Global Outlook on Financing for Sustainable Development 2023

NO SUSTAINABILITY WITHOUT EQUITY

OECD

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Foreword

Every two years, the *Global Outlook* presents new data, analysis and recommendations for members of the OECD and the international community to advance a more holistic approach to financing sustainable development globally, as called for in the 2015 Addis Ababa Action Agenda.

This third edition casts new light on international efforts to align various sources of financing for the Sustainable Development Goals (SDGs) in the context of the post-COVID-19 recovery, and the consequences of Russia's large-scale war of aggression against Ukraine. Chapter 1 assesses the global macroeconomic context, "from a Great Lockdown to a Great Divergence". Chapter 2 analyses major trends in sustainable development financing and the risk of countries most in need further losing access to finance. In that context, Chapter 3 analyses successes and shortfalls of the SDG alignment agenda, and proposes a plan of action to promote a more equitable distribution of opportunities and benefits of the ongoing drive for sustainability in finance and investment.

The report builds on expertise from the tax, investment, environment and development communities of the OECD. This edition was prepared by the Development Co-operation Directorate (DCD) under the guidance of Acting Director Kerri-Ann Jones, with Carmine Di Noia, Director of the Directorate for Financial and Enterprise Affairs (DAF), Ragnheiður Elín Árnadóttir, Director of the Development Centre (DEV), and Pascal Saint-Amans, Director of the Centre for Tax Policy and Administration (CTPA). The DCD team was led by Haje Schütte, Head of the Financing for Sustainable Development Division, Olivier Cattaneo, Head of the Policy Analysis and Strategy Unit, and Rachel Morris, Policy Analyst. Lead authors were Abdoulaye Fabregas and Qquillaccori Garcia Lopez (Chapters 1 and 2), and Rachel Morris, with valuable drafting and research support by Rae Clark (Chapter 3).

Fundamental contributions were provided by a broad team of OECD specialists, in particular Ben Dickinson, Alexander Pick, and Joseph Stead (CTPA), Riccardo Boffo, Iris Mantovani, Catriona Marshall, Ana Novik, Robert Patalano, Martin Wermelinger (DAF), Yasmin Ahmad, Catherine Anderson, Aussauma Bejaouri, Julia Benn, Thomas Böhler, Priscilla Boiardi, Eleanor Carey, Juan Casado, Guillaume Delalande, Gregory de Paepe, Rebecca Engebretsen, Ana Fernandes, Jenny Hedman, Paul Horrocks, Tomas Hos, Jieun Kim, Rahul Malhotra, Frederik Matthys, Ida McDonnell, Claire Naval, Erin Renner-Cordell, Cécile Sangaré, Jens Sedemund, Julie Seghers, Özlem Taskin (DCD), Federico Bonaglia, Nicolas Friederici, Jason Gagnon, Håvard Halland, Arthur Minsat, Sebastien Nieto, Jan Rielaender, Bakary Traoré (DEV) and Raphael Jachnik (ENV). Joelle Bassoul, Stephanie Coic, Preeya Khongwir and Henri-Bernard Solignac-Lecomte supported the production process. Susan Sachs provided editorial review.

The report benefitted from consultations and reviews by colleagues from civil society, business and academia: Sébastian Treyer, Director, Institute for Sustainable Development and International Relations (IDDRI), Damien Barchiche, Director, Sustainable Development Governance programme, as well as colleagues at Banque de France, IMF, UNCTAD, WBG, members of the UN system and experts from the OECD-UNDP G7 Alignment Initiative. Members of the OECD Development Assistance Committee (DAC) provided overall strategic guidance.

