the guarantees differ from facilities offered by other providers, such as the World Bank and MIGA?
- From a developing country perspective, how will this scheme co-ordinate with multilateral and other arrangements?
- Would developing country governments be eligible to apply, and, if so how?
- Or would the scheme be open to foreign and domestic private sector investors only?
- Large-scale projects often require some form of PPP with syndicated capital and several stakeholders. These might include developing country governments, international (and sometimes domestic) commercial banks, foreign (and sometimes domestic) investors, bilateral and multilateral agencies and other entities. How would these more complex arrangements affect the application process?
- Are the guarantees available only for large-scale projects? And, if so, what are the minimum/maximum thresholds and other terms?

13.7 Solidarity Tobacco Contribution

Voluntary levies are an important area of innovative financing for development. They are being used to support the Global Fund, and may be replicable to reinforce spending in the health sector or for other development sectors entirely.

In December 2010, the Leading Group on Innovative Financing for Development created a Taskforce on Health, which was mandated to explore an increase in taxation on tobacco as well as other issues. This Solidarity Tobacco Fund would raise finance by increasing tobacco excise in participating developed and developing countries and pooling a proportion of the proceeds to allocate to global health objectives. According to a WHO study in 2011, the Solidarity Tobacco Contribution (STC) could generate over US$5.5 billion in health funding for developing countries per year. Weighted average prices would rise, 4.3 to 9.9 per cent, ensuring that cigarettes would remain affordable relative to world prices. Potential challenges to the tax include that as governments typically face significant pressure to use the majority of tobacco revenues to fund national health priorities, mobilising significant revenues to be allocated to an international pool for health could prove difficult.

Note

1 This proposal largely summarises the ideas presented in Griffith-Jones (2012b).

Chapter 14

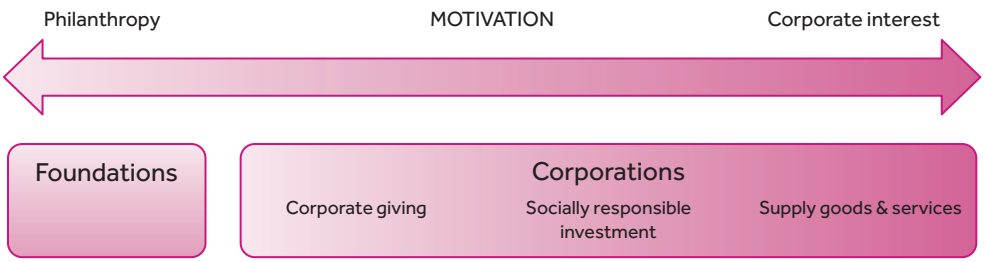
Impact Investing

Among the very substantial range of private sources (some of which, such as the AMC, are covered above), impact investment merits particular consideration. It is of particular importance to Commonwealth members, whose private sectors are either major contributors to this form of IFD or significant recipients of it. Impact investing was not explored in Section 3 as it is not an instrument or mechanism that governments of developing countries can apply directly per se. It is included here in order to raise awareness of a large and rapidly growing form of private investment.

Several Commonwealth countries, particularly but not exclusively the UK, Canada, Australia and South Africa, are well placed to develop this sector further, and to channel development finance to other member countries. Impact investment is an emerging and fast growing source of IFD and offers a new alternative for channelling large-scale private capital for development purposes.

Of the private forms of development finance that exist, donations from foundations most closely match ODA in terms of their development motive. Similar contributions from corporate entities in the form of grants (corporate giving) may be channelled through NGOs or via foundations or trusts established within their own business, and may be motivated largely by philanthropy. Socially responsible investment (SRI), which is somewhat related to corporate social responsibility (CSR), is undertaken out of both philanthropic and corporate interest. At the furthest end of the scale, companies provide goods and services linked to development but primarily motivated by corporate interest.

Figure 14.1 The motivation for private sector engagement in development



Source: Adapted from UNESCO 2013b: Figure 1

Impact investment is an innovative subset of SRI, and is considered to be a separate asset class, noteworthy because of its focus on realising positive social and environmental returns, as well as its potential to unlock significant sums of private investment capital to address development challenges. It is distinguished from SRI in that it seeks to proactively create positive social or environmental alongside financial return rather than minimise negative impact as is the case with SRI. Impact investment may be provided in a range of forms including equity, debt, working lines of credit and loan guarantees. The most common mechanism used is private equity or venture capital.

SRI funds screen companies based on positive and negative criteria, which may or may not be development related. Criteria relating to development include fair trade, environmental programmes and energy conservation and pollution. This compares with both ethical investments, which screen investment opportunities against negative criteria, and the more innovative impact investments, which include a new breed of impact investment funds that use positive screening in their investment decisions, and thus are able to combine a focus on commercial viability with a focus on social and environmental impacts.

