TRANSITION FINANCE: INTRODUCING A NEW CONCEPT

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Abstract

In answer to the call expressed within the Addis Ababa Action Agenda to mobilise all available resources – domestic and foreign, public and private – in support of the Sustainable Development Goals, the Development Co-operation Directorate develops a new work stream on transition finance to explore the evolution and interaction of public (official development assistance and other official flows) and private (foreign direct investments and remittances) sources of finance across the development continuum – studying multiple stages of development: low income countries, middle income countries, fragile contexts, and different regions of the world. Its ultimate objective is to advise the Development Assistance Committee (DAC) in preparing countries for transition (outlining the optimal financial mix and offering policy recommendations) and in building resilience.

This paper introduces the concept of transition finance and initiates research to advise the DAC on its role as a major provider of development assistance among other public and private providers of financing for the 2030 Agenda.

This document, as well as any data and map included herein, are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

Executive summary

Section 1 introduces the concepts of transition and transition finance, the main thrust of this paper, with a focus on external finance in particular from the perspective of the DAC.

Section 2 raises the question of what happens with financing for sustainable development when countries transition.

Building on the holistic approach to FSD that has been promoted, among others, by the Addis Ababa Action Agenda and the recent Global Outlook on Financing for Sustainable Development (OECD, 2018[1]), this section develops a methodology to assess the relative weight and role of different sources of external finance as countries transition. It observes major trends (what happens with each source as the country becomes richer) and dynamics (how do different sources interact and substitute with each other) that allows for the identification of expected finance mixes at different stages of transition.

It introduces two key concepts to help the analysis: tipping points – where different sources of financing become more or less prevalent (suggesting the need for adjustment), and transition finance gaps or surpluses – measuring the net gains or losses in terms of finance when countries transition.

Applying these concepts to the more granular level of sector analysis (e.g. social sectors, energy), it appears that transition finance flows differently to different sectors, with longer dependence on ODA of certain sectors like health (but also sharper decline in assistance), resulting in major transition finance gaps.

Section 3 suggests that the optimal transition finance mix is country specific. Nonetheless, lessons can be learned from the success and failure of certain countries to attract certain types of finance. The objective of this section is therefore to develop a methodology for benchmarking, and provide initial conclusions of this exercise.

First, it appears that benchmarking among countries in the same income group does not allow for a compelling enough analysis. Most outliers are either resource-rich countries or countries with an exceptionally small (such as Small Island Developing States) or large population.

This calls for benchmarking countries with similar characteristics, for example within categories of countries most in need (such as Least Developing Countries or Small Island Developing States) that share a number of characteristics and vulnerabilities. On that basis, it draws a number of tailored recommendations for the DAC, and could help improve the transition finance mix of those countries.

Finally, this section provides an example of benchmarking and identification of transition finance recommendations at country level – introducing a methodology to be used and further refined in companion country pilots.

To conclude, **Section 4** expands the scope of transition finance analysis beyond the DAC. The emergence of new donors and their increasingly important role in financing development raises questions about the future of the DAC and its priorities. Transition finance offers additional evidence to nourish this reflection, and a useful lens for observing changes that are occurring.

These preliminary observations call for further research and observations, but already suggest that the dialogue with non-DAC members on transition finance should be further developed, and issues such as debt sustainability or the respective roles of DAC and non-DAC members in leaving no one behind (orphan countries and sectors or SDGs) should be reviewed.

Background

In its 2017 High-Level Meeting (HLM) Communiqué the Development Assistance Committee (DAC) set an objective "to better understand the broad catalytic effect of official support and other resources by understanding the interlinkages among ODA, partner countries' domestic resources, private investment, remittances, philanthropy, trade finance and export credits, and other sources of finance", and to "continue to collaborate with other experts within the OECD and beyond in order to have a global overview and outlook on financing for development" (para 15).

Responding to this call, the DAC Secretariat has developed a new work stream on transition finance that initially focused on developing and introducing new concepts and analytical methods (the present paper builds on document [DCD/DAC(2018)4], as well as producing country pilot studies.

In accordance with DAC priorities, this paper focuses on countries at early stages of transition and those most in need: low-income countries (LICs), least developed countries (LDCs), small island developing states (SIDS), and land-locked developing countries (LLDCs).

Future work will build on the present paper and the methodology will be refined as more progress on country pilots is made. The 2019-20 transition finance roadmap plans on the production of at least four new country pilots, a transition finance toolkit, and an overview paper bringing together all major conclusions of relevance to the DAC.

Cecilia Piemonte (work stream lead), Olivier Cattaneo, Rachel Morris, Arnaud Pincet and Konstantin Poensgen authored this paper.

Table of contents

Abstract **3**

Executive summary **4**

Background **5**

1. What is transition finance? **8**

1.1. Definitions and scope of the work 8
1.1.1. The context: What is transition? 8
1.1.2. The scope of the work: Transition finance 10
1.1.3. Questions on transition finance of particular relevance to the DAC 11
1.2. Mapping transition stages 11
1.2.1. Transition stages or milestones and their criteria 11
1.2.2. Transition milestones and their effects 17

2. Assessing: What happens to sustainable development finance when countries transition? **20**

2.1. Methodology and general transition finance trends 22
2.1.1. Analysis by type of resource 24
2.1.2. Analysis by level of income 25
2.1.3. The role of the DAC 25
2.2. Sectoral perspective 26
2.2.1. Sectoral tipping points 26
2.2.2. Sectoral transition gaps and surpluses 28

3. Benchmarking and counselling: How to tailor transition finance solutions to country contexts?32

3.1. Identifying and learning from transition finance outliers 33
3.1.1. Other official flows 33
3.1.2. Private sector flows 36
3.2. Comparing transition finance trends and dynamics in countries most in need 37
3.2.1. Small island developing states 37
3.2.2. Least developed countries 41
3.2.3. Land-locked developing countries 43
3.3. Applying transition finance benchmarking to country contexts 45
3.3.1. Country context 45
3.3.2. Policy implications 46

4. Looking forward: Transition finance beyond the DAC **48**

References 53

Figure 1.1. There are as many graduations as transition stages..... 17
Figure 2.1. As a country's GNI per capita rises, financial inflows shift from official to private sources22
Figure 2.2. Substitution of ODA with OOF happens at different stages of transition across sectors 27
Figure 2.3. A transition gap appears when the substitution of financing flows is not perfect..... 29
Figure 2.4. Transition gap: the case of ODA and OOF to social sectors 30
Figure 2.5. In energy there is no financial gap at all, in contrast, the transition gap in the health sector seems deep and permanent..... 30
Figure 3.1. Outliers in attracting higher shares of non-concessional flows: LICs, LMICs and UMICs 34
Figure 3.2. Outliers by type of financial flows..... 35
Figure 3.3. Outliers in attracting higher shares of private flows: LICs, LMICs and UMICs..... 36
Figure 3.4. SIDS rely heavily on ODA at all stages of development..... 38
Figure 3.5. Relative distance of donors vs ODA per capita 40
Figure 3.6. LDCs rely highly on concessional finance and fail to attract remittances..... 42
Figure 3.7. LLDCs have higher share of OOF and lower share of remittances in their mix..... 44
Figure 3.8. Benchmarking scenario for Cabo Verde..... 45
Figure 4.1. When introducing all cross-border flows to developing countries, the picture changes..... 49
Figure 4.2. Non-DAC financiers intervene earlier in the development continuum with their private flows; traditional donors are in a unique position to finance some under-invested sectors with ODA/OOF 50
Figure 4.3. Sectoral allocation of aid from China 51
Figure 4.4. ODA/OOF equivalence of aid from China 52

1. What is transition finance?

Transition is the journey to sustainable development, and transition finance the financing of that journey. The analysis of transition finance focuses on the evolution and interaction of public (ODA and OOF) and private (FDI and remittances) sources of finance.

This section identifies key milestones in the journey, some of which are more formal than others, e.g. when a country graduates from least developing countries (LDCs), International Development Association (IDA) or official development assistance (ODA) lists. It notices that income remains a major criterion for most of the milestones, but is not the only one used (e.g. could include vulnerability). Therefore, a first mapping of major transition milestones is offered that explains criteria and consequences of moving up or graduating from different income and other relevant categories (or windows).

1.1. Definitions and scope of the work

1.1.1. The context: What is transition?

The **2030 Agenda for Sustainable Development** (hereafter, 2030 Agenda) reaffirmed the international community's commitment "to achieving sustainable development in its three dimensions – economic, social and environmental – in a balanced and integrated manner" (Paragraph 2). Here, **we call "transition" the journey towards this goal and the achievement of sustainable development**. Transition is an individual as well as a collective journey, responding to our aspiration for better lives. It is a journey that will significantly differ from individual to individual, or from community to community, depending on the context, the starting point, and many endogenous and exogenous factors that can serve as building or stumbling blocks (e.g. conflicts, natural disasters, economic crises). **Transition is not necessarily a linear process**, as history has revealed: risks of setbacks as well as opportunities for acceleration will emerge as humanity makes progress towards the achievement of the 2030 Agenda and its Sustainable Development Goals (SDGs).

From an economic perspective, transition is often associated with a move towards higher levels of income, measured among others by gross national income (GNI) per capita (see World Bank *Data Help Desk* for definition of country classifications that will be used in this document[1]). **Development is multi-dimensional, however**, and a number of studies look beyond traditional measures of economic performance to better understand transition challenges[2]. For example, the OECD progressively developed the concept of **well-being**, which alludes to the imperative for growth to be sustainable and inclusive, and makes a reference to different forms of capital: natural, human, economic and social (see OECD *Better Life Initiative*[3]).

Many more interpretations of the word "transition" exist in economic literature. Its definition seems to continuously evolve with the challenges facing humanity and countries at

[1] https://datahelpdesk.worldbank.org/knowledgebase/articles/906519-world-bank-country-and-lending-groups

[2] See for instance the significant work on "Development in transition" produced by the OECD Development Centre (available at http://www.oecd.org/dev/development-in-transition.htm).

[3] OECD (2013[57]), *Well-Being,* http://www.oecd.org/sdd/OECD-stat-work-2013-well-being.pdf

different stages of development in different eras: demographic transition, democratic transition, green transition, etc. For example, in the late 1980s, transition has referred to the transformation efforts made by former Soviet Union members to move from centrally planned to market economies. More recently, green transition referred to "fostering economic growth and development, while ensuring that natural assets continue to provide the resources and environmental services on which our well-being relies" (see OECD *Green Growth and Sustainable Development*[4]).

In the area of development, the OECD Development Centre pioneered research and developed the concept of "development in transition" which referred to the "daunting multidimensional development challenges" still faced by developing and emerging economies in spite of their having increased levels of national income.[5] At the same time, the 2018 OECD *Development Co-operation Report* reminded us of the international community's pledge in the 2030 Agenda to ensure "no one will be left behind" and to "endeavour to reach the furthest behind first" (Paragraph 4). Thus, **the transition challenge is widespread, from the furthest behind to the furthest ahead, reflecting different realities and priorities, but with common goals that can be achieved only if all succeed together**.

The concept of transition should not be mistaken for the concept of "graduation", which has a (or several) specific meaning(s) for the development community. For example, the OECD DAC sees graduation as the process for removal from the DAC List of ODA of countries that have exceeded the high-income threshold for three consecutive years at the time of the review.[6] Put more simply, it refers to the transition of a country from middle- to high-income (a GNI per capita higher than USD 12 056) and the resulting termination of its eligibility for ODA. Several other types of graduation exist, such as graduation from the least developed countries (LDCs) category, or graduation from the World Bank's International Development Association (IDA), etc.[7]

Graduation often has a prescriptive (legal or regulatory) dimension: in its criteria (reaching a certain threshold that could be based on income, but not only), and in its consequences (losing access to certain types of funding, facilities, or differential treatment like in the case of trade preferences). In this paper, transition is the cumulation of all formal graduation stages plus "softer" ones, such as countries' access to capital markets.

Focus on graduation, and graduation from the DAC List of ODA Recipients in particular, has distracted the development community from the real issue – transition – and the fact that all stages of transition are equally important and decisive for any country's capacity to achieve the SDGs. Assistance to partner countries should start at the earliest stages of transition and never be abandoned but continuously adjusted, both quantitatively and qualitatively, in response to the evolution of partners' needs.

Hence, this document recommends to develop a "**Transition finance toolkit**" that summarises triggers for each step, consequences and development assistance solutions.

[4] http://www.oecd.org/greengrowth/
[5] See for instance ECLAC/OECD (2018[58])
[6] For additional information about graduation from the DAC List of ODA Recipients, see http://www.oecd.org/dac/stats/historyofdaclistsofaidrecipientcountries.htm.
[7] See following section on key transition stages.

1.1.2. The scope of the work: Transition finance

Building on the **holistic approach to financing sustainable development** that was promoted in the Addis Ababa Action Agenda (AAAA or hereafter Addis Agenda), and conceptualised in the *Global Outlook on Financing for Sustainable Development*[8] [(OECD, 2018[1])] (see analysis in Chapter 2 below), this paper aims to **observe and interpret the dynamics and interactions of the various flows of financing for sustainable development (FSD) that are available to countries when they transition** through the development continuum. These include domestic and external flows, both public and private, including ODA, other official flows (OOF), foreign direct investment (FDI), philanthropy and remittances.

Conceived as an introductory analytical piece that could lead to further research, the scope of this paper has been narrowed to focus on:

- **External sources of financing**: The *Global Outlook on Financing for Sustainable Development* [(OECD, 2018[1])] re-affirmed that domestic resources are the main source of financing the SDGs, and the analysis in this document shows the trajectory of the tax/GDP ratio as countries transition. The focus remains, however, on external financing and the role of the DAC, including in domestic resource mobilisation, in comparison and interaction with other external providers of development finance. It should be noted that the tax/GDP ratio in LICs and LDCs remains below the 15% threshold recommended by the IMF for a proper functioning of public services, and the reliance on external financing is high.[9] Companion country pilots have attempted to study this issue by introducing deeper analysis of domestic resource mobilisation, and the OECD Development Co-operation Directorate is exploring the possibility of conducting a joint pilot with the Centre for Tax Policy and Administration.
- **DAC perspective**: The objective of this study is to inform DAC members about the role of official development finance (ODF which includes ODA and other official flows) in financing transition, and design strategies for optimasing the use and impact of ODF while applying a holistic approach (i.e. taking into account interlinkages and synergies, lever effects and others, with non-official financing flows).
- **Countries most in need**: An initial focus has been placed on the countries most in need with in-depth analysis of small island developing states (SIDS), LDCs and landlocked developing countries (LLDCs). Companion country pilots in Cabo Verde, Zambia and Uganda also reflect this priority. Further work is required, however, to collect a sample of country pilots representative of different stages of transition, including recent graduates from the DAC List of ODA Eligible Countries (Uruguay and Chile). This sampling should allow a better coverage of issues associated with different stages of transition, as well as a comparison of financing challenges and solutions for countries sharing common features (e.g. dependence on copper exports in Zambia and Chile, refugee costs in Uganda and Lebanon) but having different levels of development.

As countries transition, they lose access to certain types of financing, but gain access to a broader variety of actors, tools and instruments, e.g. private finance and capital markets. **This paper attempts to analyse the substitution, interactions and trade-offs among available types of financing.** While there is no "one-size fits all", this **modelisation** of trends in

[8] http://www.oecd.org/fr/developpement/global-outlook-on-financing-for-sustainable-development-2019-9789264307995-en.htm.

[9] The target of tax revenue amounting to at least 15% of GDP is commonly regarded as minimum tax revenue required for economic growth and development (e.g. (International Monetary Fund, 2011[55])).

domestic and external FSD resources (ODA, OOF, FDI, remittances) can help **measure the performance of each individual country** or group of countries in attracting certain types of financing in comparison with the rest of the world or selected peers. It also helps **draw lessons from outliers** that are particularly good (or bad) at attracting some sorts of financing, and arrive at policy recommendations for development partners (both donors and recipients).

The ultimate objective is to optimise access to FSD in partner countries and DAC members' deployment of such financing.

1.1.3. Questions on transition finance of particular relevance to the DAC

This paper takes a DAC (or donor) perspective – in contrast with, and as a complement to a recipient country's perspective. It supplements, for instance, the work done on transition by the OECD Development Centre and other multilateral agencies such as the United Nations Development Program (UNDP). That said, the **donors and countries perspectives and strategies should be aligned, as well as development and financing strategies**. Companion country pilots more concretely focus on this alignment.

An optimal financing mix is to be accompanied by an optimal policy mix. As suggested in OECD-DAC document "Transition Finance: update on ongoing discussions and work"[10], four questions pertaining to transition finance are of particular relevance to the DAC, and will be further explored in this paper:

- **How could the DAC facilitate the phasing out of ODA** and secure the progressive growth of other sources of financing (e.g. private or domestic), thereby securing long-term sustainable financing (e.g. by preserving debt sustainability)?
- **How could the DAC increase the effectiveness of ODA**, identifying the best and most innovative tools, policies and partnerships available along the development continuum to best serve the financial needs of transitioning countries?
- **How could the DAC design long-term support strategies that go beyond ODA?** In other words, how could DAC members continue to support countries after ODA graduation to preserve the benefits of ODA in the longer term and avoid setbacks?
- **What kinds of capacity building efforts, promotion of transfers of all kinds (from private investment to technologies or knowledge) and domestic resource mobilisation efforts, could be fostered by ODA while phasing out in anticipation of transition?**

1.2. Mapping transition stages

1.2.1. Transition stages or milestones and their criteria

For the purpose of this paper, **transition is defined as a journey to sustainable development, and transition finance as the financing of that journey**. The journey has a number of **key milestones** that reflect progress towards the achievement of the SDGs (e.g. graduation from the LDC category), and triggers major changes in the financing mix available to countries (e.g. graduation from the DAC list of ODA recipients). So-called **windows** are the different stages of this journey in between milestones and correspond to various financing opportunities – that can include thematic sub-windows with their own modalities, e.g. World Bank IDA private sector window, crisis response window, sub-window for refugees and host communities.