Editorial

The global outlook on financing for sustainable development has deteriorated since our last projection in 2021. Sustainable development needs are greater and resources for developing countries are less. Extreme poverty levels are rising for the first time in decades. Countries most in need are paying a high price for Russia's war of aggression against Ukraine, while impacts from COVID lockdowns and supply chain disruptions linger. As a result, growth has been dragged down, and inflation driven up, with high food and energy prices hurting poor people the most. 193 million people experienced acute food insecurity in 2021. This is an increase of nearly 40 million people in one year, even before Russia's war against Ukraine disrupted global food supply. At the same time, the increasing impact of climate change is felt around the world. Despite having contributed historically the very least to global greenhouse gas emissions, developing countries have lost 20-25% of cumulative GDP per capita since the turn of the 21st century due to temperature increase.

These pressures are squeezing developing countries' resources, undermining the global sustainable development goals. Since the outbreak of the pandemic, the Sustainable Development Goals (SDGs) financing gap has widened from USD 2.5 trillion to at least USD 3.9 trillion per year, and is estimated to increase by USD 400 billion per year in 2020 to 2025. The concurrent crises have inflated low-income countries' costs of responding to emergencies in the short-term, and decreased the availability of resources to invest in long-term sustainable development. To manage this, more countries are being forced into debt. At the end of April 2022, more than half of low-income countries (55%) were at high risk of debt distress, or already in debt distress.

This *Global Outlook* demonstrates that inequalities between and within countries are magnifying at an accelerated pace, with long term, interconnected consequences for all countries. More than two years after the COVID-19 outbreak, access to vaccines remains low in developing countries – only 11% of people have been vaccinated in low-income countries compared to 73% of people in high-income countries. Poverty gaps between women and men continue to grow. By 2030, for every 100 men aged 25-34, 121 women will be living in extreme poverty. Reduced access to education during the pandemic, particularly for households with lower digital connectivity, turned back progress on educational attainment for lower income groups. The share of children in developing countries in "learning poverty" could rise 20% above pre-COVID-19 levels. Unless action is taken to better match the total global finance available with development needs, the global impacts and costs of future health, economic, social, political and environmental crises will get worse.

This vicious cycle can be broken. The global finance exists; we need a global coordinated effort to align more available capital with sustainable development goals. Global financial assets grew to reach USD 469 trillion in 2020. While the tightening of the global financial context will decrease the availability of liquidity, there is still room to shift some of this wealth in the interest of all. The annual SDG financing gap in developing countries (USD 3.9 trillion in 2020) represents less than 1% of these global financial assets. The problem is that global financial resources are

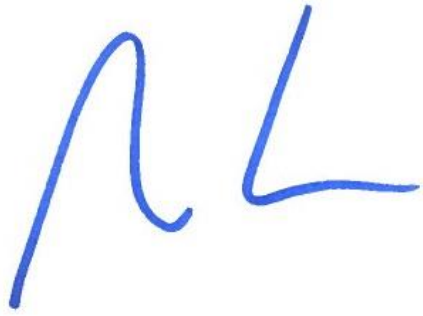
disproportionately raised and invested in richer parts of the globe, and sustainable finance is bypassing those who need it the most.

We need a new sustainable finance plan that better weighs global risk prevention and management in investments. While all actors in the system have a role to play, leadership must come from governments and private sector actors in high-income economies. Drawing from the expertise of a wide array of OECD policy communities, the *Global Outlook* provides two sets of recommendations.

First, high-income countries should lead efforts to make the global system of financing for sustainable development more *equitable*. They can help reduce the barriers impeding the access of developing countries to sustainable finance. Examples include helping developing countries to deepen their domestic sustainable finance markets, supporting country-led, integrated national financing strategies and strengthening domestic revenue mobilisation.

Second, working with financial intermediaries, high-income countries must strengthen standards, regulations, policies and other incentives to improve SDG risk management, strengthen the impact and accountability of sustainable finance and ensure that domestic policies do not create additional barriers for developing countries to access finance.

The UN's 2030 Agenda is based on the premise that all global challenges and solutions are shared across all countries. As recent crises prove, each country's progress depends on the progress of others. Achieving more sustainable outcomes is only possible if we achieve more equitable access to financing for sustainable development.