Box 14.1 The growth in private equity funds and SRI

Private equity funds are increasingly becoming part of the core activities of agencies such as the IFC and AfDB, and they play an important role in the Commonwealth. For example, the Commonwealth Private Investment Initiative, targeting developing regions and SMEs, has raised over US$800 million since its launch in 1995 (see Commonwealth Secretariat 2011 for further information); the IFC has raised US$1 billion for its African Latin American, and Caribbean Fund, US$600 million of which is leveraged from other sources; and the AfDB has committed US$1.09 billion to 37 funds since 1997, most of this since 2008 (AfDB 2012b). It should be noted that mainstream funds focus almost exclusively on commercial viability, with development impact through job creation and improved incomes, for example, viewed as an added benefit.

SRI is large and growing fast: the UK market grew eight-fold from £1.5 billion in 1998 to £12.2 billion in 2013 (The Ethical Investment Research and Information Service, quoted in B&GT 2013); the US market reached US$3.7 trillion in 2012 (US SIF 2013); and the European market reached €5 trillion in 2010 (Eurosif 2010). SRI has become increasingly mainstreamed in the Commonwealth, with the establishment of FTSE4Good indices for companies with strong environmental and social records, tracker funds based on a number of new ethical indices, and SRI-related trade organisations.

Impact investments can be made in both developing and developed markets. They have the potential to profitably channel significant amounts of private finance to fund the development of market-based solutions which address pressing development challenges including sustainable agriculture, affordable housing, healthcare, clean technology and financial services for the poor. Impact investments target a range of returns from below market to market rate, dependent on circumstances. A survey of leading impact investors reveals that reported return expectations vary dramatically, ranging from outperforming traditional investments to trading off financial returns for social impact. At present, there is no global estimate of profitability or market size, but potential profits over the next ten years for a small group of businesses in five sectors (housing, rural water delivery, maternal health, primary education and financial services) was estimated at US$183–667 billion alone, with invested capital of between US$400 billion and US$1 trillion (JP Morgan 2010).

Impact investment is thus a rapidly expanding area that requires close monitoring. The very wide-ranging estimates are evidence of the need for many more data on the scale and destination of impact investment, and private investment more widely.

More analysis is also needed regarding the costs and benefits of impact investment on each development sector. Investments may initially seem beneficial, but may not deliver in reality. In particular, whether the societal returns on investment are higher than the private returns is a question that should be explored. Such a cost–benefit analysis is unlikely to be addressed by for-profit business, and would therefore need to be funded through philanthropic donations such as by the investor itself (IMF 2012b: 13).

Finally, if developing country governments and other development actors wish to leverage private sector involvement, this involvement would need to be aligned as closely as possible with development priorities in order to maximise impact.

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Chapter 15

Pooled Approaches to Development Sector-level Challenges

In any consideration of innovative financing instruments and mechanisms, it is important that thought is given to ensuring that all development sectors benefit in some way, and that some sectors do not benefit disproportionately at the expense of others. Section 3 identified sectors that benefit from specific current innovative financing instruments and mechanisms, and sectors that have the potential to do so.

In addition, experience in Commonwealth countries detailed in this toolkit has highlighted the need to ensure that financing for specific purposes is sourced from as wide a range of sources as possible in order to mitigate the risk of essential projects being suspended if one source should fail.

To these ends, development actors may consider establishing development sector-specific facilities similar to the 'Innovative Facility for Agriculture, Food Security and Nutrition', which is being advocated by the Leading Group on Innovative Financing for Development. This facility would include mechanisms to generate new resources, as well as new mechanisms for catalysing private investment, a number of which are already in existence in some form, but whose revenues are not currently channelled towards food security.

Mechanisms to generate new resources, as proposed in the 'Innovative Facility for Agriculture, Food Security and Nutrition', include national taxes, such as an FTT or a tax on fats and sugar products or fertilisers; voluntary contributions from lotteries, consumers, firms, employees and related industries; allocating funds generated under the EU Emissions Trading System (justifiable given the close links between food security and climate change); and migrants' remittances.

Mechanisms proposed in the facility to catalyse private investment include risk management tools such as weather index-based insurance and guarantee funds; innovative credit tools such as warehouse receipts which permit the use of stocks as collateral; PPPs in infrastructure projects needed by the agricultural sector; smart subsidies on agricultural inputs to increase fertiliser use and reverse the trend in soil fertility depletion; and, again, migrant remittances. There is also scope to boost private investment in technical innovation via incentives, AMCs and development impact bonds (Leading Group on Innovative Financing for Development 2012).

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