[10] DCD/DAC(2018)4

As stated above, **some of those milestones are more formal than others**, for example when a country graduates from LDC, IDA or ODA (with strict conditions and a formal process), compared to just moving from one income category to another, or gaining access to new sources of financing.

A first step would be to map those milestones, and better understand conditions and consequences attached to them. Table 1.1. attempts to do so, and provides the example of a dozen milestones – with relevant criteria, process, and list of countries concerned – focusing on four different types of transition windows that are relevant to different actors (e.g. multilateral institutions, DAC members), revealing the variety of factors that affect countries' access to certain types of financing:

- Country income categories, as defined by the World Bank, from low-income countries (LICs) to high-income countries (HICs);
- DAC List of ODA Recipients;
- Multilateral concessional finance; and
- Least developed countries (LDCs).

This list is not exhaustive, however, and a transition finance toolkit (see below) could aim to fill in more information gaps. For instance, it would be useful to better identify the consequences of graduation and resources available to accompany countries through this process (e.g. UN support for LDC graduation and smooth transition).

Table 1.1. Understanding the full spectrum of financing opportunities developing countries face when transitioning

Transition stage	*Institution that defines the category*	*Belonging to this grouping allows to benefit from:*	*Minimum GNI per capita required to graduate:*	*Other criteria to graduate:*	*Period of transition:*	*Other comments on decision criteria*	*Countries having (recently) graduated and planned to graduate*
LDC Category	United Nations	Several International Support Measures (ISMs); Blended finance; preferential tariffs: Duty Free Quota Free (DFQF) access to third country markets; starting in 2019, requires DAC donors to give at least a grant element of 45% if delivering ODA loans	USD 1 230 or USD 2 460	Possibilities to graduate: 1) USD 1 230 if HAI >= 66 or EVI <= 32 3) GNI pc > USD 2 460 4) HAI>='66' and EVI<=32	3 years to identify and certify, another 3 years of transitioning out of the category	Discussion are triggered when threshold are crossed but it is not automatic; Decisions made by the UN GA, recommendation by CDP and endorsed by ECOSOC. Criteria have to be met for a second consecutive time.	Angola (2021), Vanuatu (2020), Equatorial Guinea (2017), Samoa (2014), Maldives (2011), Cabo Verde (2007) and Botswana (1994) Tuvalu: decision deferred to 2021 Kiribati: decision will take place in 2021. Bhutan, Sao Tome and Principe, and Solomon Islands are recommended – UN GA will decide between 09/2018 and 09/2019
ODA eligibility	OECD DAC	Concessional grants and concessional loans as defined by the DAC (ODA)	USD 12 056	All LDCs as defined by UN included; LIC and MIC defined by WB included; belonging to the EU excludes from group.	ODA recipients list revised every three years;	Income criteria has to be met for three consecutive years; from 2018 onwards, in the event of a major GNI setback, , the DAC can consider reinstatement.	Chile (2018), Seychelles (2018), Uruguay (2018) Antigua and Barbuda (2020)e, Palau (2020)e, Argentina (2020)e, Panama (2021)e e: Secretariat estimations
low-income country (LIC)	World Bank	Concessional loans from DAC community: starting 2019, DAC donors to give at least a grant element of 45% if delivering ODA loans.	<= USD 995		Yearly (WB); DAC particularities: period of transition is 3-y average		
lower middle-income country (LMIC)	World Bank	Concessional loans from DAC community: starting 2019, DAC donors to give at least a grant element of 15% if delivering ODA loans.	=> USD 996 & <= 3 895		Yearly (WB); DAC particularities: period of transition is 3-y average		
upper middle-income country (UMIC)	World Bank	Concessional loans from DAC community: starting in 2019, DAC donors to give at least a grant element of 10% when delivering ODA loans.	>= USD 3896 & <= 12 055		Yearly (WB); DAC particularities: period of transition is 3-y average		

Transition stage	*Institution that defines the category*	*Belonging to this grouping allows to benefit from:*	*Minimum GNI per capita required to graduate:*	*Other criteria to graduate:*	*Period of transition:*	*Other comments on decision criteria*	*Countries having (recently) graduated and planned to graduate*
AfDB		Non-concessional loans	None	Must fulfill creditworthiness status			
AfDF (AfDB concessional window)	AfDB	Grants and concessional loans through ADF	USD 1 215 (fiscal year 2014/15)	Creditworthiness	2-5 years (transition framework adopted in 2011)	Income criteria must be met for 2 consecutive years; blend and gap status if one of income or creditworthiness criteria not fulfilled	Nigeria (2018), Zambia, Ghana and Kenya (2022), Congo (2015), Cabo Verde (2015)
IDB	IDB	Concessional and non-concessional loans	USD 2.834 for concessional finance	Creditworthiness; Population size, debt service ratio, and IADBs country institutional and policy evaluation index.[11]	Not defined	Not clear how a country enters or exits the list of eligible countries.	
AsDB concessional window	AsDF	Grants and concessional loans	IDA operational cut-off	Creditworthiness; LDCs remain blend even when both criteria are fulfilled.	4 years (regularly)	Discussions are triggered when the threshold is crossed but it is by no means automatic.[12]	
AsDB	AsDB	Availability of commercial capital flows on reasonable terms.	IBRD benchmark	Availability of commercial flows on reasonable terms; attainment of certain level of development	5 years (regularly)	AsDB uses IBRD benchmark to trigger graduation process; close consultations with borrowers.	Brunei Darussalam, Hong Kong, China, Rep. of Korea, Singapore, Taipei

[11] Currently, Plurinational State of Bolivia ("Bolivia"), Guyana, Honduras and Nicaragua are eligible for concessional finance via blended loans; Haiti benefits from grants exclusively.

[12] Graduation from concessional assistance is normally triggered when a country exceeds the per capita GNI operational cut-off and achieves adequate creditworthiness for regular OCR or market-based resources. Graduation from concessional assistance involves close consultation with the DMC. The process of graduation normally takes about 4 years to complete, after crossing the income threshold (ADB, 2018[6])

Transition stage	*Institution that defines the category*	*Belonging to this grouping allows to benefit for:*	*Minimum GNI per capita required to graduate:*	*Other criteria to graduate:*	*Period of transition:*	*Other comments on decision criteria*	*Countries having (recently) graduated and planned to graduate*
IDA	World Bank	Grants and concessional loans.	IDA operational cutoff currently USD 1 145	Creditworthiness, macroeconomic prospects, risk of debt distress, vulnerability to shocks, institutional constraints, and levels of poverty and social indicators.	Typically, more than 6 years after GNI per capita exceeds IDA operational cutoff.	Flexible multistage graduation process, which relies on careful case-by-case analysis of specific country situations.	Bolivia (FY17), Sri Lanka (FY17) and Viet Nam (FY17).
IBRD	World Bank	Non-concessional loans. Small States and Countries in Fragile and affected situations (Group A countries) benefit from a maturity premium regardless of their income category.	USD 7 175	Credit worthiness, institutional capacity	Not defined	Discussions are triggered when threshold is crossed but it is by no means automatic.	Hungary, Republic of Korea, Latvia (1998) Botswana, Dominica, Equatorial Guinea and St. Vincent and the Grenadines graduation also initiated.[13]

Source : (UN/DESA, 2018[2]) for LDC category; (World Bank, 2018[3]) for LIC, LMIC and UMIC; (AfDB, 2014[4]) and for AfDB; (IDB, 2017[5]) for IDB; (ADB, 2018[6]) for AsDB; (IBRD/IDA, 2018[7]) for IDA and IBRD

13 World Bank (2018[59])

This initial snapshot of milestones reveals the diversity and complexity of graduation processes and the even greater diversity and complexity of the whole transition journey. Companion country pilots show, for example, that LDC graduation of Cabo Verde – a formal graduation step – triggered less disengagement from DAC members than Zambia's transition from the low-income country (LIC) to lower middle-income country (LMIC) category. A conclusion of those empirical observations is that **DAC members should remain vigilant and provide support to partner countries at every stage of transition**, since eligibility criteria and thresholds do not always reflect the country's capacity to handle the graduation process and its consequences.

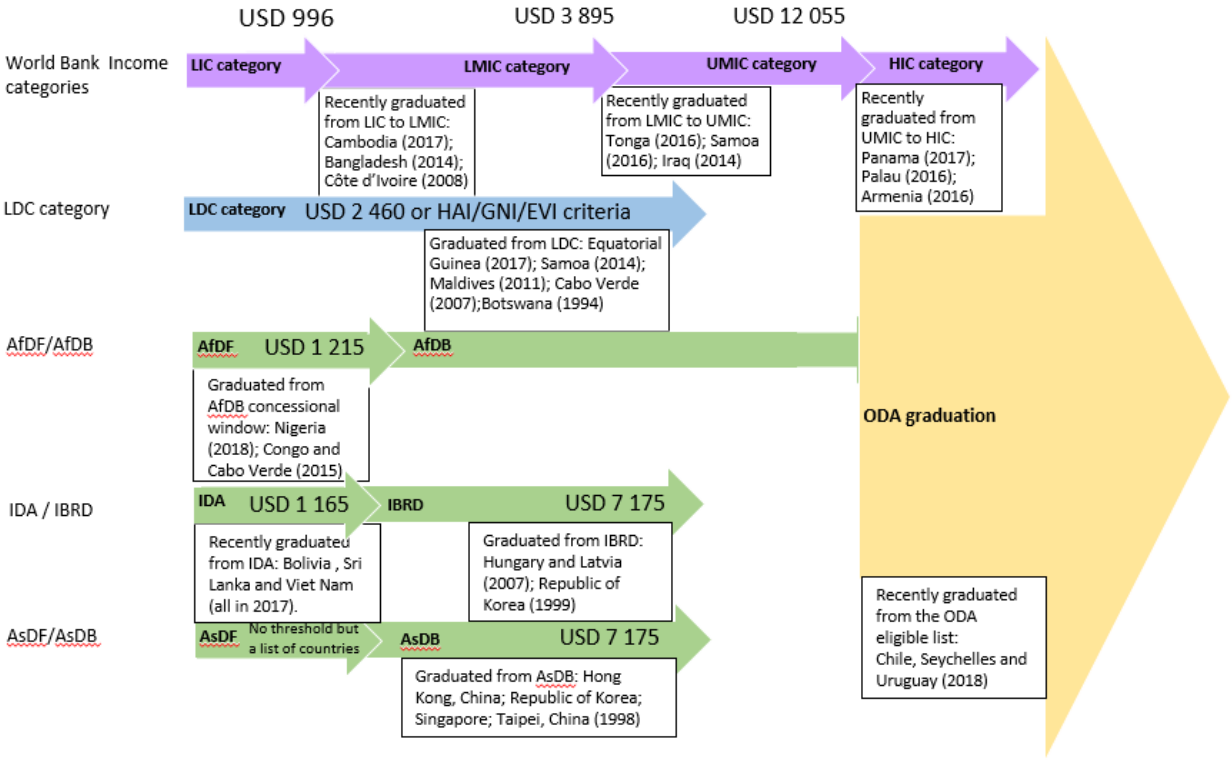
The focus on "official" milestones (i.e. defined by the DAC, World Bank, UN) should also not fully distract attention from other types of milestones or relevant signals, such as sovereign credit rating or Joint Bank/Fund analyses of debt sustainability framework that can play an important role and influence creditors' behaviour. For instance, this work does not explore the role of Credit Rating Agencies (CRAs) that have the capacity to influence important amounts of capital in and out of countries as well as the cost of access to capital (including for DAC or multilateral agencies, e.g. with IDA having a AAA rating) – important research having been dedicated to this role and the criteria used by CRAs to determine sovereign ratings.[14]

This initial snapshot also shows that income per capita remains an important reference and a criterion used in all graduation decisions, while other criteria may vary from process to process (e.g. economic vulnerability and human development indices for the LDC category, debt/credit worthiness for some multilateral institutions). Therefore, the analysis conducted below mainly uses income per capita and country income groups, as defined by the World Bank, to show a country's progress in the transition journey, without prejudging the relative importance of these milestones vis-à-vis others. It does, however, also explore transition finance issues for selected categories of countries most in need such as small island developing states (SIDS), LDCs and landlocked countries (LLDCs) whose definition is not only income-specific.

As illustrated by Table 1.1. and Figure 1.2., **there is a large number of countries reaching one milestone or another and having to deal with graduation processes or their consequences**. Again, **this calls for further attention of the DAC and its support to countries in transition so as to avoid socio-economic setbacks** that could be prompted by changes in the access or terms of financing sustainable development. It is worth noting that the DAC has recently introduced a mechanism for "reverse graduation", already in place for multilateral financing, to account for exceptional and extreme development setbacks.

[14] See for instance (Katz, Salinas and Stephanou, 2009[60]) or (Elkhouri, 2008[61])

Figure 1.1. There are as many graduations as transition stages



Source: Authors' design.

1.2.2. Transition milestones and their effects

Transition milestones open or close a number of financing windows. In other terms, they are **key determinents of the level of concessionality** of financing made available to countries (see Box 1.1.).

The level of concessionality could also vary within each window. For example, at the 2014 DAC High-Level Meeting, DAC ministers agreed to new concessionality thresholds for granting ODA loans based on income per capita and LDC status. The new agreement will take effect as from ODA reported in 2019 (2018 data) and intends to provide incentives for targeting a greater share of highly concessional resources to poorest countries.

Box 1.1. Understanding the terms and conditions of concessional finance

The degree of concessionality of a loan is measured by its "grant element". The grant element is defined as the difference between the loan's nominal value (face value) and the sum of the discounted future debt-service payments to be made by the borrower (present value), expressed as a percentage of the loan's face value. Whenever the interest rate charged for a loan is lower than the discount rate, the present value of the debt is smaller than its face value, with the difference reflecting the (positive) grant element of the loan.[15]

Highly concessional financing provides an alternative to otherwise limited liquidity and access to capital markets (due to high-risk scenarios). For example, when developing countries access the bond market in foreign currency, the maturity of their issues seldom exceeds 10 years. By comparison, ODA loans, with average maturities of around 30 years and average interest rates of under 2%, represent a highly preferential flow of resources to recipient countries.[16]

However, allocation of concessional loans requires careful examination of the macroeconomic context and sectors targeted (i.e. social sectors require higher concessionality while commercially viable sectors do not require concessionality to thrive) as well as the debt sustainability level of the beneficiary government.

Effects of reaching transition milestones go beyond concessionality of financing. For example, graduation from the LDC category could terminate access to special and differential treatment, e.g. for trade remedies or disputes, or tariff preferences, e.g. under the Generalised Scheme or System of Preferences or the duty-free and quota-free access for LDCs.[17] The HIPC (Heavily Indebted Poor Countries) Initiative also allows for countries to benefit from debt relief on the basis of certain conditions, including IDA eligibility – other conditions include debt burden, the track record of sound policies through IMF and WB, and a Poverty Reduction Strategy Paper.

A key conclusion from companion transition pilots is that, beyond losing access to some funding, levels of concessionality, or other types of preferences, **partner countries loose access to the invaluable technical expertise attached to DAC or multilateral institutions' financing and projects**. For example, the termination of the Norwegian project on tax for development in Zambia after the country reached LMIC status created a vacuum in the Zambia Revenue Authority that is in dire need of technical assistance (see companion country pilot).

Another key conclusion from the companion country pilots is that **support to anticipate and mitigate the effects of reaching certain transition milestones needs to be increased**, including with a view to prevent development setbacks. A number of transition support groups already exist to monitor and follow development progress. For example, in the case of LDCs, a number of international actors provide indicators (e.g. UNCTAD productive capacity), reports (e.g. CDP monitoring reports, EIF Diagnostic Trade Integration Studies, OECD

[15] http://ida.worldbank.org/financing/resource-management/grant-element-calculations.
[16] https://www.tresor.economie.gouv.fr/Articles/1b040048-5002-4806-9877-b08143bbedf3/files/ed5e0fd2-0ab1-4a7b-96de-898bdf0b2970.
[17] A report by UN-OHRLSS argued that loosing access to preferential trade agreements as consequence of LDC graduation may be more significant than a potential reduction in ODA receipts (UN-OHRLLS, 2017[54]). In this spirit, the UN GA resolutions 59/209 and 67/221 call for market access to be extended for a number of years following LDC graduation.

production transformation policy reviews), and other types of impact assessments (e.g. UNIDO, UNDP, FAO). Nevertheless, as explained by the *Global Outlook on Financing for Sustainable Development* (OECD, 2018[1]), the multiplication of diagnostics and actors raises new co-ordination and implementation challenges, and the link between development and financing strategies is often overlooked.