Mathias Cormann

Secretary-General of the OECD

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Abbreviations and acronyms

AI	Artificial intelligence
BaU	Business as usual
BBB	Build(ing) back better
CIT	Corporate income tax
COVAX	COVID-19 Vaccines Global Access
CRA	Credit rating agency
DAC	Development Assistance Committee
DFI	Development finance institution
DGFCF	Domestic gross fixed capital formation
DRM	Domestic resource mobilisation
DSSI	Debt Service Suspension Initiative
ESG	Environmental, social and governance
EU	European Union
FDI	Foreign direct investment
FSD	Financing for sustainable development
G7	Group of Seven
G20	Group of Twenty
GDP	Gross domestic product
GSSS	Green, social, sustainability and sustainability-linked
HIC	High-income country
IFF	Illicit financial flow
IMF	International Monetary Fund
INFF	Integrated National Financing Framework
IS-FSD	OECD-UNDP Impact Standards for Financing Sustainable Development
LDC	Least developed country
LIC	Low-income country
LLDC	Landlocked developing country

LMIC	Lower middle-income country
MDB	Multilateral development bank
ODA	Official development assistance
ODF	Official development finance
OOF	Other official flows
PDB	Public development bank
PPG	Public and publicly guaranteed
SDG	Sustainable Development Goal
SDR	Special Drawing Rights
SIDS	Small island developing states
TOSSD	Total Official Support for Sustainable Development
UMIC	Upper middle-income country
UN	United Nations
VAT	Value-added tax
WHO	World Health Organization

Executive summary

The pandemic and Russia's war of aggression against Ukraine heighten the risk of a Great Divergence between developed and developing countries, and increase pressure on financing for the Sustainable Development Goals (SDGs). The COVID-19 crisis prompted the largest global recession since the Second World War. The nascent global economic upturn masks a protracted recovery in the poorest countries. The war in Ukraine is further driving up food and energy prices, affecting the most vulnerable households.

The impact of health, economic, social, political and environmental shocks are now generating a ratchet effect in developing countries, which could lock them into a protracted recovery and reverse course away from the SDGs. The need for SDG financing to build back better (BBB) has increased, particularly in the poorest countries. The cost of maintaining peace and security has surged due to Russia's war against Ukraine, and governments must juggle competing priorities across the SDGs: accommodating the influx of refugees under stretched development budgets, promoting a net-zero transition in the context of soaring energy prices, etc.

Following the COVID-19 outbreak, available resources are not keeping pace with those growing SDG financing needs, resulting in a scissors effect. The SDG financing gap in developing countries increased by 56% percent in 2020, totalling USD 3.9 trillion. The war further casts a shadow over the financing for sustainable development outlook, with heightened uncertainty due to:

- **Mounting pressure on official development assistance (ODA)**. ODA from DAC countries rose to USD 162.2 billion in 2020, its highest level ever recorded, and a 7% increase over 2019. However, global inflation is degrading the purchasing power of ODA, at the same time that it is being called upon to respond to growing humanitarian and development challenges.
- **Future constraints on government revenue.** Developing countries' available government revenue (i.e. government revenue available after debt service payments) is expected to remain almost 20% below pre-pandemic projections into the foreseeable future. Projections for 2022-24 for middle-income countries (MICs) suggest government revenue will be lower by about USD 95 billion annually due to the political and economic context.
- **Spiralling debt and debt servicing costs.** Between 2020 and 2025, external debt service in developing countries is projected to reach USD 375 billion on average, already a jump from the USD 330 billion on average between 2015 and 2019. With 45% of their outstanding debt maturing by 2024, compared with 36% for all developing countries, low-income countries (LICs) are particularly exposed to rollover risk (OECD, 2022[1]).

