THE EVOLVING DEVELOPMENT FINANCE ARCHITECTURE: A SHORTLIST OF PROBLEMS AND OPPORTUNITIES FOR ACTION IN 2011

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<u>Summary</u>: The current "architecture" is largely impervious to top-down attempts at restructuring and to bottom-up competitive pressure. Shared norms can nonetheless help, and joint action can reduce information gaps and other sources of market failure, in six areas:

1. *Include new actors in setting global norms.* Neither emerging national sources of cooperation nor non-official actors share all the basic premises underlying the Paris and Accra consensus. This diversity needs to be recognised in reaching a new compact at Busan, perhaps by structuring different "tiers" of mutually consistent commitments.

2. Clarify the role of ODA. Need to define the "catalytic" purpose of ODA-type funding alongside other and larger flows. Would supporting the emergence of the developmental State be at its core? How to be sure ODA really crowds-in other funding, yet is not captured by special interests?

3. *Deal with under-aided and fragile states.* Orphan countries, many of which are fragile, have lower funding than their needs and performance warrant, with serious consequences. There are missing mandates and resources needed to correct these gaps, implying a re-think of the roles of bilateral and multilateral assistance. Instruments and roles in the extended transition between humanitarian and structural assistance need revisiting also.

4. *Reduce fragmentation and volatility.* More complexity and diversity brings greater opportunities for some, greater costs for others. Where the latter are high, should there be international discipline? What more can be done to reduce volatility and increase predictability, such as releasing existing forward-spending intentions?

5. *Integrate global funds and national needs.* Demand for new targeted schemes outstrips incentives to adapt existing channels. Beneficiaries should be involved earlier, especially as thematic funding is not fully additional. Disruption from uncertain outcomes of contests can also be serious. Codes of conduct informed by health sector experience could limit similar problems surfacing elsewhere.

6. *Close key information gaps.* Demands for more timely and transparent data have led to several new initiatives. Partners may need to examine the tradeoffs between the precision of data and strict classification of development flows with a platform that provides more timely data on a wider variety of development flows.

<u>Introduction</u>. As the Background Note for the Workshop suggests, the "architecture" of development finance, including official aid but going far beyond it, has evolved rapidly and organically. This "architecture" is not so much a product of conscious design as it is an ecosystem or "network of networks", involving thousands of separate but inter-related actors, including several hundred large and medium-sized institutions, public and private, local and global.

Such a system is unlikely to be re-configurable through a top-down, blueprint-designed approach – even one powerfully sponsored by the likes of the G20, were any such plan hypothetically to emerge there.

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Intellectual and political capital invested in a sweeping but theoretical redesign effort would therefore likely yield poor returns, relative to the current more tractable and pressing global preoccupations.

Nor, conversely, is the development finance system fully subject to bottom-up competitive discipline, ensuring that "consumer" preferences between alternative offerings ultimately drive the growth of successful "suppliers" and the exit of unsuccessful ones. In fact, most suppliers who offer a high grant element of development assistance face no real competition. They are driven more by their domestic pressures and incentives. Some of the more serious information gaps and other sources of market failure might, however, be mitigated through targeted interventions.

That said, at its best, the formulation of shared development principles, for example under the Paris-Accra processes to be revisited by Busan next year, can and does result in changing internal incentives and behaviour to some extent, at least among some of the more important development actors subscribing to them.

What could some of the remaining underlying system-wide problems and some partial, but actionable collective responses look like?

Here are **six major topics for consideration**:

1. Inclusion of *non-DAC and non-official actors* in any new global compact.
2. Clarity on a *catalytic role for ODA* within larger development finance picture.
3. Addressing the needs of *under-aided and fragile states.*
4. Addressing the negative consequences of *fragmentation and volatility*.
5. Integrating *global thematic initiatives* into country contexts.
6. Addressing key *information gaps* through collective political action.

1. Insufficient inclusion of "new" partners (non-DAC governments and private/non-profit actors) into the architecture which generates development effectiveness norms. This is a major underlying theme both of the workshop itself and of the process leading to Busan-HLF4. There is widespread recognition that any future articulation of the principles of development effectiveness should capture the much greater diversity of experience, objectives and perspectives now on offer in a changed world.