Therefore, building on this methodological paper and its companion country pilots, **it is suggested to develop**:

- An OECD **transition finance toolkit** that would allow a quick **a**ssessment, **b**enchmarking and **c**ounselling (ABC framework) of countries in transition with specific recommendations to the DAC to optimise the use and impact of official development finance, ensuring its resilience and progress towards the Goals (see Box 1.2);
- A **transition finance support team** or cross-institutional expert support team/mechanism that would assist countries reaching key transition milestones (e.g. when accessing capital markets or negotiating with non-traditional actors) and guide their borrowing decisions – building on the experience of the Joint Bank/Fund analyses of debt sustainability framework for LICs or the OECD Tax Inspectors Without Borders.

Box 1.2. The ABC framework for transition finance diagnostics

- **Assessing:** What is the transition context in the country? What role are DAC members and partners playing in the transition context? How has access to financing for sustainable development been impacted by the transition?
- **Benchmarking:** What are the substitution effects between public, private, domestic and international resources as the country transitions? How does this substitution of broader flows compare with country peers undergoing similar transitions? What lessons and best practices can be drawn from other country contexts?
- **Counselling:** How can development partners help the phasing out of ODA and secure the progressive growth of other sources of financing (e.g. private or domestic)? How to increase the effectiveness of ODA, identifying the best and most innovative tools, policies and partnerships available? How could development partners design long-term support strategies that go beyond ODA? How can development partners provide support to avoid setbacks when ODA is no longer an option? What kinds of capacity building efforts (e.g. to allow trade and investment or domestic resource mobilisation), promotion of transfers of all kinds (from private investment to technologies or knowledge) could be fostered by ODA to smooth the transition?

2. Assessing: What happens to sustainable development finance when countries transition?

What happens with financing for sustainable development when countries transition?

Building on the holistic approach to Finance for Sustainable Development (FSD) that has been promoted, among others, by the Addis Agenda and the recent Global Outlook on Financing for Sustainable Development *(OECD, 2018[1]), this section develops a methodology to assess the relative weight and role of different sources of external finance as countries transition. It observes major trends (what happens with each source as the country becomes richer) and dynamics (how do different sources interact and substitute with each other) that allows for the identification of expected finance mixes at different stages of transition.*

Major trends include the progressive substitution of external with domestic finance, as well as public with private finance, and a phasing out of concessionality as countries transition. This section also offers a breakdown of transition finance challenges faced by countries at different levels of transition (by income groups: LICs, LMICs and UMICs)

It introduces two key concepts to help the analysis: tipping points – where different sources of financing become more or less prevalent (suggesting the need for adjustment), and transition finance gaps or surpluses – measuring the net gains or losses in terms of finance when countries transition.

Applying these concepts to the more granular level of sector analysis (e.g. social sectors, energy), it appears that transition finance flows differently to different sectors, with longer dependence on ODA of certain sectors like health (but also sharper decline in assistance), resulting in major transition finance gaps.

The previous section introduced the concepts of transition – the journey to sustainable development, and transition finance – the financing of that journey. It also described the milestones delineating the various stages of transition such as graduation from one income group to another, the associated conditions – if any – and their effects on the diversity and concessionality of available development finance.

Against this background, **how does financing for sustainable development evolve as countries transition? What are the financing challenges faced by countries as they move through the development continuum and towards the SDGs? How can the international community ensure that supply for financing meets the demands of SDGs? What is the role of DAC members in striking this balance?**

This section attempts to answer these questions through the lens of the Addis Ababa Action Agenda (AAAA) that provided the global framework for financing development post 2015, and called upon all available resources – domestic and foreign, public and private – to support the SDGs. More recently, the *Global Outlook on Financing for Sustainable Development* (OECD, 2018[1])) took stock of efforts made within this framework and explored potential synergies and trade-offs among the various actors and sources of FSD. It concluded that the potential of a truly holistic approach (see Box 2.1) to financing the 2030 Agenda had remained

untapped, and that in the absence of a systemic change, the international community runs the risk of defaulting on its promise.

Box 2.1. What is a "holistic" approach to financing for sustainable development?

Paragraph 8 of the Monterrey Consensus on Financing for Development (2003) provides a definition for the holistic approach to financing for development:

"*In the increasingly globalizing interdependent world economy, a* ***holistic approach*** *to the interconnected national, international and systemic challenges of financing for development - sustainable, gender-sensitive, people-centred development - in all parts of the globe is essential. Such an approach must open up opportunities for all and help to ensure that resources are created and used effectively and that strong, accountable institutions are established at all levels. To that end, collective and coherent action is needed in each interrelated area of our agenda, involving all stakeholders in active partnership*."

Accordingly, the holistic approach has two main dimensions:

- Areas of the development agenda – economic, social, environmental – are interrelated;
- Actions are collective and coherent, involving all stakeholders in active partnerships.

Its intermediate objective is to mobilise more resources, as well as to increase accountability and the effective use of current and future resources. Its final objective is to open up opportunities for all through sustainable, gender-sensitive and people-centred development. A holistic – or integrated – approach is inclusive ("all stakeholders") and makes the most of their interactions, so that their collective impact on sustainable development is more than the sum of the parts.

Source: *Global Outlook on Financing for Sustainable Development* (OECD, 2018[1]).

The following aims to fill in this research gap, and **further explore the contribution of different resources and actors, across sectors, as countries transition,** as well as **better understand the trade-offs and synergies among these resources and actors**.[18] As new sources of external and domestic finance become available with higher levels of income, the dynamic effects become increasingly complex. Not all resources (concessional, non-concessional, private, philanthropic, remittances, as well as domestic resources) deliver the same contribution to sustainable development or achieve the same level of development impact. One dollar of private investment invested in carbon-intensive industries does not equate to the same level of sustainable development impact as one dollar of ODA invested in renewable energy. **Work on transition finance seeks to identify the policy and financing**

[18] Please note that the data in the charts and figures from section 1 to 3 are limited to outflows from DAC members, non-DAC members reporting to the DAC, and multilateral agencies. Section 4 includes data on inflows from these same actors and expands its coverage to inflows from all other actors (mainly BRICS).

strategies needed to ensure that the sustainable development impact of all resources is maximised as ODA is phased out.

For that purpose, this section introduces a **new methodology for transition finance assessment**. This methodology helps understand the **standard behaviour** of actors, resources and their substitution patterns as countries transition. It also introduces new concepts such as **tipping points** – where major substitutions or behaviour changes occur, and **transition gaps or surpluses** – where substitution of resources is not perfect and countries become better or worse off in terms of financing as they transition[19].

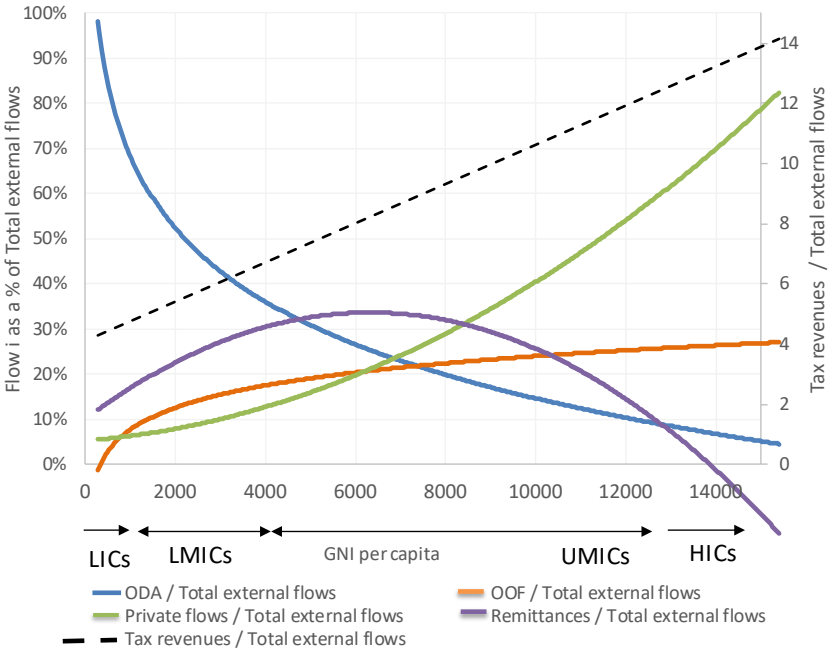
2.1. Methodology and general transition finance trends

Coming back to our initial question: **what happens with financing for sustainable development when countries transition?**

In line with the AAAA holistic framework, financing for sustainable development comprises resources from domestic and external resources, both public and private. Figure 2.1 illustrates this financing mix, focusing on the distribution of external resources (left y axis), while including the relative importance of domestic resources (right y axis), and showing the evolution of the mix as income per capita increases (x axis).

Figure 2.1. As a country's GNI per capita rises, financial inflows shift from official to private sources

DAC, non-DAC OECD members and multilateral agencies' outflows, 2012–16 net disbursements, 2016 prices.



Note: Please note that the data in the charts and figures from section 1 to 3 are limited to outflows from DAC members, non-DAC members reporting to the DAC, and multilateral agencies. Section 4 includes data on inflows from these same actors and expands its coverage to inflows from all other actors (mainly BRICS).

[19] It is important to note that although this study does not expound on debt sustainability issues, it does not minimise its importance. The need to build capacities to ensure macro/fiscal and debt management stability is well recognised, and its effective and sustainable delivery welcome in early transition stages.

The x-axis represents the GNI per capita in USD, from lesser to higher levels (left to right). Then at each level of development (or GNI per capita status) the chart illustrates an average composition of the external financing mix. The four solid curves representing respectively concessional finance, non-concessional finance, private flows and remittances sum up to 100% at each level of GNI per capita (each dot of each curve illustrates its importance over the total mix at any GNI per capita level). The dotted curve should be read on the right vertical axis and represents domestic resources as a percentage of all external flows.
Source: Authors' calculations based on (OECD, 2018[8])'Creditor Reporting System database (ODA, OOF flows, and private flows), (World Bank, 2018[9]), "migration and remittances data', (UNUWIDER, 2018[10]) 'tax revenues' database, and (IMF, 2017[11]) 'Balance of Payments' database (FDI, portfolio investments, and long-term and short-term debt).

A number of conclusions can be drawn from the analysis of this figure that could help **predict the availability and role of different resources and actors as countries transition**. Of course, each individual country (and even sector as will be shown later) has a different financing mix, and the objective is not to have every single country follow the same path – there is no one-size-fits-all. Nonetheless, this picture illustrates the remoteness from average and raises the right questions pertaining to transition finance. Examples of questions it could raise include:

- If a country remains excessively reliant on ODA as it transitions: How to explain this dependence? How to promote, if deemed desirable, the substitution of ODA with other resources?
- If a country cannot attract enough FDI compared to its income group peers: What is the reason? How to remedy this situation? What could be the role of other resources, such as ODA, to help increase the country's attractiveness for foreign investors?
- If a country's ratio of domestic/external resources is too low: What is the reason? Is there a case for mobilising more domestic resources, including with a better targeting of ODA?

There is no good or bad performance, but questions about the optimal transition finance mix are to be raised and answered at country level. As noted already, **not all resources have the same role to play or development impact, or can be substituted**. For example, remittances are mainly used for consumption, unlike FDI that targets economic infrastructure, or ODA that plays a particular role in social sectors.[20] [21] Excess of a resource could be just as detrimental as its shortage: for example, the analysis below shows the risks of an excessive dependence on certain types of resources (e.g. ODA, remittances) and the imbalances often

[20] Further literature provides insights into the different uses of various financing flows. In a comprehensive literature review on the impacts of remittances, Adams (2011[45]) states that while some sources find that remittances are used for consumption goods (e.g. food), other studies tend to show that households spend receipts on investment in, for example, education and housing. ODI (2016[46]) argues that international sovereign bonds (long-term public debt) are mainly used to finance large-scale infrastructure investment. Private capital may be driven by profit rather than poverty eradication and sustainability concerns (Glennie and Hurley, 2014[47]). In the same time, the report argues, international public finance can help to promote investment along more sustainable dimensions and also leverage private capital to riskier projects. Lastly, international public finance is said to have a unique role in financing global public goods. Regarding ODA to LICs, Martins (2011[48]) argues that around two-thirds of foreign exchange provided was used to finance imports whereas the other third was used to build up international reserves. Similarly, half of ODA to sub-Saharan African countries between 1980 and 2016 was used to finance reserve flows (debt servicing, capital flight, reserve accumulation) according to (Serieux, 2011[49]).

[21] More information on remittances (e.g. diaspora bonds) will be highlighted on a case-by-case basis, when analysing specific country pilots.

associated with it (e.g. a strong performance in attracting private external flows could hide a non-cooperative fiscal/tax regime – fiscal paradise).

The figure does not show either **whether changes in the financing mix are driven by supply or demand**. The answer is probably a combination of both: for example, as a country becomes richer and has a more solid fiscal basis, its tax revenues will increase and its need for ODA will decline (demand); at the same time, DAC members willing to target countries the furthest away from the SDGs will symmetrically phase out their ODA contribution in the country (supply).

The following provides the methodology for assessing and benchmarking, and country analysis – as applied in the companion transition finance country pilots – should help tailor conclusions and policy recommendations to the country's and donors' needs.

2.1.1. Analysis by type of resource

Finance for sustainable development is a mix of different resources that evolves as countries transition. At any given point on its transition journey, a country can expect to have access to different types of resources. The challenge will be to ensure a smooth transition with no major financing gaps (i.e. substitution of one resource with another as the former declines) or socio-economic setbacks (i.e. ensuring the resilience of any resource's development impact as the resource is phased out).

Two major trends are observed:

- First, a **substitution of external with domestic resources**: From the onset, domestic resources are the largest source of finance for the economy – with a 4 to 1 ratio of tax revenues/external flows. This ratio keeps increasing, however, with tax revenues representing more than 12 times the value of external flows as the country reaches high-income status. **Domestic resource mobilisation is therefore a key component of financing sustainable development, and should remain a primary objective of ODA** – in all its dimensions, including addressing informality, institutional capacity building, and reform of the tax and incentives regime.
- Second, a **substitution of public with private resources**: Highly dependent on public external support (mainly ODA) in early stages of transition, countries progressively move towards a private financing of their economy. Public financing itself evolves, with a **progressive substitution of ODA with OOF, corresponding to a decline in the concessionality** as countries transition – the role of OOF being essential to mobilise private resources. At the lower end of the income spectrum, ODA represents about 96% of external financing, and private finance around 5%; at the higher end, when the country reaches high-income status, the sum of ODA (10%) and OOF (26%) represents 32% of external financing, compared to 55% for private finance. The tipping point (i.e. when private flows surpasses ODA) happens very late in transition at about USD 7 000 of GNI per capita) when countries lose access to multilateral development finance. Here again, **private sector development, trade and investment promotion, improvement of investment climate and business environment have a key role to play for DAC members to facilitate this substitution**.

Flows of remittances demonstrate a bell curve, reaching a peak – 35% of external flows – in the UMIC category (at around USD 6 000 of GNI per capita), and sitting anywhere from zero to 12% at the lower and higher ends of the transition spectrum. This bell curve could be easily explained by the drivers of migration (when the country becomes richer, migrants become

increasingly qualified and can remit higher amounts, but after a certain stage of transition, economic migration becomes less attractive, and the relative economic weight of migrants declines) and the country's capacity to channel remittances through a formal and well-functioning financial system (increased visibility of transfers). Around this peak, do remittances surpass ODA in terms of relative share of external finance. Private flows surpass remittances later as does ODA.

The relative contribution of remittances to external financing varies a lot from country to country – in 2017, remittances represented more than 30% of the GDP in the Kyrgyzstan, Tonga and Tajikistan, and more than USD 60 billion a year in India and People's Republic of China.[22] An excessive reliance on remittances, for example for some SIDS, is not necessarily good, and excessive migration could have some negative effects on local development (e.g. loss of rare qualifications).[23] Nonetheless, the **DAC members could play a major role in maximising the benefits from migration, including through reducing the cost of remittances, developing an adequate financial system to channel remittances through the productive economy, increasing the development impact of remittances (e.g. new diaspora bonds)**.

2.1.2. Analysis by level of income

A similar analysis could be made looking through the **income-grouping lens**: What are the key financing challenges at different stages of transition? Briefly,

- For **LICs**, the main challenge is the sharp decline in ODA, by 25 percentage points, that is mainly compensated by rising remittances and more timidly by OOF, while FDI does not pick up. In the same period, the relative weight of domestic tax revenues grows by 25%.
- **LMICs** experience the first acceleration of private finance whose relative weight doubles, the relative weight of domestic tax revenues grow by 50%. Symmetrically, over the period, dependence on ODA drops from 65 to 35% of external flows. The share of OOF grows from 7 to 15% of external flows, and remittances approach its peak reaching 31%.
- **UMICs** experience the main tipping points or transformations in the transition finance mix, with, just after reaching a peak, the decline of the relative importance of remittances. Both, FDI and OOF surpass ODA as a share of external flows, and the acceleration of domestic resources doubles: the gap between domestic and external resources keep increasing.

2.1.3. The role of the DAC

The DAC has a major role to play in ensuring a smooth transition of countries. Increased awareness and understanding of major transition stages and their financing challenges should help DAC members design more efficient transition finance programmes that would include:

- **Better anticipation and preparation of substitutions** – using ODA and OOF to support a sustainable transition finance path;

[22] See World Bank data on migration and remittances available at https://www.knomad.org/

[23] Economic literature on the impact of remittances on economic growth and development has not yet converged towards a consensus. While some studies find a positive relationship and, for example, argue that remittances provide alternative means of finance investment in countries less financially developed (e.g. (Giuliano and Ruiz-Arranz, 2009[51]); (Fayissa and Nsia, 2010[50])), others note that remittances may induce a "Dutch disease" effect or undermine domestic productivity (Meyer and Shera, 2017[52]).