- **Increased volatility of private investment.** External private flows to developing countries excluding China declined significantly by 13% (USD 148 billion), but the drop was milder than anticipated. While capital flows declined by -20%, remittances flows almost completely recovered by the end of 2019. However, estimates for 2022 suggest that recovery of cross-border capital flows will be short-lived. Portfolio investment and other investment are expected to decline by 50% and 45%, respectively, in 2022, while foreign direct investment (FDI) is projected to drop by 23%.

The good news is that a sustainability boom is underway, with fast-growing supply and demand for sustainable finance and investment, that could shift trillions of dollars in the system towards the SDGs. COVID-19 served as a wake-up call to public and private actors about the impact of non-financial risk (i.e. global health, climate change, geopolitical instability, etc.) on financial performance. The line between sustainability risk and financial risk is blurred. Investors recognise the need to limit future sources of market volatility and to seize investment opportunities. The SDGs, by definition, are universal in that they encompass all countries, developed and developing. Moving to a universal SDG paradigm can help ESG risk-mitigation strategies integrate potential transboundary impacts.

SDG-alignment of finance can only deliver to the fullest for the 2030 Agenda if countries with larger SDG financing needs also benefit from it. The *OECD Global Outlook on Financing for Sustainable Development 2023* proposes a two-step approach for developed countries to reinforce the *equity* pillar of SDG alignment, while promoting the *sustainability* pillar for SDG alignment of all actors along the investment chain.

The first step calls on developed countries to prioritise support for domestic resource mobilisation and integrated national financing strategies, to help the poorest countries avoid the looming fiscal and credit crunch. External support should specifically target domestic revenue mobilisation, for example, by fulfilling Addis Tax Initiative commitments, supporting medium-term revenue strategies, and strengthening international tax co-operation and carbon pricing frameworks for sustainable revenue generation. Developed countries can further help developing countries deepen sustainable finance markets by promoting assessment of SDG qualities of investment. Next, developed countries can help attract external finance aligned to integrated national financing strategies in developing countries, including by pooling technical assistance to help countries access sustainable funds, and by targeting debt swaps, bonds and guarantees where appropriate. Finally, higher income countries can help improve the global frameworks for the transparency and accountability of external debt in the poorest and most vulnerable countries.

The second step builds on the 2021 *Global Outlook* and OECD-UNDP *Framework for SDG Aligned Finance* to call for mutually reinforcing actions by all actors along the investment value chain to shift trillions towards the Goals (OECD/UNDP, 2020[2]). Working with institutional investors, asset managers, development finance institutions and other financial intermediaries, higher income country governments can promote a shared public-private commitment (e.g. adherence to the 1% SDG Investment Club) to shift 1% of the trillions in the global financial system in support of SDGs in developing countries. For such commitments to succeed, developed countries should ensure that risk perception criteria and ratings reward long-term action to achieve the SDGs. Developed countries can also implement stronger regulations to avoid SDG-washing at home. Linking ESG and SDG key performance indicators, promoting global and interoperable frameworks for sustainable finance criteria, and raising adherence to guidelines for responsible business conduct, each represents key actions. Finally, higher income countries can strengthen the policy coherence of domestic and external financing for sustainable development; for instance, by reducing domestic support for fossil fuel subsidies that lead to harmful spillovers globally.