Co-operation from "emerging donors" does not necessarily share all the basic premises underlying the Paris Declaration and Accra Agenda for Action. Rather, these operate under different guiding principles such as southern solidarity, mutual benefit and unconditional cooperation. These lead them towards, for example, greater blending of concessional finance with other instruments, to yield a distinctive balance of economic, commercial and political benefits. These principles may also point away, for example, from aid untying or harmonisation with other funders as policy priorities, and indeed to reject much traditional "aid" terminology altogether. In less controversial areas, such as country ownership and the role of the MDGs, the differences may be more of practical interpretation than of overall principle, but probably remain significant.

Private, philanthropic and not-for-profit actors are likewise rapidly growing in significance, quantitatively and qualitatively, and although these groups are increasingly engaged in the "aid" effectiveness debate, they too do not necessarily subscribe to all its founding principles. They may offer alternative models of "country", as against government, ownership, as well as highly diversified resource platforms, some of which (*e.g.* value chain management) do not fit well with the conventional aid paradigm. They may be as relevant to transforming markets and opportunities as to supporting existing ones. They are only now actively starting to structure their presence in the international agenda-setting process, no easy task over such a large spectrum of members.

In any new "international development compact" or comparable vision and set of global standards that emerges from Busan, and of course the process that defines them, this growing diversity needs to be recognised explicitly. It may mean, as some have suggested (*cf.* Park 2010), that there will need to be several different "tiers" of development effectiveness principles to which different categories of development partners find themselves able to subscribe, but that are broadly consistent with the undertakings in other tiers. But, the search for an expanded global normative framework and an architecture that can deliver it is both important and urgent.

2. Insufficient clarity on the catalytic role of ODA vis-à-vis a broader range of development finance flows. Closely related to the first proposition is the recognition that development is a product of many sources, instruments and types of development flows, led by market-terms investment, loans and trade, as well as remittances and voluntary and charitable giving of all kinds, and of course domestic resource mobilisation.

What then is the specific role that ODA can play, to make the most effective possible use of scarce public funds to complement these other flows that already dwarf it? ODA's interaction with these other sources should ideally be defined in terms of its comparative advantage, but how could that notion be made specific enough to be useful?

This quest could have several complementary strands. Overall, a case can be made that scarce ODA should be increasingly focussed on supporting the emergence of the "developmental State." This "developmental State" would harness all these other sources by: putting in place the necessary institutions; defining national development strategies; and holding itself accountable for results. There could be specific applications of this approach in different areas (*e.g.* infrastructure) and country contexts.

This is a possible starting point, but by no means covers all situations where ODA may either crowd-out, or preferably crowd-in, these other flows. Mere association or packaging of some private with some public support tells us relatively little by itself, though it might enable all participants to claim they are "leveraging" each other in innovative ways. There are also obvious dangers of "capture" of tax-funded support by special interests, with little to show by way of net development gains. As a safeguard, there needs to be clarity on what specific obstacles and risks are mitigated by the ODA stake, what additional sources are thereby released, and what is the total additional development impact of the whole package.

3. Addressing the specific needs of under-aided and fragile states: toward a better division of labour. Some low-income countries have limited ability to tap external funding of all kinds, and some also have chronically poor access to concessional aid, partly as a result of their institutional fragilities. They may also simply have, for better or worse, fewer historical partners. The most preoccupying cases are where total external assistance is much lower than would be justified using objective international benchmarks based on need and performance rankings. Three quarters of the countries appearing on at least two of these under-aided lists are fragile or conflict-affected. The total annual funding gap, relative to these benchmarks, could be as high as $14 billion.

The case of such marginalised or "*orphan*" countries deserves special attention within the overall development architecture debate. This is partly on grounds of cross-country fairness and efficiency, and partly because of the well-known negative regional and global spillovers of extreme fragility.

There appears to be a missing global function here. No institutions today are explicitly mandated to identify and correct systemic misallocations of this kind. As multilaterals reflect international collective action and are relatively free from some of the domestic policy constraints facing many bilaterals, they are the logical choice. However, as bilaterals progressively concentrate, and if multilaterals are expected to fill most of the resulting gaps, then multilateral resources are insufficient and should presumably increase. Where would this increase come from? Such a reflection could spark a wider discussion of the comparative advantage of different parts of the overall development cooperation system, and of how its funders, including new actors, should divide resources among them.