- **Better support to countries in transition** through adequate capacity building (e.g. debt management support), investment in enablers (e.g. domestic resource mobilisation, trade and investment promotion) and in channels (e.g. financial system, business environment);
- **Better mitigation of the effects of ODA phasing-out and resilience building**, as well as definition of new forms of co-operation less funding-focused.

2.2. Sectoral perspective

This analysis of transition finance trends and challenges could be conducted at an even more granular level. Indeed, the recent OECD report on *Sector Financing in the SDG Era* (OECD, 2018[12]) provided, for the first time, the sectoral allocation of official development finance which comprises ODA and OOF. The following section builds on this work to refine the picture of transition finance. Unfortunately, the same level of granularity does not exist for all sources of transition finance (e.g. for FDI).

While preliminary, this analysis shows the potential of the transition finance approach to better understand the **challenges associated with financing sectors**. A main conclusion is that **not all sectors have similar patterns of transition finance**: substitution takes place at different stages of transition, and not all sectors are better off in terms of financing as the country becomes richer. Transition results in either a financing surplus or financing gap, raising questions about the resilience of ODF, and stressing the need for heavy and early investment in building domestic capacity or opening markets in selected sectors.

As explained in *Sector Financing in the SDG Era*, **the sectoral analysis of transition finance could help better assess of ODF contribution to the SDGs and the measurement of financing gaps**. It could also allow **drawing policy recommendations for the DAC that are sector-specific**.

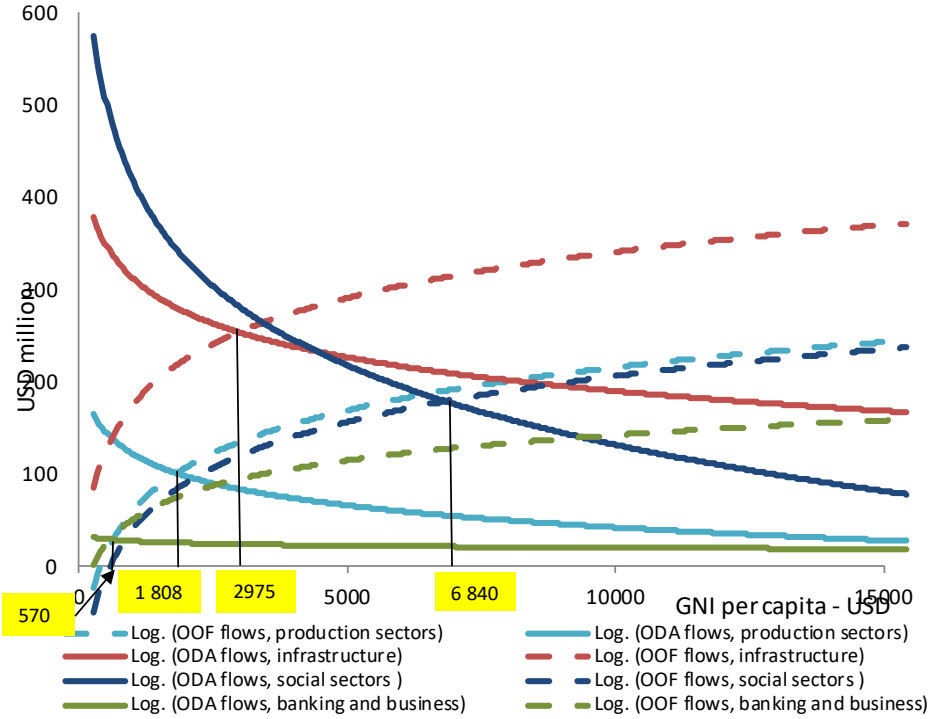
2.2.1. Sectoral tipping points

Looking at the dynamics of the allocation and respective roles of ODA and OOF (i.e. the move to more or less concessionality and the change in financial instruments– see Box 2.1) as countries transition, **it appears clearly that transition finance challenges are sector specific**.

Figure 2.2 shows those dynamics for four key SDG-related sectors: banking (SDG 8), production (SDGs 8 and 12), infrastructure (SDG 9), and social sectors (SDGs 3 and 4). Those dynamics could be explained through the analysis of tipping points – the intersection of the ODA and OOF curves that signifies an inversion of the volumes of two types of resources, and the slope of the curves – a steep decline of ODA showing a faster disengagement of DAC members or faster substitution of non-concessional finance.

Figure 2.2. Substitution of ODA with OOF happens at different stages of transition across sectors

USD million commitments, 2012–16 average, 2016 prices



Source: Authors' calculations based on (OECD, 2018[8])'Creditor Reporting System database (ODA and OOF flows).

The share of OOF in external finance becomes greater than the share of ODA at very different stages of transition across sectors:

- Very early in the **banking and business sector** (LIC – USD 570 of GNI per capita): This shows the clear private sector orientation of this area. ODA is minimally used, or at least not in a visible way (e.g. assistance could be provided through budget support).
- At LMIC stage (USD 1 808 of GNI per capita) for **production sectors**: Again, this is not surprising given the private sector orientation of this area. However, OOF quickly picks up in this sector, revealing significant potential return on non-concessional funding (both from the supply and demand sides).
- At a later LMIC stage (USD 2 975 of GNI per capita) for **infrastructure**: Second largest sector of our sample at the lower end of the transition spectrum, infrastructure becomes the largest at the higher end when countries reach high-income status. It is also by and large the most attractive sector for OOF all along the transition spectrum.
- Substitution happens last in **social sectors** (UMIC – USD 6 840 of GNI per capita): This is a traditional area of intervention for the DAC with ODA. However, the slope of the curve shows that disengagement of the DAC is extremely rapid, suggesting that transition finance challenges could be more acute, and transition even better prepared.

This implies forms of intervention that include domestic resources mobilisation, institutional capacity building, skills development, market opening, etc. able to ensure resilience of progress made towards the SDGs and avoid any kinds of setbacks.

Further analysis should address a number of challenges associated with transition finance in sectors. For example, companion country pilots (e.g. Zambia) balance the need for financing infrastructure with the **risk of debt** when the terms and conditions of non-concessional finance are not sufficiently favourable. There is also a potential for using transition finance analysis to back the **cascade approach** with additional quantitative and empirical information, facilitating the identification of public and private funding opportunities on the basis of a country's position in the transition spectrum.

2.2.2. Sectoral transition gaps and surpluses

It is not enough to know at which point substitution between different sources of financing occurs**. Comparing the financing situation of the sector before and after the tipping point, is the country better or worse off? In other terms, has the evolution of the financing mix through transition created a financing gap or surplus?**

This question should be answered with great care, in particular in the absence of disaggregated data for non-official development finance flows. **A transition finance gap is not necessarily a bad thing**: It could be the result of a successful creation of markets and, in the logic of the cascade[24], a normal withdrawal of external public engagement to the benefit of the private sector or domestic public spending. A transition finance gap **could be problematic, however, if DAC disengagement is not mirrored by a growth of private or domestic financing**. A transition finance gap could become a stumbling block on the journey to the SDGs. Similarly, a transition finance surplus could be problematic if it generates excessive debt. Therefore, the analysis of transition gaps and surpluses is essential to making policy recommendations on transition finance. It could also significantly help portfolio managers in their investment planning.

This section provides **four examples of sectoral transition gap analyses** covering the areas of the production sector, social sector (and health sub-sector), and energy sector.

Figures 2.3 to 2.5 show that, when summing up ODA and OOF, a transition finance gap or surplus may appear. Again, this should be interpreted with great care, and not be perceived upfront as positive or negative, but it is a valuable information to guide policy makers and portfolio managers. Exploring the four scenarios:

- In the case of **production sectors** (Figure 2.3), a **financing gap** appears very early in the development spectrum (USD 200 of GNI per capita, i.e. LIC stage). The gap **disappears**, however, when the country reaches USD 2 000 of GNI per capita (LMIC). This suggests that the DAC could move faster to non-concessional finance – however the gap can probably be due to the absence of absorption capacity, or interest, of the private sector. Or it could be interepreted as a premature abandonment of concessional finance in a sector not yet ripe for private or non-concessional financing.
- In the case of **social sectors** (Figure 2.4), the **gap** appears at a later stage (USD 2 000 of GNI per capita) but is **never filled and increases** as countries transition. This calls

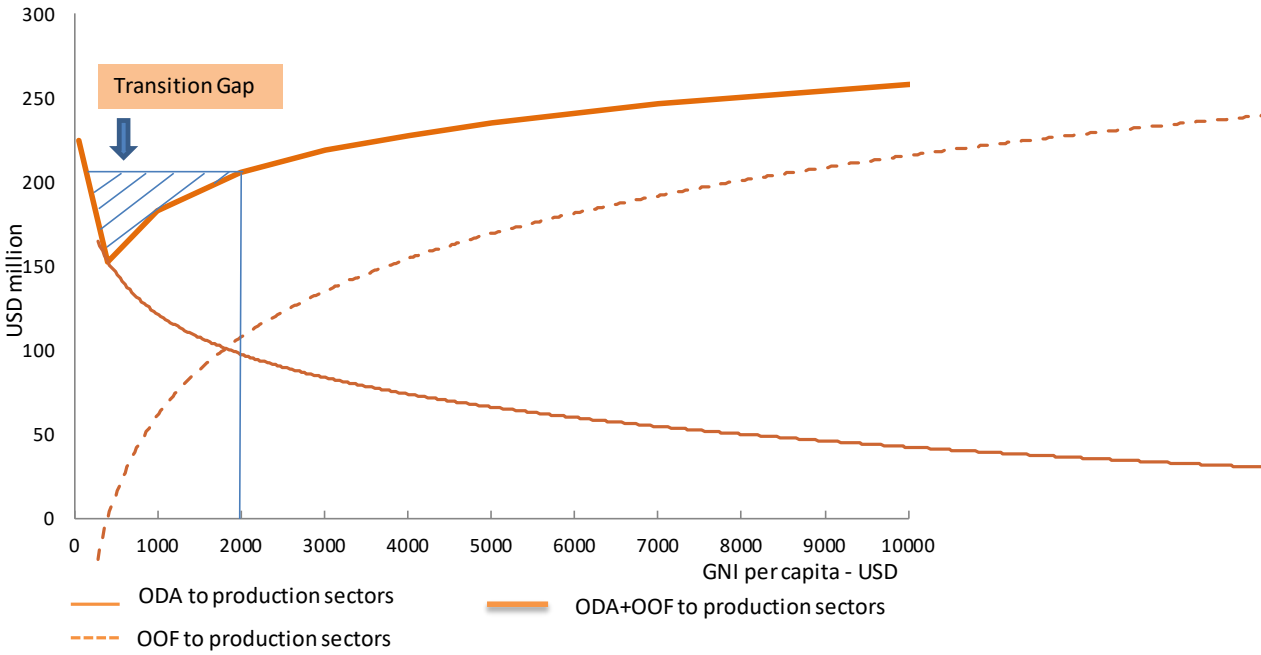
[24] The World Bank introduced the cascade approach to "create markets and leverage more private financing" (World Bank Group, 2017[53]). The cascade approach seeks to first mobilise commercial finance and use official and public resources only when market solutions are not feasible or within reach only through upstream reforms.

for either more continuous support of the DAC for social sectors as countries transition, or early efforts to mobilise domestic resources and build capacity or open markets to sustain financing to the sector (and associated SDGs).

- This conclusion applies even more so to the **health sub-sector** (Figure 2.5 right) where the transition **gap is extremely wide**. DAC members should be particularly vigilant when such a picture emerges, because it could translate into a situation of "everything to nothing". Indeed, high dependence on ODA increases the acuteness of transition finance challenges and the need to deploy resilience measures.
- The **energy sector** (Figure 2.5, left) provides an example of **perfect substitution** between ODA and OOF with a constant level of financing throughout the transition spectrum, from low to high income.

Figure 2.3. A transition gap appears when the substitution of financing flows is not perfect

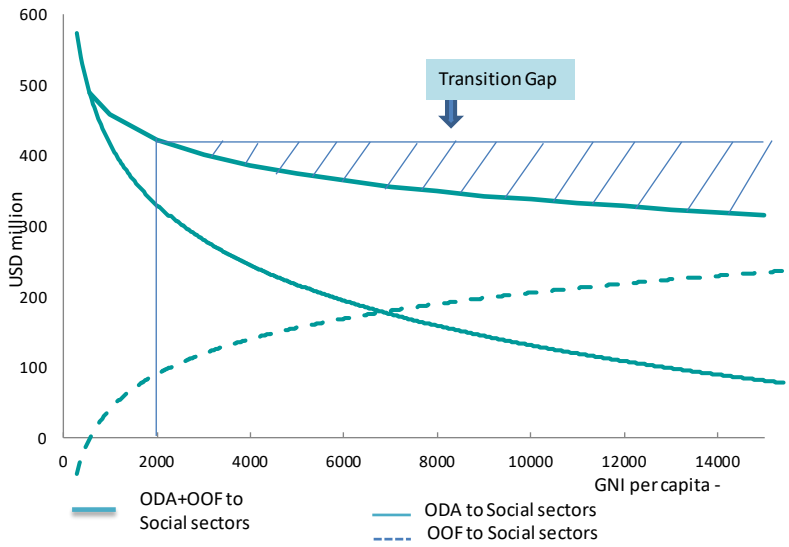
USD million commitments, 2012–16 average 2016 prices.



Source: Authors' calculations based on (OECD, 2018[8])'Creditor Reporting System database (ODA and OOF flows).

Figure 2.4. Transition gap: the case of ODA and OOF to social sectors

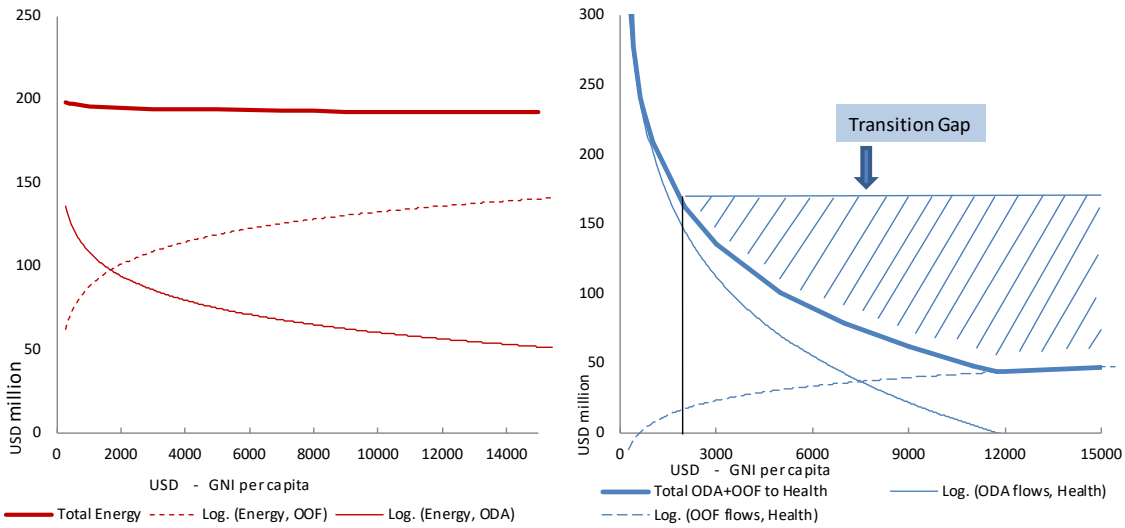
USD million commitments, 2012–16 average, 2016 prices.



Source: Authors' calculations based on (OECD, 2018[8])'Creditor Reporting System database (ODA and OOF flows).

Figure 2.5. In energy there is no financial gap at all, in contrast, the transition gap in the health sector seems deep and permanent

USD million commitments, 2012–16 average, 2016 prices.



Source: Authors' calculations based on (OECD, 2018[8])'Creditor Reporting System database (ODA and OOF flows).

Potential for further research in this area is significant. Understanding the nature of transition gaps is crucial for the DAC to more effectively deploy its resources. Financing gaps also for the DAC to react at particular stages of transition in order to ensure a healthy phasing out of ODA, thereby avoiding setbacks. For example, should the DAC deploy new sources of finance or reallocate existing ones, and/or leverage more OOF (if the

recipient's debt levels allow it)? Also, selecting the appropriate type of aid is crucial: are in-kind or project-type interventions better suited to face needs or is capacity building, for example, a more adequate and socially profitable way of delivering assistance?

To think holistically, from a DAC portfolio-management point of view, requires considering both the tipping point and transition gap/surplus concepts, as key elements to better grasp the financial needs (demand), and respond adequately with the most efficient mix of financial solutions (supply).

3. Benchmarking and counselling: How to tailor transition finance solutions to country contexts?

The optimal transition finance mix is country specific. Nonetheless, lessons can be learned from the success and failure of certain countries to attract certain types of finance. In this sense, the objective of this section is to develop a methodology for benchmarking, and provide initial conclusions of this exercise.

First, it appears that benchmarking among countries in the same income group does not allow for a compelling enough analysis. Most outliers are either resource-rich countries or countries with an exceptionally small (such as SIDS) or large population. In other terms, natural resource endowment and population size are more determinant of countries' transition finance mix than the level of income alone.

This calls for a benchmarking of countries with similar characteristics, for example within categories of countries most in need (such as LDCs or SIDS) that share a number of characteristics and vulnerabilities. The paper not only identifies outliers within those categories, but also compares the transition finance trends and dynamics observed in those countries with those observed in other developing countries. On that basis, it draws a number of recommendations for the DAC that are tailored to those categories, and could help improve the transition finance mix of those countries.