Overview

From a Great lockdown to a Great Divergence

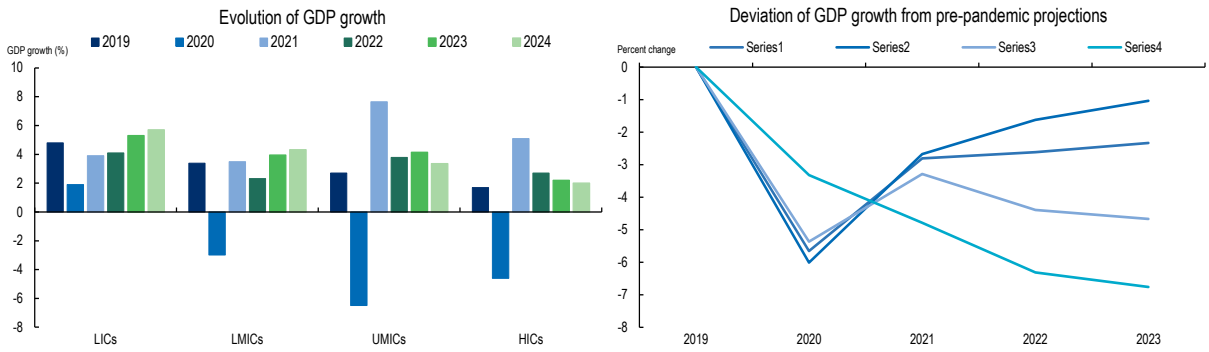
COVID-19 and Russia's war of aggression against Ukraine are exacerbating global fault lines

Following the pandemic, a K-shaped recovery emerged across countries (Figure 1). Output losses in developing countries sank to 5% of their pre-pandemic gross domestic product (GDP) projections, while high-income countries (HICs) dipped only by 3%. Among the countries most in need, the GDP of small island developing states (SIDS) dropped the furthest, by -8.6%, in large part because the tourism sector was directly affected by travel restrictions and lockdowns. Altogether, developing countries lost USD 1.4 trillion in GDP annually due to the COVID-19 crisis, more than half of the pre-COVID-19 annual SDG financing gap (IMF, 2020[3]; Intergovernmental Panel on Climate Change, 2022[4]).

The uneven recovery following the COVID-19 crisis resulted from two main drivers:

- **First, low access to vaccination slowed re-opening of economies**. Despite the progress achieved through COVID-19 Vaccines Global Access, which has delivered more than one billion doses of COVID-19 vaccines in developing countries, only 11% of the population of LICs were fully vaccinated by March 2022 versus more than two-thirds of the population of both HICs (73%) and upper middle-income countries (UMICs) (71%) and 47% of the population of lower middle-income countries (LMICs).
- **Second, narrow fiscal and monetary space constrained stimulus spending**. HICs were able to deploy stimulus packages 700 times greater than those of LICs on a per-capita basis, 86 times greater than in LMIC and 20 times greater than UMICs. As a percentage of GDP, fiscal support measures in 2021-22 for rescue and recovery were on average three and six times lower, respectively, in LICs and MICs than in HICs.

Figure 1. The K-shaped recovery shows an emerging Great Divergence between countries (2019-24)



Note: On the left, the values for 2021 are estimates and the values for 2022-24 are forecasts. The classification by income group follows the World Bank's guidance of 1 July 2021. On the left, the deviation is calculated as the percent deviation between June 2022 and January 2020 projections from the World Bank's Global Economic Prospects series.
Source: Left side: World Bank (2022[5]), *Global Economic Prospects, June 2022*, https://doi.org/10.1596/978-1-4648-1843-1. Right side: World Bank (2020[6]), *Global Economic Prospects, January 2020: Slow Growth, Policy Challenges*, https://openknowledge.worldbank.org/bitstream/handle/10986/33044/9781464814693.pdf and World Bank (2022[5]), *Global Economic Prospects, June 2022*, https://openknowledge.worldbank.org/handle/10986/37224/9781464818431.pdf.