The subset of architectural questions on support for *fragile states*, specifically, includes the issue of whether the international community yet possesses flexible enough instruments to span the extended and complex process of transition from humanitarian assistance to long-term development co-operation. The boundary between the two is increasingly fluid, further complicating the international architecture. Within this problem set, there is also arguably much room for improvement in the division of labour between the major multilaterals, such as the World Bank and the UN, alongside other actors in post-conflict and post-disaster transitional contexts. The challenge of developing appropriate norms for development effectiveness in situations where country ownership is weak, contested, or even absent is a real one for Busan.

4. Addressing the negative consequences of fragmentation and volatility of development assistance. It is becoming commonplace, if not ritualistic, to regret the increasing complexity and fragmentation of the development cooperation architecture and especially of its "official aid" dimension. New actors are nonetheless entering the field every year, and virtually none have ever exited. In addition, the average size of co-operation activities probably continues to fall, although this cannot be confirmed based on data reported to the DAC. This very diversity and complexity is, on the positive side, an opportunity for greater choice and risk diversification on the part of beneficiaries of cooperation, given sufficiently accurate information about its terms and characteristics. More institutionally advanced host governments therefore tend to consider this a positive development.

However, potentially this trend also entails significant costs, especially for low-capacity aid-dependent countries, in terms of disproportionate transaction costs incurred, insufficient staff in smaller cooperation agencies to tailor support to the many local contexts, etc. (OECD reports that 50% of all aid relationships deliver less than 5% of country disbursements, as just one proxy indicator.) Some of this *fragmentation* problem is traceable to insufficient flexibility by some external partners to shift resources and staff within and across countries as needs change, and some to everyone's understandable reluctance to exit longstanding relationships, even when these have lost much of their original substance. Should there not be some international guidance or collective restraint on avoidable fragmentation, if and when this is perceived as a serious obstacle by the host country, and/or a poor use of administrative budgets which are ultimately scored against ODA?

A related quality-of-support problem is the exceptionally high *volatility* of much official development assistance-higher than most other dimensions of partner country economies. Volatility (variance of actual disbursements around their expected value) links back to requirements by the source country or institution that can add major elements of uncertainty to the already underlying uncertainty in country, including fulfilment of ill-defined, unilateral and onerous conditions.

Predictability of future commitments also has to do with the willingness to share indicative information on future intentions, before formal approvals are given. Relatively fast progress could be made on this latter front if donors agreed to release forward plans at country level already collected systematically by the DAC under strict confidentiality requirements, and if more cooperation sources voluntarily joined such arrangements. The recent release of the 2010-2012 datasets for Rwanda and Ghana on a trial basis offers the prospect of rapid improvement. More generally, especially given the generally longer-term horizon of the main emerging sources of cooperation, there is considerable room for improving the average *stability and time horizon* of development flows.

N.B. These are not trivial problems: aid loses perhaps 10-20% of its value when not predictably delivered (Kharas, 2008), translating into an estimated global loss of $12b to $24b per annum for DAC ODA alone. Fragmentation costs, variously calculated, may be of the order of $5b per annum on top of that (Killen and Rogerson, 2010).

5. Integrating vertical or "thematic" multilateral initiatives and funds better into country needs and contexts. A specific subset of these country-level effectiveness concerns arises with global funds, or rather with the larger global programs and initiatives targeting specific thematic objectives. Some of these are set up as free-standing multilateral institutions, while others are under trust fund arrangements with, *e.g.*, the World Bank or a UN agency. Some of the best known of these programs are in the health, education, food security and climate change areas. Many of the development effectiveness lessons drawn so far concern the health sector, especially the Global Fund to fight Aids, TB and Malaria (GFATM), with its unique operating and governance model and arguably the fastest initial funding growth of any international cooperation agency in history.

This slice of the global cooperation architecture attracts major attention, as high-profile international efforts to deliver major global public goods and to link funding closely to tangible results inevitably have strong political appeal. Nonetheless, the *Accra Agenda for Action* enshrines a non-binding *"Think Twice"* discipline, asking potential sponsors to try to use, or adapt, existing delivery channels rather than create new ones in response to every new (or redefined) challenge.