Finally, this section provides an example of benchmarking and identification of transition finance recommendations at country level – introducing a methodology to be used and further refined in companion country pilots.

The previous sections introduced the concept of transition finance and suggested methods to assess the dynamics and trends of different sources of development finance as countries transition. As explained, the finance mix varies according the level of development, with key milestones and tipping points where the prevalence of some sources ends to the benefit of others (e.g. substitution of concessional with non-concessional finance, or public by private finance). In most cases, this transition results in a finance gap or surplus that should be compensated by an adjustment of domestic resources. A more granular approach also revealed the sector-specificity of these dynamics and trends.

Each country, each sector within each country, follows its own transition path. One can only assess general dynamics and trends, and compare a country's path to the one of others. Benchmarking is a useful tool that allows for such comparison and draw lessons for the way forward. For example:

- Looking at different countries with the same level of income, why are some better or worse than others at attracting certain types of financing? Does it have to do with policies or characteristics of the countries beyond income?
- Looking at a country's peers (e.g. same economic structure, same vulnerabilities) or aspirational peers, what policies have allowed a greater access to transition finance or the reduction of dependence on specific types of financing?

This section explores the question of transition finance benchmarking, and attempts to identify transition finance outliers (best and worst performers) from which lessons could be learned. Starting with benchmarking among countries in the same income categories, the analysis reveals that other factors than income levels should be taken into consideration. It identifies a number of country characteristics that shape transition finance paths, such as resource endowments or population size, and progressively moves to benchmarking countries in categories defined around specific characteristics or vulnerabilities, such as small island developing states (SIDS), land-locked developing countries (LLDCs), or least developed countries (LDCs). Finally, it includes an example of benchmarking at country level with selected peers, as developed in the companion transition finance country pilots, since the ultimate objective of this exercise is to tailor transition finance analysis to country contexts.

3.1. Identifying and learning from transition finance outliers

As mentioned in Section 1, **the level of income remains the main criteria for the classification of countries and their inclusion into/exclusion from different country categories and financing windows**, such as LDCs or List of ODA Recipients. **The aspiration of countries is to move up income categories towards greater wealth and wellbeing.** Securing finance for transition, either domestic or external, is essential to success. Hence, **what could be learned from outliers that are better or worse at attracting certain types of finance than others in their income category?**

The analysis below takes the examples of OOF and private sector flows, and identifies a number of **outliers**. Thereby, it also reveals the limits of a benchmarking exercise based on income only. In line with literature, **the analysis points at natural resources (commodities) endowments and market size as key determinants of a country's capacity to attract OOF and private finance** – especially for FDI.[25][26] Only a few outliers remain once those biases are removed.

3.1.1. Other official flows

Figure 3.1 shows which countries depart most from the trend and have a higher share of OOF/total external flows than other countries in their income group. **A dozen countries are identified as outliers, among which nine are commodity-based economies**. Ukraine, Paraguay and Belarus stand out as the only real outliers.

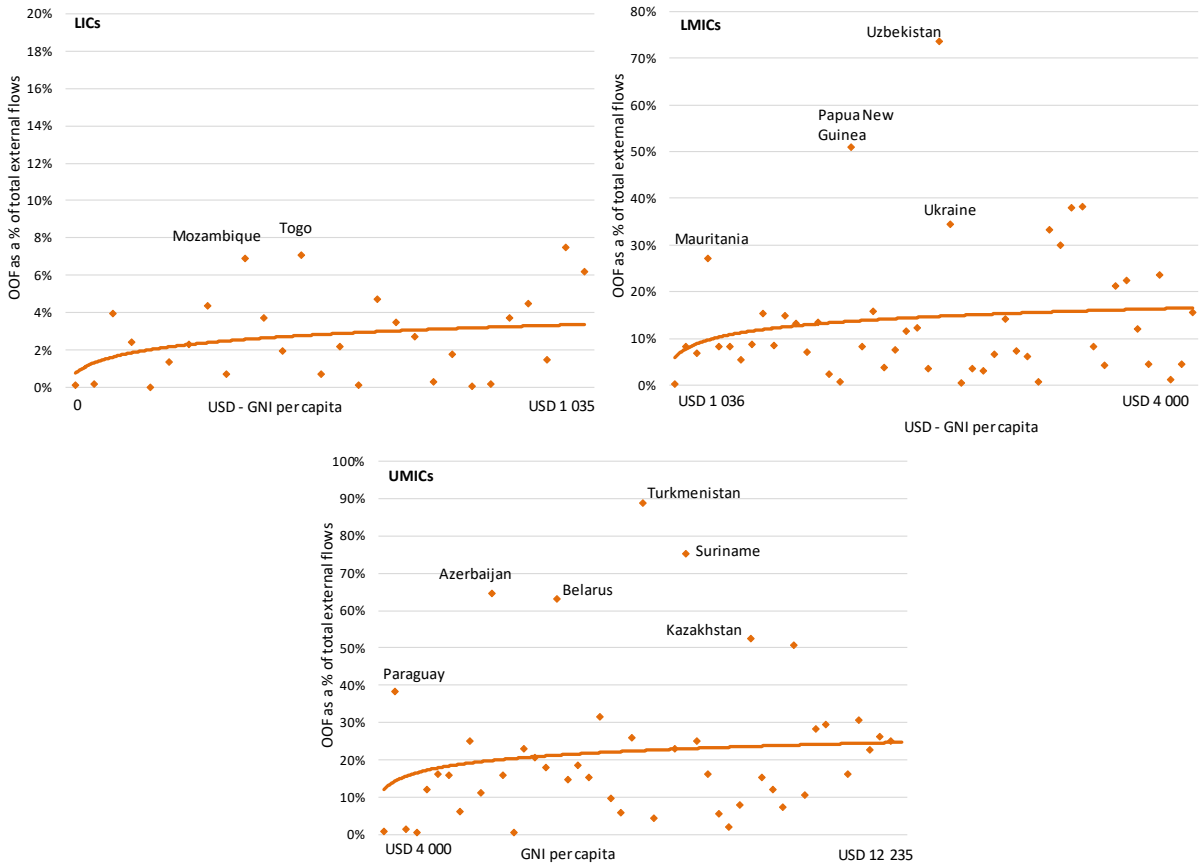
Further analysis should help explaining the performance of the outliers. Among others, consideration should be given to geopolitical (e.g. for Ukraine) and macroeconomic conditions (e.g. for Paraguay).

[25] See (Gómez, 2009[31]); (Kalirajan, 2010[32]); (Kawaguchi, 1994[29]); (Venables, 2000[30]) etc.

[26] As mentioned above, debt sustainability issues are not expounded on in this paper, but constitute a factor to be considered in further work.

Figure 3.1. Outliers in attracting higher shares of non-concessional flows: LICs, LMICs and UMICs

DAC, non-DAC OECD members and multilateral agencies' outflows, 2012–16 net disbursements, 2016 prices.



Source: Authors' calculations based on (OECD, 2018[8])'Creditor Reporting System database (OOF flows).

Table 3.1. Outlier by income group: are they commodity-based economies?

	OOF champion (1)	Commodity-based economy (2)
LICs	Mozambique	Yes
	Togo	Yes
LMICs	Mauritania	Yes
	Papua New Guinea	Yes
	Ukraine	No
	Uzbekistan	Yes
UMICs	Azerbaijan	Yes
	Belarus	No
	Kazakhstan	Yes
	Paraguay	No
	Suriname	Yes
	Turkmenistan	Yes

Note: The threshold used to categorise an economy as commodity-based is 10%, i.e. if more than 10% of GDP has a commodity origin, then the economy is defined as commodity-based.

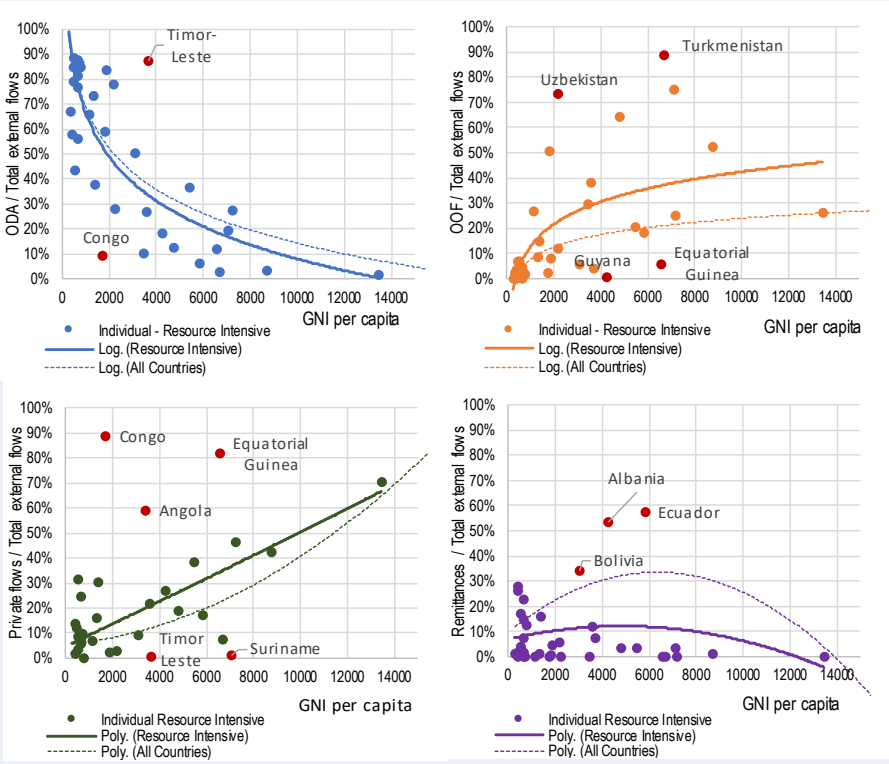
Box 3.1. Resource endowment and transition finance mix

Comparing transition finance trends in resource-rich countries to other countries confirms that resource endowment is a major factor of attractiveness for private sector and OOF (see Figure 3.2).

Well-known to the economic literature, this stylised fact raises a number of policy considerations for transition finance and the DAC. For example, the prevalence of OOF over ODA should not result in neglecting social sectors (health and education) or institutional capacity building that are even more essential in resource rich countries (needs for infrastructure and higher share of OOF and private sector flows also raises questions with regard debt sustainability); how to best use ODA and other resources to promote diversification of the economy and reduce excessive reliance of certain commodity exports? Figure 3.3 also highlights countries departing most from the trend, and have been the best or worst at attracting different types of finance.

Figure 3.2. Outliers by type of financial flows

DAC, non-DAC OECD members and multilateral agencies' outflows, 2012–16 net disbursements, 2016 prices.



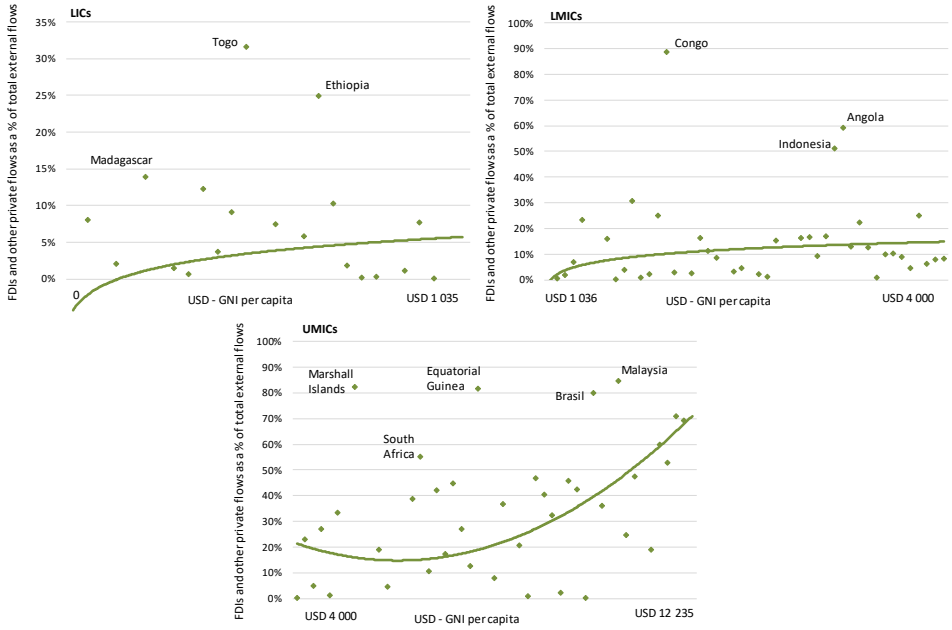
Note: The four charts illustrate the external finance mix at each stage of development. Solid line corresponds to the trend line of the resource rich countries, dotted line corresponds to the trend line of all countries, data points corresponds to each resource rich country individual share of external flow. Flows are split between ODA, OOF, private, and remittances the note here. If you do not need a note, please delete this line.
Source: Authors' calculations based on (OECD, 2018[8])'Creditor Reporting System database (ODA, OOF flows, and private flows), (World Bank, 2018[9]), "migration and remittances data', and (IMF, 2017[11]) 'Balance of Payments' database (FDI, portfolio investments, and long-term and short-term debt).

3.1.2. Private sector flows

A similar analysis is conducted for private flows. Figure 3.3 highlights countries departing most from the trend in terms of share of private sector in total external financing. Again, a **dozen countries are identified as outliers** in Table 3.2, with a **vast majority of resource-based economies and/or countries with large domestic markets**.

Figure 3.3. Outliers in attracting higher shares of private flows: LICs, LMICs and UMICs

DAC, non-DAC OECD members and multilateral agencies' outflows, 2012–16 average, net disbursements, 2016 prices



Source: Authors' calculations based (IMF, 2017[11]) 'Balance of Payments' database (FDI, portfolio investments, and long-term and short-term debt).

Table 3.2. Outlier by income group: are they commodity-based economies? Are they big market?

Income grouping	Private flows champion (2)	Commodity-based economy (3)	*Population Million (4)*
LICs	Ethiopia	Yes	
	Madagascar	Yes	
	Togo	Yes	
LMICs	Angola	Yes	
	Congo	Yes	
	Indonesia	No	*264*
UMICs	Brazil	No	*209*
	Equatorial Guinea	Yes	
	Malaysia	No	32
	Marshall Islands	No	*0.05*
	South Africa	No	*57*

Note: The threshold used to categorise an economy as commodity-based is 10%, i.e. if more than 10% of GDP has a commodity origin, then the economy is defined as commodity-based; Marshall Islands attract high levels of non-FDI private flows (bank and non-bank securities) because of its tax haven condition (See footnote 23).

This analysis confirms that **two of the most significant determinants of a country's attractiveness for private external finance are resource endowments and market size**. It also shows the **limits of a benchmarking exercise that elects income as sole criteria for sample selection**.

3.2. Comparing transition finance trends and dynamics in countries most in need

The previous section revealed the limits of a benchmarking exercise that solely uses income to classify countries. The following section uses the **narrower lens of selected country most in need categories (SIDS, LDCs, and LLDCs) that share common characteristics beyond income levels**. For each of those categories, transition finance trends and dynamics are compared to those generally observed (i.e. for all countries), and outliers are identified.

This approach is in line with the OECD DAC most recent work that aimed to develop co-operation approaches and tools tailored to respond to a wide variety of country contexts, with a special focus on countries most in need (LDCs, LICs, LLDCs, SIDS and fragile countries).[27]

3.2.1. Small island developing states

The OECD DAC identifies 35 countries[28] as SIDS located across different geographic areas: the Caribbean, the Pacific, and the Atlantic, Indian Ocean, Mediterranean and South China Sea (AIMS). SIDS share a number of structural challenges and geophysical constraints that result in disproportionately large economic, social and environmental challenges. These structural features have a major impact on their ability to access development finance at any stage of transition (OECD, 2018[13]), (OECD, GFDRR, 2016[14]). SIDS share a number of common characteristics, such as small geographic and population sizes, remoteness and high exposure to environmental disasters. However, they are a disparate group in terms of income level,

[27] At the 2014 DAC High-Level Meeting (HLM), ministers recognised the need to better target concessional finance and agreed to "allocate more of total ODA to 'countries most in need', including least developed countries (LDCs), low-income countries, SIDS, landlocked developing countries and fragile and conflict-affected states". The DAC reaffirmed this commitment at its 2016 HLM, acknowledging the need to better tailor development co-operation instruments and approaches to different country circumstances and needs. In its May 2017 meeting, the DAC discussed the issue of transition finance in general and how it relates to countries most in need, in particular. More recently, the 2017 DAC High Level Communiqué called for "analytical work to help identify where ODA is most needed (such as in least-developed countries, low-income countries, small island developing states, landlocked developing countries, and fragile and conflict-affected contexts) and where additional actions may be required" (para. 19). It recognised "the need to ensure that development co-operation approaches and tools can effectively respond to the new complexity of sustainable development by providing appropriate support to countries as they transition through different phases of development" (para. 20). The Communiqué also called for review and reflection "on the evidence base that documents the consequences of different graduation processes on access to development finance from all sources, and (…) policy analysis on the different patterns of co-operation, including financing, channels, and objectives in countries in transition" (para. 20).