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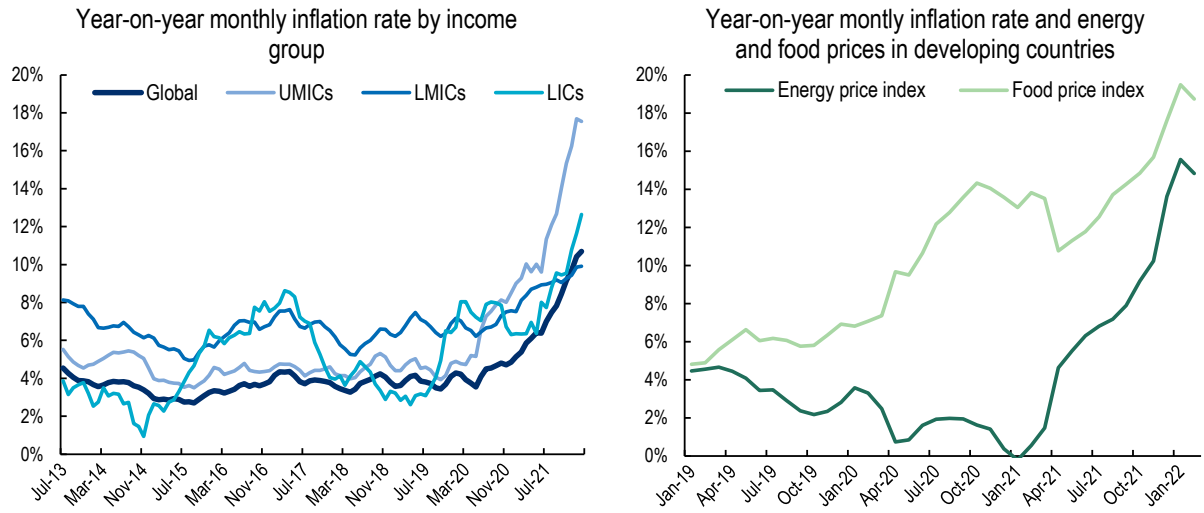
Russia's war in Ukraine is increasing financial instability and driving up inflation, further widening economic disparities between developed and developing countries. LICs stand to lose the most: for them, the war could result in an additional loss of approximately USD 718 billion in 2022 and 2023 (IMF, 2022[7]). More than half of LICs (55%) are at high risk of debt distress or already in debt distress as of end of April 2022. The cost of financing for sustainable development is also increasing due to inflation, which rose in developing countries from 2.7% in 2020 to 4.3% in 2021, compared to a milder increase globally, from 2.2% to 3.4%, over the same period (Figure 2). The poorer segments of the world's population are experiencing larger welfare losses because the war-induced price increases have a greater impact on their real disposable income.

Figure 2. Inflation hits developing countries through increases in food and energy prices



Note: The year-on-year monthly inflation rate corresponds to a simple average of the Headline Consumer Price Index growth rate for a sample of 59 developing countries and 45 high-income or unclassified countries for which all monthly figures between July 2012 and February 2022 are available. The year-on-year monthly inflation rate for energy prices corresponds to a simple average of the Energy Price Index growth rate for a sample of 26 developing countries for which all monthly figures between January 2018 and February 2022 are available. The year-on-year monthly inflation rate for food prices corresponds to a simple average of the Food Price Index growth rate for a sample of 63 developing countries for which all monthly figures between January 2018 and February 2022 are available.

Source: Ha, Kose and Ohnsorge (2021[8]), "One-stop source: A global database of inflation", https://openknowledge.worldbank.org/handle/10986/36037.