Assuming flat or only slowly growing overall cooperation budgets, potential beneficiaries must also be consulted explicitly and early. Part of their total unearmarked assistance envelope is implicitly being top-sliced away to finance such purposes, to be recycled back later in earmarked form. The net benefit for any given country or group of countries will depend on their internal ability to adjust spending around these earmarks and their relative success in the proposed cross-country competition for funds, whose ground rules may not be settled for some time.

More generally, sponsors of global initiatives have a duty to be much clearer about how this funding is "new and additional" to what existing baseline of effort, and on what indicators they will be held accountable for delivering on such pledges. Such a code of conduct could form part of the new consensus.

With regard to *existing* global funds and thematic programmes, perhaps the greatest challenge is to ensure that as far as possible they are well aligned to national strategies and use national systems. For example they should be able to use national planning documents directly, rather than requiring these to be reconfigured into tailor-made, project-specific proposals in a form and timing which is not locally relevant. Some progress has been made in the health sector in this direction, but with considerable time and effort.

A different set of problems surrounds the longer-term *predictability and sustainability* at country level of global programs which take the form of "challenge" funds, *i.e.* where success depends on ratings by independent experts of multiple proposals across countries at set times, with no minimum or maximum country allocations. Therefore, countries can face big disruptions based on the uncertain outcomes of repeated contests, which also add to fragmentation in the number and complexity of assistance programs. Here again, as overall funding is inevitably rationed and many country needs are of a recurring nature, global funds will be forced to develop ways to smooth and extend their disbursement profile to minimise hardship and disruption, and here again, progress is neither fast nor easy.

It is of considerable global importance that lessons of this kind inform the Busan development effectiveness consensus, and even more urgently the design of new climate change financing initiatives and their institutional architecture.

6. Greater transparency of development finance flows, using real-time information. The paradox is that we have information technologies today that enable tracking of the whole universe of development cooperation at a level of detail and sophistication (down to geo-coding via GPS of tens of thousands of project activity locations) plus speed and affordability unthinkable at the time of the Paris Declaration, and probably even Accra two years ago. And yet, to some extent information is more fragmented than ever, partly due to the multitude of actors and the relatively weak incentives for their voluntary inclusion into the main current information platforms, such as the DAC's reporting framework and IATI, the International Aid Transparency Initiative.

One of the consequences of this still partial buy-in is that many host countries are still "flying without radar" in terms of having a composite picture of current and future development flows to inform their own domestic decisions. Their civil society and parliaments have at best a sketchy basis from which to exert accountability pressure. And they as well as DAC donors have at best a partial understanding of the evolving patterns of activity of non-DAC actors, variously estimated at around 40% of total concessional finance and rising. Emerging sources of cooperation do not get the recognition they deserve for their rapidly spreading and intensifying engagement, regardless of the typology used. Most funders fail to internalise the decisions of others, even in approximate terms, thereby contributing to gaps and overlaps, such as aid orphans.

Stripped of many technical complications, this may be a classic case of the difficulties of collective action in a large group of voluntary players, with no sanctions against free riders, and where some potential participants can already obtain good-enough information on others' positions without necessarily making their own aid flows known. It needs a major political push, and some "tiering" for new categories of participants (see first section on the architecture of their inclusion) to allow for progressive involvement within their comfort zone. Indeed, IATI is already effectively operating as a "tier" of enhanced commitment within the DAC membership.

It may also be a case of the "perfect is the enemy of the good"', in the sense that the tradeoffs between quality and timeliness of information availability, in this as in many other areas, has swung decisively to the latter, while many of the primary reporting agents may still prefer slower, more deliberate approaches. Practical agreements to use provisional data where possible could help. But clearer political signals may be needed to address internal incentives working against faster disclosure and reduced control.

The advantages of dealing with the information gap issues at political level is that this can throw into relief more substantive, nontechnical differences on development effectiveness principles that can be dealt with in their own right. In the case of emerging sources of finance, one such alleged factor is their concern not to be seen by their domestic constituents, whose own development needs are still great, to be giving "foreign aid". If that were indeed a major obstacle, it would not be beyond the reach of the Busan-HLF4 process to identify a broader nomenclature of development cooperation that would reduce such problems, while giving adequate recognition where it is due.

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