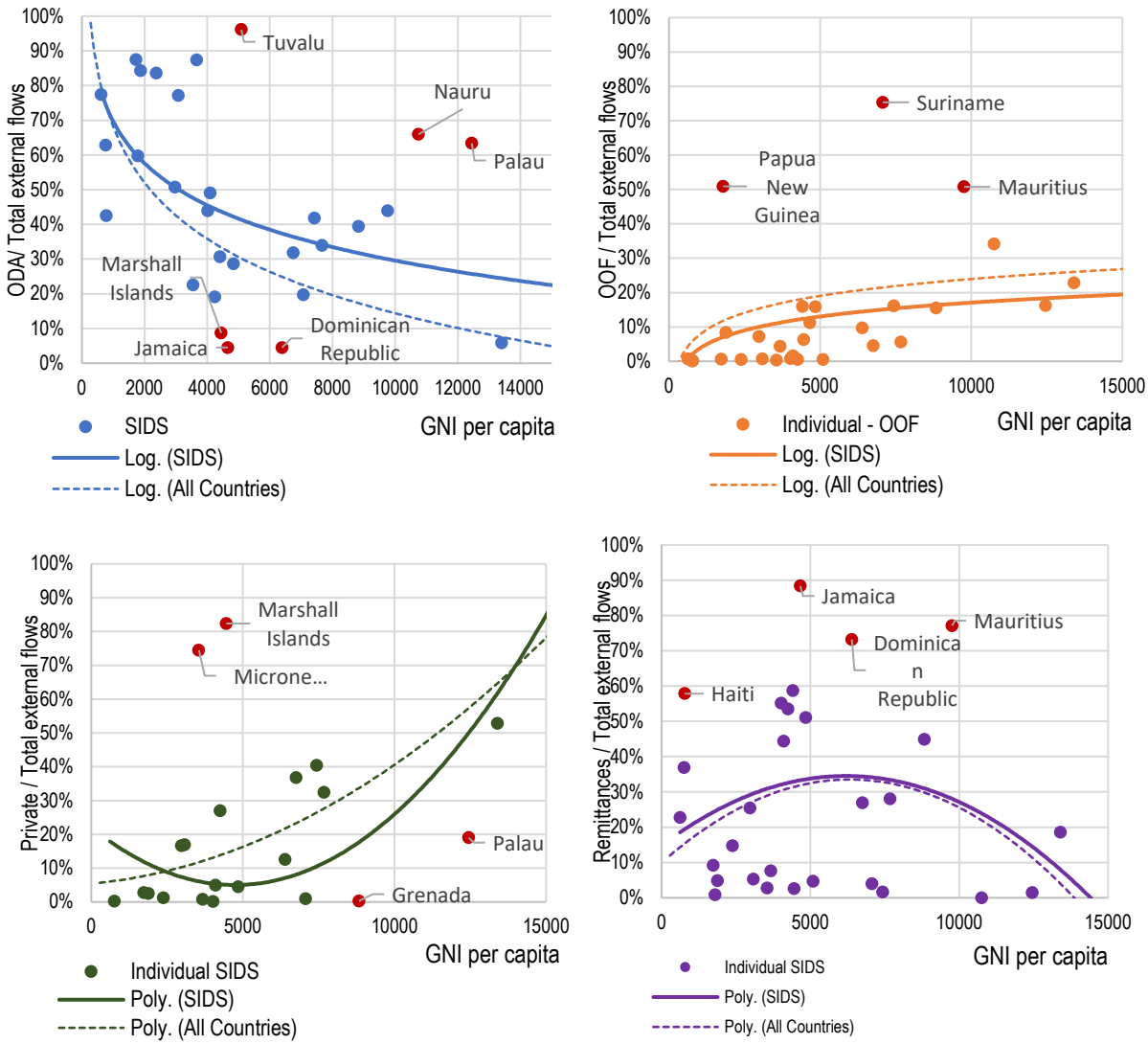
[28] As with other country groupings, there are several definitions of SIDS. The United Nations identify 52 countries or territories under this grouping. They first defined a SIDS grouping in 1992, then came others such as the European Union with ACP (Africa, Caribbean and Pacific), and the World Trade Organisation with the economic vulnerability index (Small Vulnerable Economies). The World Bank has been applying a small island exception in determining IDA eligibility since 1985.

population density, geographic spread and relative development progress. While most SIDS are UMICs (24 countries); eight are LMICs and another three are LICs.

Figure 3.4 shows **trends and dynamics of transition finance in SIDS** compared to those generally observed (i.e. in all countries). The main conclusion is that **SIDS are more dependent than other countries on ODA, with a lower share of OOF and private finance than average, at all stages of transition.**

Figure 3.4. SIDS rely heavily on ODA at all stages of development

DAC, non-DAC OECD members and multilateral agencies' outflows, 2012-16 net disbursements, 2016 prices.



Note: The four charts illustrate the external finance mix at each stage of development. The solid line corresponds to the trend line of SIDS, the dotted line corresponds to the trend line of all countries, data points correspond to each resource-rich country's individual share of external flow. Flows are split between ODA, OOF, private, and remittances

Source: Authors' calculations based on (OECD, 2018[8])'Creditor Reporting System database (ODA, OOF flows, and private flows), (World Bank, 2018[9]), "migration and remittances data', and (IMF, 2017[11]) 'Balance of Payments' database (FDI, portfolio investments, and long-term and short-term debt).

In addition, a number of **outliers** appear that have a significantly different finance mix than the average SIDS. What lessons could be drawn from the observation of those trends and dynamics, as well as the analysis of contexts or policies that might explain the singularity of some SIDS with regard transition finance? For example:

- How to explain the higher dependence of Tuvalu, Nauru and Palau, and the lesser dependence of the Marshall Islands, Jamaica and the Dominican Republic on ODA? Clearly some factors are not policy related (e.g. extreme remoteness and small size of the former three SIDS), but this observation should call for even more efforts on behalf of the DAC to address those specific situations of extreme dependence.
- How to explain the larger share of OOF in Papua New Guinea, Suriname and Mauritius, or the larger share of private finance in the Marshall Islands and Micronesia?
- How to explain the disparities in terms of the role of remittances in financing transition of the different SIDS? (see Cabo Verde benchmarking exercise below)

The idea is not that a finance mix is better than another one, or that attracting more private finance is better than ODA – on the contrary, it could be a sign of e.g. non-cooperative tax policies.[29] Nonetheless, **an excessive dependence on one source of financing or another could be both a cause and a result of higher vulnerability. Policies and DAC support should aim at reaching an optimum mix at different stages of transition.** This analysis suggests that, **in spite of good results in attracting ODA, SIDS do not have an optimum finance mix, remain in need of transition finance diversification, and the emphasis of ODA on creating markets – as hard as it could be, for instance by promoting the blue economy – is to be increased.**

Box 3.2. The SIDS ODA dual dependence conundrum

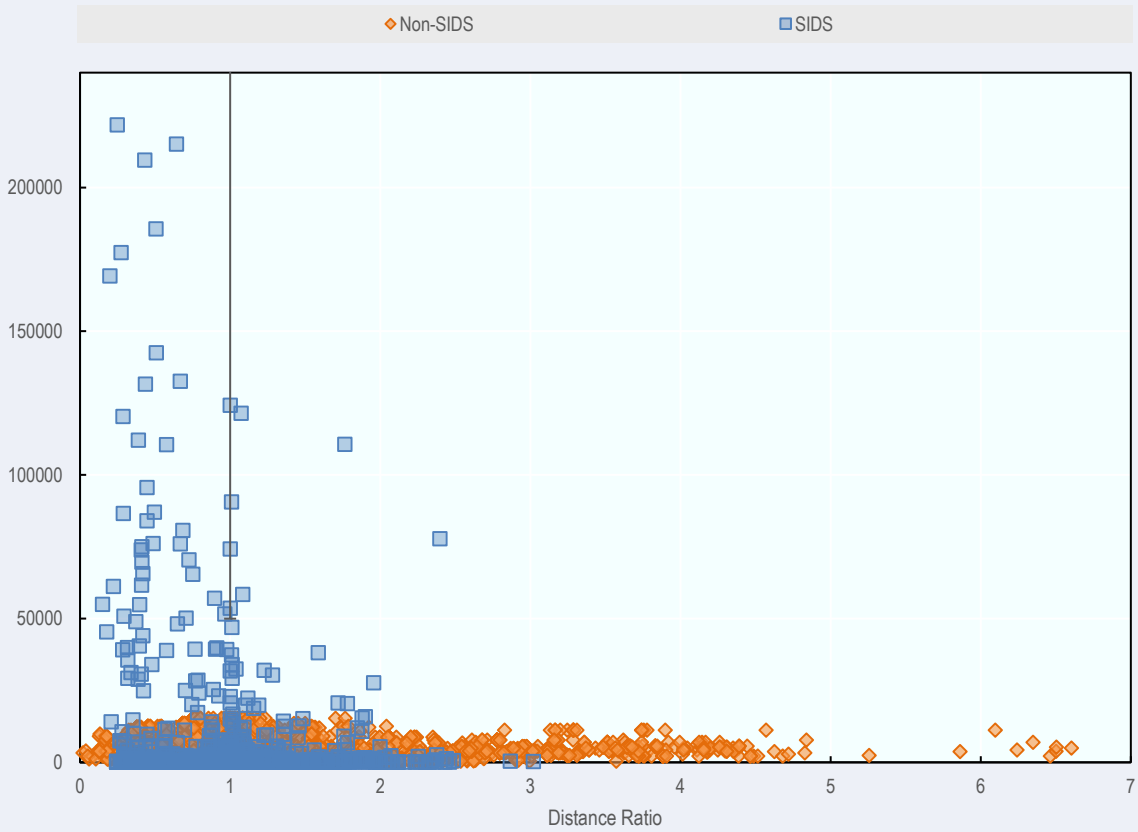
At any given stage of transition, SIDS receive higher levels of ODA per capita than their peers. On one hand, this could be positively interpreted as a reflection of their good capacity to mobilise for their cause; on the other hand, however, it could be negatively interpreted as a reflection of their high dependence on ODA and lack of attractiveness for other actors. The latter explanation better reflects conclusions of recent research on the topic (OECD, 2018[15]). SIDS possess special characteristics and share common vulnerabilities: exposure to climate change and disaster, heavy reliance on imported food, dependence on few economic markets. Because of high transportation cost and incapacity to produce goods locally (no economies of scale), SIDS mainly rely on trade and exchanges with their most proximate markets. This single sourcing increases their economic vulnerability and exposure to exogenous economic shocks.

Figure 3.5 illustrates this vulnerability and the dual dependence of SIDS: on ODA and on neighbouring larger markets. While SIDS receive more ODA than other countries with the same level of income, they receive it mainly from neighbouring countries. This finding has been already exemplified in in the literature, but failed to distinguishing between SIDS and non-SIDS countries.

[29] For example, **Marshall Islands**, **Micronesia**, **Palau** and **Grenada** belonged to the 17 jurisdiction considered as tax havens by the European Commission. As of December 5th: more than half of the jurisdiction on the EU list were also belonging to the SIDS list.

SIDS need more diversified transition finance, both from the perspective of the types of resources (e.g. harnessing the challenge of attracting private investment), and from the perspective of the donor spectrum. **When donors face economic crises, there are highly likely to reduce their aid by significant amounts**. Dang & al. estimated that donors reduce their aid contribution by 28% after being hit by banking crisis (Dang, Knack and Rogers, 2013[16]).

Figure 3.5. Relative distance of donors vs ODA per capita



Note: The x-axis represent the ratio between the distance of a donor and its recipient and the median distance of a donor and all its recipients. A ratio lower than 1 indicates that a recipient is closer to a donor than the average recipient is, and when the ratio is superior to ones it indicates that the recipient is more distant from the donor. Y axis represent the ODA per capita received by all aid recipients from each donor.
Source: Authors' calculations

Responding to this challenge of dual dependence has two tracks:

- Making the case for the SIDS, so that more donors join their support group, and exposure to macroeconomic shocks imported from immediate neighbours is reduced;
- Diversifying the official development finance provided by traditional donors, for further encouraging self-sustained growth, as most ODA to SIDS is directed to social rather than productive sectors.

Development of infrastructure and improvement of governance are essential in attracting private investment. For example, Mauritius has been a champion in attracting FDI with USD 3 605 per capita in 2016 ranking highest compare to its regional peers. As UNCTAD report noted: "*The economic performance of Mauritius was largely the result of the policy commitment towards maintaining a stable macroeconomic environment, a predictable regulatory regime and a reputation for good governance. It was also the result of effective use of trade preferences, particularly with Europe and India, and of a consistent policy effort aimed at establishing a competitive investment climate*" (UNCTAD, 2017[17]). Investments in productive sector have led to impressive results with Mauritius being a regional leader in ICT and fisheries contributing to 18% of exports earnings.

Regional donors should continue to engage in financing private sector development and emergence of economic sectors to reduce SIDS vulnerabilities and diversify their sources of financing.

3.2.2. Least developed countries

The LDC category includes 47 countries, representing 13% of the world's population and 38% of the world's extreme poor. These 47 countries are categorised as having long-term structural handicaps measured by three indicators, recorded simultaneously. A country can be included in the LDC category if, its GNI per capita (Atlas method, World Bank) is lower than USD 1025, its human asset index (HAI) is lower than 60, and its economic vulnerability index (EVI) is above 36. The dispersion of LDC countries is heterogeneous when looking solely at the income level: 30 countries are LICs, 15 are LMICs, and two are UMICs. Therefore, the general assessment of LDCs financial mix is largely skewed toward the pattern observed for LICs in Figure 2.1.

Despite progress in poverty reduction, LDCs still face structural issues such as low productivity, low economic base and high exposure to economic shocks and disasters: commodity prices, climate change, epidemics, and natural disasters.[30]

Figure 3.6 compares **trends and dynamics of transition finance in LDCs** to those observed on average (i.e. all countries). Main observations are:

- The **share of ODA in external flows is higher for LDCs than for other countries** – this could be explained by specific pledges made by the development community and the DAC in favour of LDCs, such as the 0,15%-0,20% of GDP pledge, or access to certain financing windows independently of their income level.[31] This discrepancy has been largely explored by the economic literature (see e.g. (Alesina and Dollar, 2000[18])). Again, Tuvalu, Angola and Equatorial Guinea appear as outliers.
- **LDCs have, on average, a lower share of OOF and private sector finance in external finance**. This is the flip side of the coin, reflecting the higher dependence on ODA and their vulnerability. LDCs have difficulties accessing capital markets (Presbitero et al., 2016[19]) and attracting foreign investment, lacking quality infrastructure, institutions and policies (Gelos, Sahay and Sandleris, 2011[20]) (Morrissey and Udomkerdmongkol, 2012[21]). It also makes the case for special and differential treatment aimed at promoting trade and investment, hence private sector financing. Mauritania, Angola, Togo, and Timor Leste appear as outliers.

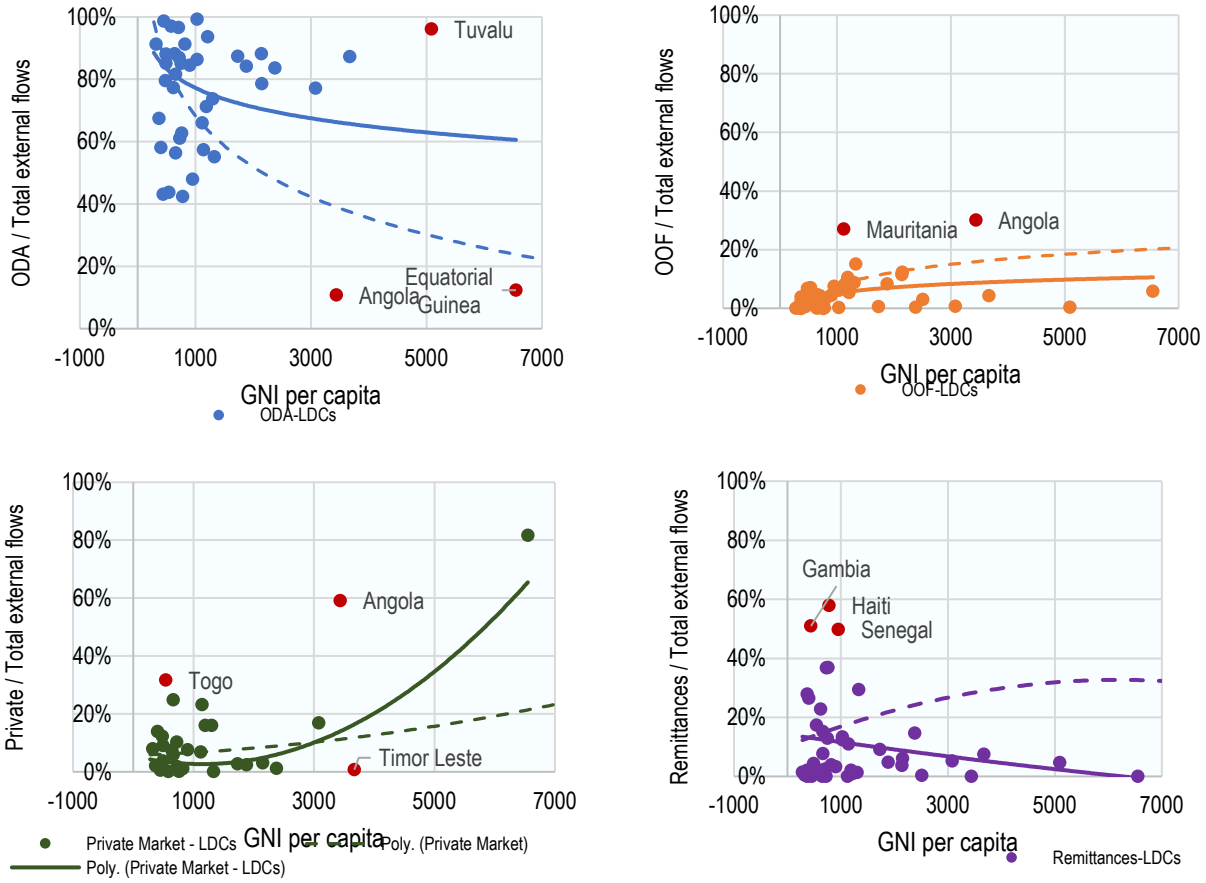
[30] http://unohrlls.org/custom-content/uploads/2016/08/State-of-LDCs2016.pdf
[31] DCD/DAC(2014)50

- On average, **LDCs attract less remittances than other countries**. In addition, they have **higher transfer costs**: 10% compare to 8.1% world average, far from the SDG target of 3%. These high transfer costs could indicate lack of competition and development of financial services (Beck and Martínez Pería, 2011[22]). Gambia, Haiti and Senegal emerge as outliers – the latter two benefiting from their large diaspora in the US and France[32].