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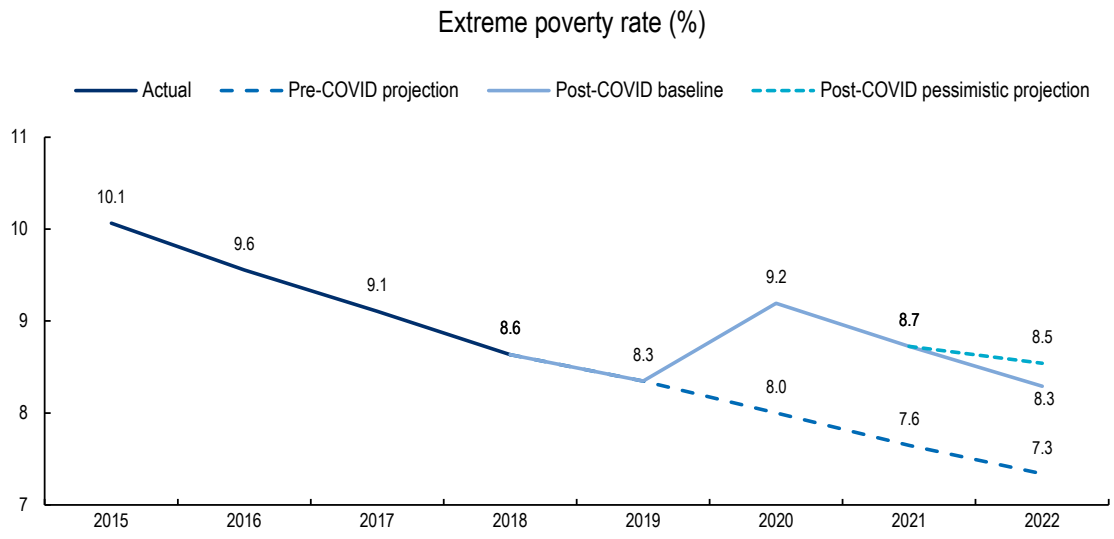
The pandemic and Russia's war against Ukraine marked the end of two decades of decreasing extreme poverty. Despite the aim of SDG 1 "End Poverty" to eradicate extreme poverty, its global rate has been set back by at least three years, from 8.3 in 2019 to 9.2 in 2020 (Figure 3). The UN Secretary-General Report 2021 notes that, unless urgent action is taken, ending poverty will be out of reach by 2030 due to the triple threat of "COVID-19, conflict and climate" (UN, 2021[9]). The combined effect of the COVID-19 pandemic and the war could lead to 75 to 95 million more people living in extreme poverty in 2022 than anticipated in pre-pandemic projections. These setbacks have direct negative consequences at the country and global levels, eroding the social, political and economic foundations necessary to achieve other targets. The gap between post-COVID-19 poverty levels and pre-COVID-19 projections is largest in LICs, at around four percentage points in 2022.

Figure 3. Following years of decline, global extreme poverty rose in 2020, setting back at least three years of progress



Note: Extreme poverty is measured as the number of people living on less than USD 1.90 per day. Data for 2015 to 2018 are official global poverty estimates cited in Gerszon, Mahler et al. (2022[10]). Data for 2019 to 2022 are World Bank projections.
Source: Gerszon, Mahler et al. (2022[10]), "Pandemic, prices, and poverty", https://blogs.worldbank.org/opendata/pandemic-prices-and-poverty.