In other terms, **while LDCs have been successful in attracting more ODA, they still have extreme difficulties attracting private sector investment and accessing financial markets or even non-concessional public finance**. This is illustrated, for instance, by recent research on blended finance that shows that LDCs receive only 7% of all private finance mobilised between 2012 and 2015 (OECD, 2018[23]).

Figure 3.6. LDCs rely highly on concessional finance and fail to attract remittances

DAC, non-DAC OECD members and multilateral agencies' outflows, 2012-16 net disbursements, 2016 prices.



Note: The four charts illustrate the external finance mix at each stage of development. The solid line corresponds to the trend line of LDCs, the dotted line corresponds to the trend line of all countries, data points correspond to each resource-rich country's individual share of external flow. Flows are split between ODA, OOF, private, and remittances.

[32] Around one million Haitians live in the USA and it is estimated that around 300 000 Senegalese live in France

Source: Authors' calculations based on (OECD, 2018[8])'Creditor Reporting System database (ODA, OOF flows, and private flows), (World Bank, 2018[9]), "migration and remittances data', and (IMF, 2017[11]) 'Balance of Payments' database (FDI, portfolio investments, and long-term and short-term debt).

3.2.3. Land-locked developing countries

The LLDCs category is a grouping of 32 developing countries that face particular challenges related to their lack of direct access to the sea, which leads to geographical isolation from international markets. Imports and exports of goods and services need to transit through other countries. This generates higher trade costs, major logistical and infrastructure challenges (e.g. changes in transport modes, international road and rail connections with neighbours' networks). Overall, the quality of infrastructure in LLDCs remains below the world average (WEF, 2018[24]). Reaching international markets is especially difficult since neighbouring countries of LLDCs usually have similar levels of development and infrastructure challenges.[33]

Figure 3.7 allows a comparison of **transition finance flows to LLDCs** with the average for all developing countries:

- **LLDCs have only a slightly larger share than average of ODA in external flows**. Most LLDCs then receive less ODA than average as they transition, with a few notable exceptions like Eswatini and Botswana that affect the overall picture with significant ODA flows to the health sector.[34]
- With regard to private sector, **LLDCs have difficulties attracting foreign investments in early stages of transition**, but are on average at par with other countries. Ethiopia appears as an outlier, with a significant capacity to attract foreign private capital in spite of not being on the IMF list of resource-rich developing countries.[35]
- **OOF trends depart from the average as countries transition**: Uzbekistan, Kazakhstan and Azerbaijan receive significantly more OOF than other countries, probably due to their infrastructure needs in the energy sector.[36] At the opposite, Eswatini (for the reasons evoked above), Bhutan and Bolivia received a significantly smaller share of OOF than average.[37] Most other LLDCs are either on par of below average with other countries, which is surprising in light of their infrastructure investment needs.
- The **share of remittances in external finance is also significantly smaller than average in LLDCs** – probably due to the increased difficulties of emigration with

[34] Botswana and Eswatini have both extremely high level of AIDS prevalence with respectively 22% and 27% of adults suffering from AIDS (3rd and 1st world highest rate). Therefore, Botswana and Eswatini benefit from large inflow of aid support especially in the health sector (mainly from the United States and the Global Fund).

[35] Ethiopia stands out with GNI per capita of USD 660 and a share of 27% of private flow. If its large population create an attractive internal market, Ethiopia has significantly expanded its industrial base attracting foreign investment in textile manufacturing. It has implemented attractive fiscal policies with the creation of seven special economic zones linked to the Djibouti harbour through new road building (Ethiopia Investment Policies and Incentives and opportunities, UNIDO, 2017).

[36] Uzbekistan (oil, copper, and uranium), Kazakhstan (oil and metals), and Azerbaijan (oil) (and to a smaller extend Mongolia with copper and coal) engage large loans with multilateral development banks to finance their infrastructure development.

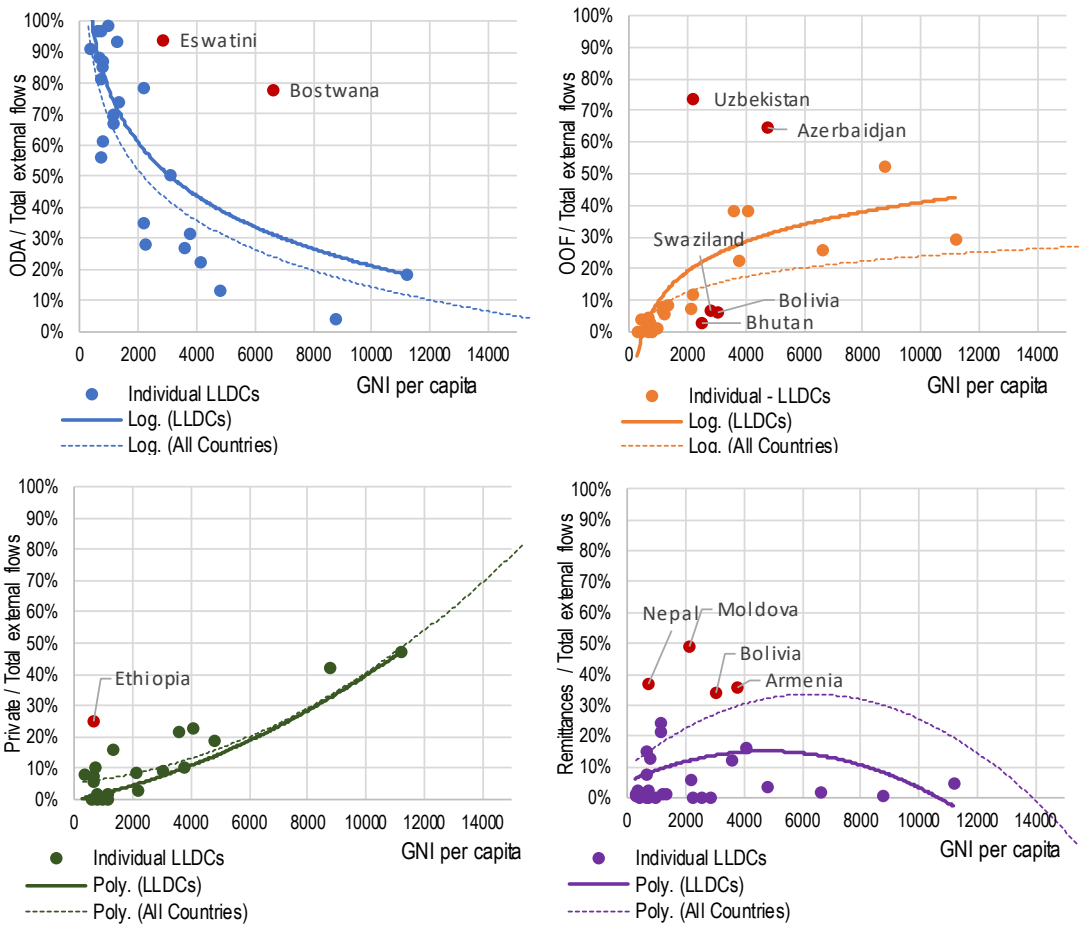
[37] Bolivia and Bhutan are not only landlocked but also have high elevation (La Paz is 3600m above sea level and Thimphou 2334m), increasing even further the infrastructure cost and reducing the financial sustainability of projects.

more countries to cross before reaching a port (Hatton and Williamson, 2005[25]), with a few notable exceptions: Nepal, Moldova, Bolivia and Armenia that have important communities abroad.

Overall, this picture shows that **LLDCs do not benefit from the attention they would deserve from the development community in terms of addressing their specific vulnerabilities**, in particular with regard their important infrastructure and private sector investment needs. Literature has shown that this could exacerbate LLDCs vulnerability by making those countries "policy locked" in addition to land locked (Borchert et al., 2012[26]).

Figure 3.7. LLDCs have higher share of OOF and lower share of remittances in their mix

DAC, non-DAC OECD members and multilateral agencies' outflows, 2012-16 net disbursements, 2016 prices.



Note: The four charts illustrate the external finance mix at each stage of development. The solid line corresponds to the trend line of LLDCs, the dotted line corresponds to the trend line of all countries, data points correspond to each resource-rich country's individual share of external flow. Flows are split between ODA, OOF, private, and remittances.

Source: Authors' calculations based on (OECD, 2018[8])'Creditor Reporting System database (ODA, OOF flows, and private flows), (World Bank, 2018[9]), "migration and remittances data', and (IMF, 2017[11]) 'Balance of Payments' database (FDI, portfolio investments, and long-term and short-term debt).

3.3. Applying transition finance benchmarking to country contexts

Moving progressively from the bigger to the smaller picture, previous sections have shown that a number of biases, including resource endowments and population size, or the inclusion in certain categories of countries most in need, affected the transition finance mix of countries, and the use of income as a sole ground for benchmarking. Even within categories of countries that share the same vulnerabilities, such as the SIDS or LLDCs, disparities exist that require a tailored approach to transition finance. The **selection of peers should be country-specific to get the most of the benchmarking exercise**, even if previous steps (within income groups or countries most in need categories) have already allowed a number of policy recommendations of relevance, for instance, in multilateral discussions on development finance.

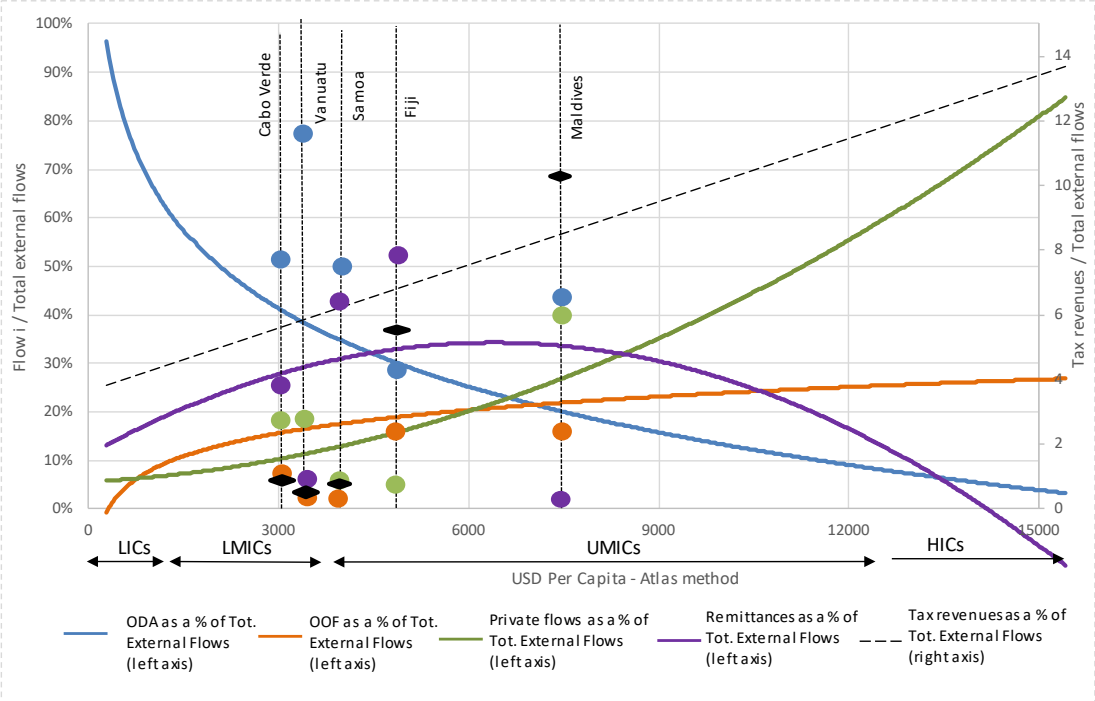
Definitions and methodologies presented in this paper are to be "operationalised" and applied to specific country contexts. This is the objective of the toolkit to be developed, and the companion country pilots that have been initiated with support of the DAC.

This section illustrates the benchmarking exercise with the examples of Cabo Verde 'Cabo Verde Transition Finance Country Pilot' (OECD, 2018[27])).

3.3.1. Country context

Figure 3.8. Benchmarking scenario for Cabo Verde

DAC, non-DAC OECD members and multilateral agencies' outflows, 2012–16 net disbursements, 2016 prices.



Source: Authors' calculations based on (OECD, 2018[8])'Creditor Reporting System database (ODA, OOF flows, and private flows), World Bank "migration and remittances data' (World Bank, 2018[9]) and (UNUWIDER, 2018[10]) 'tax revenues' database, and (IMF, 2017[11]) 'Balance of Payments' database (FDI, portfolio investments, and long-term and short-term debt).

Cabo Verde is a SIDS of 550 000 inhabitants and a GNI per capita of USD 3 000. It graduated from the LDC category in 2007. Because of its market size and other special characteristics (small island, remoteness, diseconomies of scale, environmental vulnerability), it was not just benchmarked to countries having the same GNI per capita, but compared to other SIDS. Figure 3.8 shows how financial flows to Cabo Verde, Vanuatu, Samoa, Fiji and the Maldives perform relative to the average financial mix equilibrium[38].

The transition finance picture shows that Cabo Verde, Vanuatu, Samoa and the Maldives are still **highly ODA–dependent** (blue dots), above the developing countries' average, at their respective level of development. This is not the case for Fiji that sits right on the average. Considering **non-concessional flows**, all the countries of the sample **under-perform** vis-à-vis the average (orange dots) – probably due to the multilateral actors' small islands exception for ODA that tips the balance in favour of this kind of financial support. The purple dots show the relative importance of **remittances** on each of these economies: for Cabo Verde it is **significant**, representing 25% of external finance in the period analysed, remaining on the average when compared to countries with similar GNI per capita levels. Only Samoa and Fiji present higher shares: Samoa because it has a large diaspora that is currently permanent resident of New Zealand, and Fiji because it has a significant security force working abroad for the UN's Peacekeeping Operations. Vanuatu[39] and the Maldives have lower remittances levels. In Cabo Verde, Vanuatu, and Samoa, domestic revenues are at a troublingly low level relative to their total external flows[40] (Fiji and the Maldives perform better on this indicator, even if Fiji is under the average level).

3.3.2. Policy implications

While not going into a detailed analysis (see dedicated companion country case study), what kind of policy questions emerge from this simple transition finance benchmarking exercise?

- While **ODA** is relatively high, how to maximise its benefits and better use it to facilitate transition towards a more balanced finance mix? Could ODA leverage even more other resources (mainly private) to accelerate and make growth more sustainable?
- Given the importance of **remittances**, how could transfer costs be reduced[41]? How could DAC members leverage remittances and increase their development footprint (e.g. diaspora bonds)?
- Concerning **OOF**, it seems there is still scope to attract more of them (mainly bilaterally), for example to meet the challenge of infrastructure. How to do it?
- Concerning **private flows**, and observing the Maldives, it would be useful to draw lessons and policy recommendations that could be applied. What can be said about

[38] Cabo Verde graduated from the LDC category in 2007, Maldives in 2011, Samoa in 2014 and Vanuatu will be eligible for graduation in 2020. Fiji have a similar GNI per capita and geographical-economical characteristics.

[39] Even if Vanuatu (as other Pacific islands) benefit from the Recognised Seasonal Employer schema (RSE) that allows citizens to live and work in New Zealand for up to seven months over any eleven-month period. See https://www.immigration.govt.nz/about-us/research-and-statistics/research-reports/recognised-seasonal-employer-rse-scheme

[40] More research would be useful on this important issue.

[41] The Global Outlook on Financing for Sustainable Development highlighted that reducing 1% the cost of sending remittances could return USD 30 billion. Currently, cost rates fluctuate between 14-20% of the transferred amounts.

the quality of investments, especially FDIs? For example, as a snapshot, it can be noted from the companion case study on Cabo Verde, that "even if … FDIs are high in Cabo Verde (higher than the average at a similar income level) they do not always translate into local development gains. Although Cabo Verde receives large relative volumes of FDI, the development footprint of these resources is challenging to measure. Tourism accounts for the largest… 90% …however, this sector contributes to regional inequalities and is comprised of mainly foreign owned companies which present challenges for local value capture".

- Concerning **domestic resources**, Cabo Verde is able to get comfortable levels of tax revenues over GDP for its level of development (20.7% in 2017) but low levels of tax revenues over external flows (1.7)[42]. Why is this the case? It would be useful to test explanatory hypotheses and possible solutions for such a situation[43].

Aspirational economies are good potential benchmarking countries. Looking for other outliers or countries to benchmark, and as requested by the Cabo Verdean authorities themselves, countries such as Mauritius and the Seychelles can also be studied[44]. Learning from small island success stories (especially studying other essential FDI determinants, such as the labour market flexibility, the degree of innovation and openness of the economy, the growth rate, the tax rates, the inflation rate, the foreign exchange management, financial depth, school enrolment, judicial independence), and drawing inspiration from successful policy reforms can shed light on solutions to similar challenges that Cabo Verde faces today.

[42] Vis-à-vis the average, around 6, and compared to Fiji (5.3) and the Maldives (around 10).

[43] An intuitive and first hypothesis to test could be a large size of the informal economy in Cabo Verde (as in Vanuatu and Samoa). This factor as a determinant of such a situation could be analysed, and some solutions proposed (in fact these countries perform relatively well when looking for the tax/GDP ratios: 20.7% for Cabo Verde, 24% for Samoa and 16.7% for Vanuatu, then the causes of low domestic resources/external flows ratio should be studied further).

[44] For example, the Maldives presents an example of successful private sector resource mobilisation following LDC graduation. The Maldives is working to ensure that fisheries contribute to the long-term sustainable development of local communities by incentivising environmentally sustainable fishing value chains. Through the use of ecolabels, Maldives has created a price premium for local fishermen and the possibility for consumers to make more informed choices.

4. Looking forward: Transition finance beyond the DAC

This section expands the scope of transition finance analysis beyond the DAC. The emergence of new donors, and their increasingly important role in financing development, raises questions about the future of the DAC and its priorities. Transition finance offers additional evidence to nourish this reflection, and a useful lens for observing changes that are occurring.

This section observes that transition finance flows from DAC members to partner countries follow significantly different patterns (trends and dynamics) than flows from other donor countries. In particular, DAC members offer a higher level of concessionality (through ODA) and focus more on social sectors than other actors of the development community. Other donors have more success in mobilising private finance in terms of volumes and in early stages of transition of partner countries.

These preliminary observations call for further research and observations, but already suggest that the dialogue with non-DAC members on transition finance should be further developed, and issues such as debt sustainability, or the respective roles of DAC and non-DAC members in leaving no one behind (orphan countries and sectors or SDGs) should be reviewed.

Building on the holistic approach to financing sustainable development that had been promoted by the Addis Ababa Action Agenda and the Global Outlook, among others, this paper has introduced the concept of transition finance, its methodological underpinnings and possible policy applications.

With the ultimate objective of optimising access to FSD in partner countries, this new concept informs and provides tools to the DAC to assess and analyse the dynamics and interactions of the various finance flows to countries as they transition. It uses solid and comprehensive data[45] from the DAC and multilateral actors on the financing to developing countries, and builds rich and deeply significant evidence-based pictures, from which it is possible derive solid diagnostics and policy recommendations.

Nevertheless, it cannot be ignored that **in the last ten years, development co-operation has changed considerably**, with **new actors** such as the BRICs, south–south co-operation and new development banks emerging on the scene. In fact, the first two companion transition finance country pilots (Cabo Verde and Zambia) reveal that it is not possible to develop comprehensive diagnostics and derive the most appropriate policy recommendations, without a keen understanding of the role played by emerging actors such as China.

Engaging with those new actors in a transparency effort (i.e. collecting more and better data), and **having a discussion about the respective roles of the DAC and those actors** in a fast-changing world will be essential – not only for the actors themselves, but also for their

[45] The series of figures and tables presented are the following: standarised OECD/DAC statistics on ODA, non-concessional finance and private flows, and data from the World Bank for remittances and UNWIDER for tax revenues. These data have a high degree of granularity, detailing donors and recipients (so country of origin and destination of flows is known).

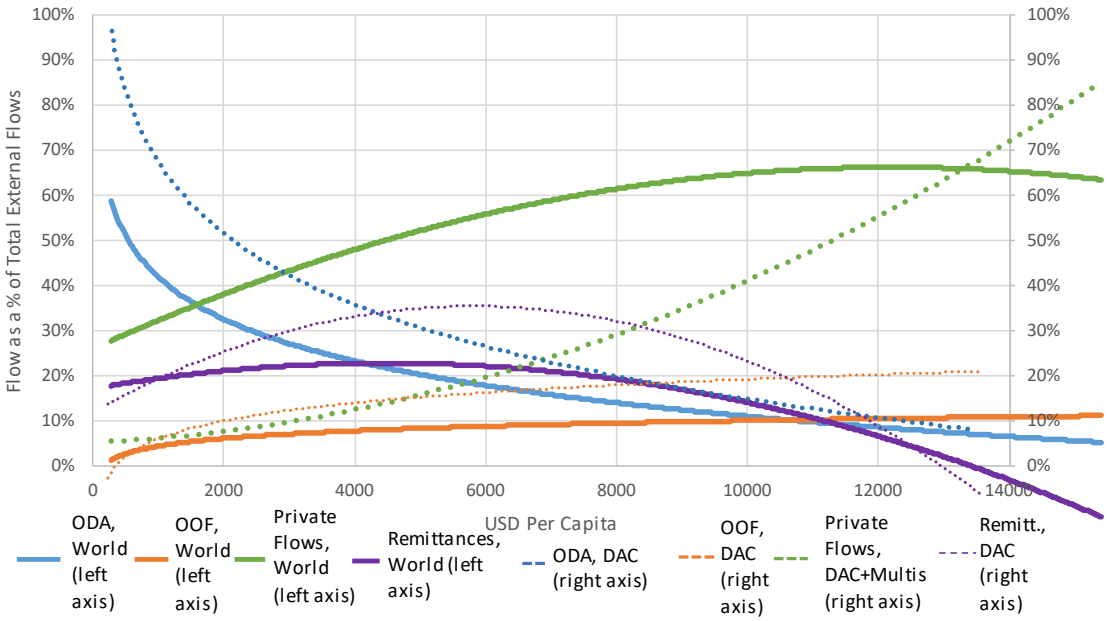
partners seeking an optimal transition finance mix. An holistic approach should take all the sources and actors into consideration. Co-ordination should start at the DAC and expand beyond it.

Transition finance work offers a good starting point for this reflection, as illustrated by the analysis below: **DAC and non-DAC members have very different financing patterns, hence different roles to play in countries transition towards the SDGs** – or need to reconsider their financing patterns if they are not satisfied with this role (e.g. specific role of the DAC in social sectors).

Figure 4.1 attempts to address this situation, mapping transition finance from all world actors vis-à-vis the DAC community. For the "all world actors" it uses other data sources, less granular, but useful to get an overall view of the worlds' participants[46]. Figure 4.2 isolates the two curves of ODA and private flows to provide a clearer picture of key facts.

Figure 4.1. When introducing all cross-border flows to developing countries, the picture changes

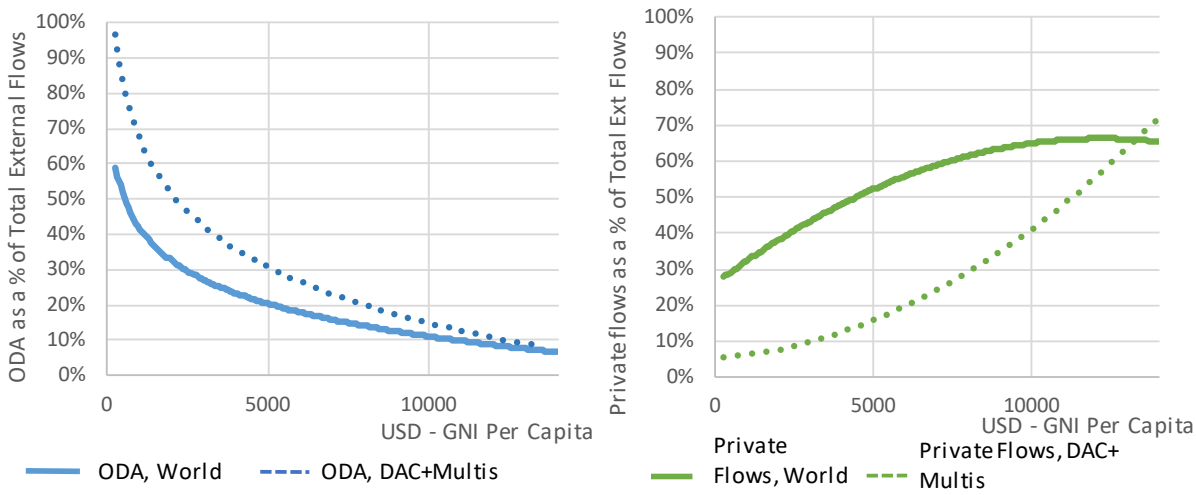
World inflows to developing countries (solid lines) and DAC, non-DAC and multilateral outflows to developing countries (dotted lines), 2012-16, 2016 prices.



Note: the solid lines represent all of the world, and the dotted lines the DAC only, expressed in share of total external flows.
Source: Authors' calculations based on (OECD, 2018[8])'Creditor Reporting System database (ODA, OOF flows, and private flows), (World Bank, 2018[9]), "migration and remittances data', and (IMF, 2017[11]) 'Balance of Payments' database (FDI, portfolio investments, and long-term and short-term debt).

[46] ODA data from the BRICS come from DAC estimations (see http://www.oecd.org/dac/stats/non-dac-reporting.htm). Private flows data come from the IMF and the World Bank ("All cross border" flows where the destination is known but not the country of origin).

Figure 4.2. Non-DAC financiers intervene earlier in the development continuum with their private flows; traditional donors are in a unique position to finance some under-invested sectors with ODA/OOF



Note: the solid lines represent all of the world, and the dotted lines the DAC only, expressed in share of total external flows.
Source: Authors' calculations based on (OECD, 2018[8])'Creditor Reporting System database (ODA flows and private flows) and (IMF, 2017[11]) 'Balance of Payments' database (FDI, portfolio investments, and long-term and short-term debt).

A number of major differences appear:

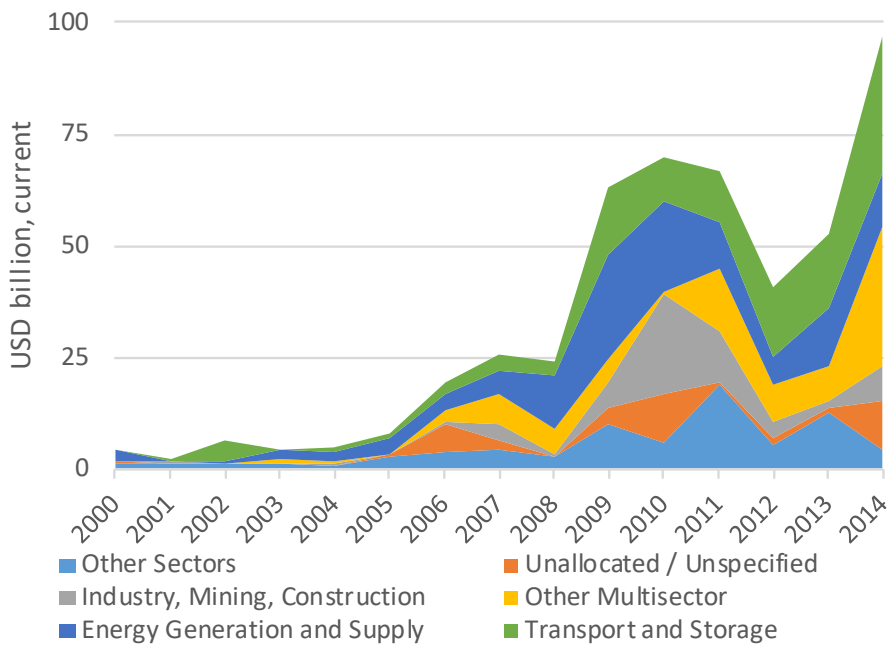
- The amplitude of variation of relative shares of different financing flows is much larger for the DAC than for the world as a whole. At maximum, private sector flows represent two thirds of total external flows for all actors together (and 60% for ODA), whereas ODA represents up to 96% of total external flows for the DAC. Thus, the question of transition is of particular relevance to the DAC that generates fast and large phasing out of certain types of financing (drop of almost 90 percentage points). Substitution between sources of finance for the world as a whole is much smoother, with fluctuations of the order of 30 percentage points maximum.
- At any point in transition, the share of ODA in external finance is significantly larger when the DAC alone is considered. ODA is a DAC instrument, and other countries provide less ODA-like support. The share of ODA drops twice as fast for the DAC than for the world as a whole.
- The curves of private sector finance are reversed (one convex, one concave), which means the DAC is much slower at mobilising private finance than other actors. This could be explained by differences in levels of development, and the higher reluctance of investors in DAC members to enter less sophisticated and riskier markets. For countries with more comparable levels of development, on the contrary, the risk perception is different.
- The share of OOF in external finance is larger for the world as a whole than for the DAC members alone. This largely reflects the patterns described above: DAC members use more ODA and less non-concessional and private types of financing. The direction of causality is hard to assess, however.
- Overall, the share of remittances in external finance is larger for the DAC alone than for the world as a whole. Again, this could be explained by differences in levels of

development: DAC members are more attractive for migrants and/or offer higher wages that allow for more remittances; they also receive a larger portion of voluntary migrants as opposed to forced migrants who often live in poorer conditions.

The number of policy discussions and interpretations that the analysis of differences in transition finance could trigger is important.

For example, the **larger share of ODA and smaller share of private finance from DAC** members in early stages of transition could be seen in two different lights. In a **negative light**: DAC members are less efficient than others at mobilising private finance for development; or in a **positive light**: DAC members and ODA have a unique role to play for leaving no one behind, absent concessional finance from other actors in the poorest countries and social sectors like health or education (see Figures 4.3 and 4.4 on the sectoral allocation of aid from China and ODA/OOF equivalence). The question then becomes whether DAC members are satisfied with this role, when other actors ripe the benefits of development allowed by ODA through private or non-concessional financing of projects with higher financial returns.

Figure 4.3. Sectoral allocation of aid from China

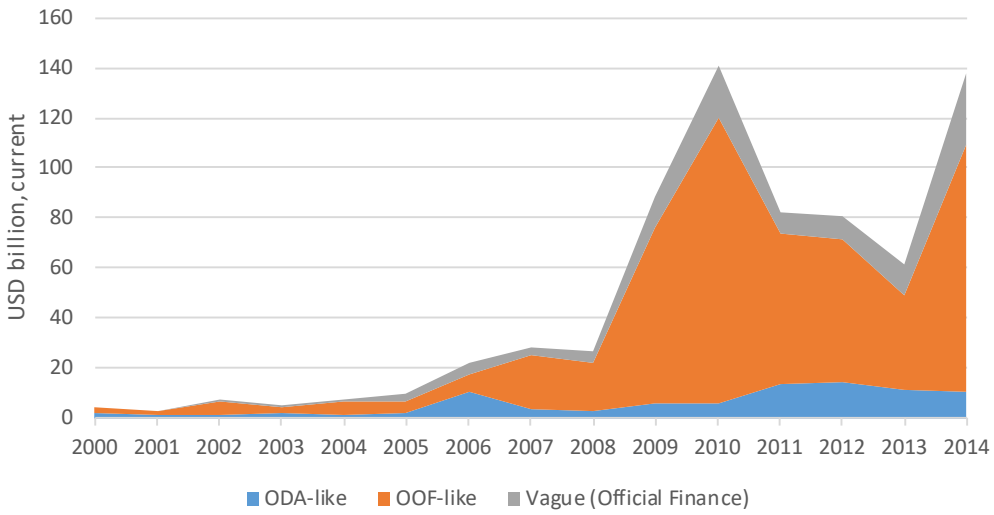


Source: (Johns Hopkins, 2018[28]) CARI database

This also raises the **question of how the DAC could improve its performance at mobilising additional private finance in early stages of transition of its partner countries**. Blended finance is one of the venues explored to achieve this objective. More innovation could be introduced, for example through guarantees and other forms of de-risking or risk-sharing[47].

[47] Even if guarantees can be attractive and useful tools to ensure financing, the question arises whether local authorities have sufficient capacity to deal with them, especially in LICs.

Figure 4.4. ODA/OOF equivalence of aid from China



Source: (Johns Hopkins, 2018[28]) CARI database

One step further, **the desirability of changing the DAC financing patterns to align them with those of other actors is questionable**. Indeed, the early absence of concessionality and involvement of the private sector could raise debt sustainability issues (e.g. if the country has large infrastructure financing needs – see companion country pilot on Zambia). On the contrary, observations could call for increasing efforts of non-DAC actors and additional concessionality in countries most in need and social sectors, with a view to level the playing field. A number of lessons could also be drawn for South-South and triangular co-operation since financing patterns reveal complementarities of the actors and areas for mutual learning or experience sharing.

Looking forward, **it would be important for the DAC to invest in better understanding its financial portfolio positioning in developing countries vis-à-vis other development actors**. In order to improve its own financial strategy to further favour developing countries, but also to engage in fruitful private financing relationships, the DAC should continue to invest and dedicate efforts in studying the new world financing dynamics.

Indeed, these new world equilibriums are not only financial but also geo-political, and working on this financial diagnostic is a key piece of a large puzzle to establish peaceful external relations in a sustainable world.

Thinking holistically requires thinking about benefits for all: shifting the trillions is mainly about incentivising the private sector to invest in sustainable development activities in developing countries.

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