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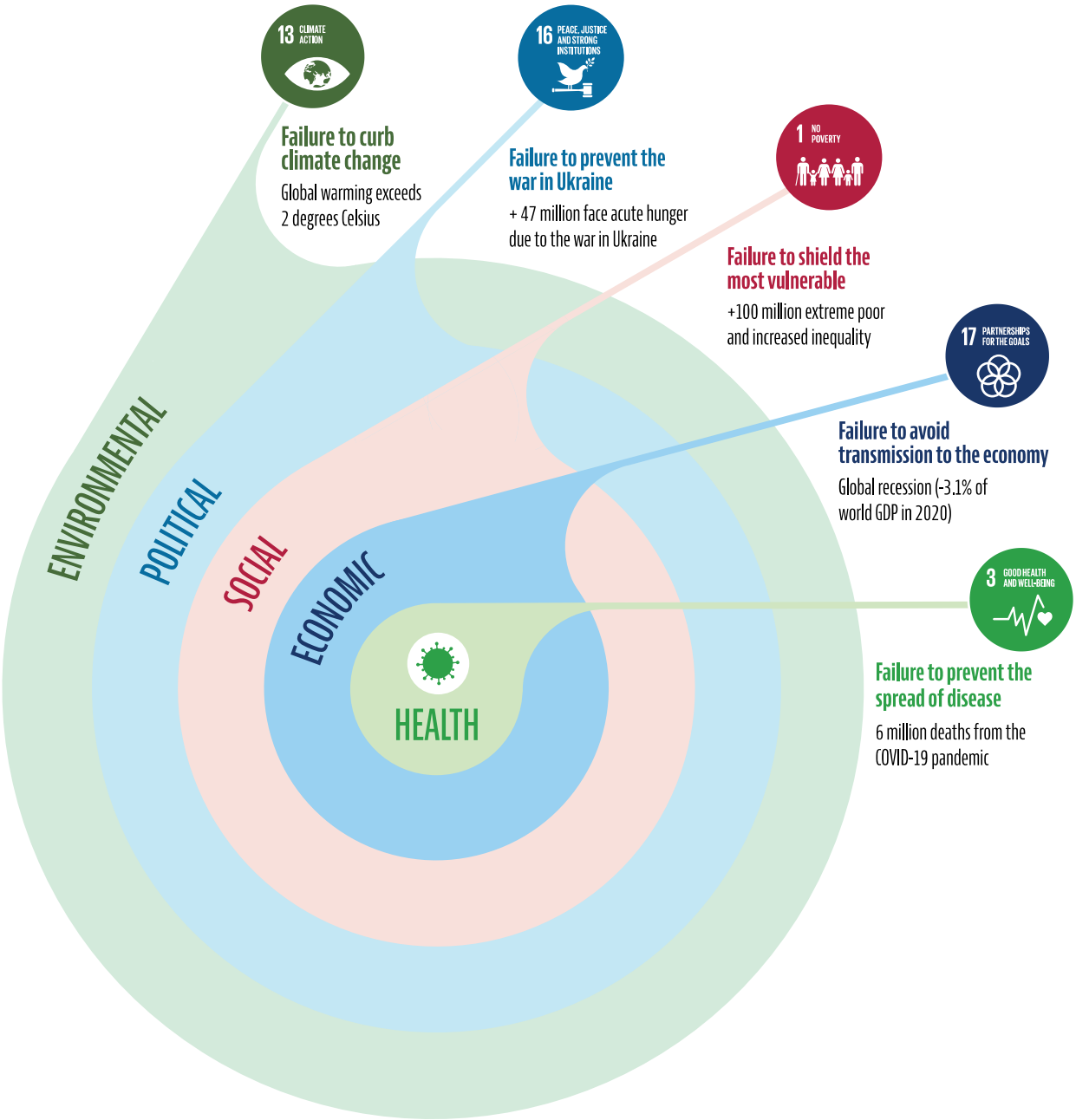
In addition to growing economic and financial inequalities between countries, inequalities within countries, such as those related to gender and access to education, have been magnified. Inequality within LICs and MICS will increase due to income losses affecting low-skill workers, youth and women. It is now estimated that by 2030, for every 100 men aged 25 to 34 living in extreme poverty, 121 women will be living in similar conditions; prior to the COVID-19 pandemic, the difference was 118 women for every 100 men living in extreme poverty (Azcona et al., 2020[11]). The pandemic has had the largest impact on the lowest quintiles of the world's population. By 2021, the average income of the bottom 40% of the population in developing countries was estimated to be about 2% lower than before the pandemic. However, the average income of the top 60% of the population in developing countries should return to almost pre-COVID levels (Narayan et al., 2022[12]).

Failure to address multidimensional shockwaves could lock in protracted SDG divides

Each crisis leads to heightened costs and setbacks across the SDGs (Figure 4). Failure to tackle global challenges adds a cross-cutting multiplier for costs and setbacks in the long-term. Governments' failure to contain the COVID-19 pandemic led to the largest economic recession since the Second World War, slowing or reversing progress across the SDGs. For example, without remote learning, the pandemic had devastating impacts on SDG 4 "Quality Education". The share of children in LICs and MICs with learning poverty could rise from the pre-COVID-19 estimation of 50% to 70% (UNESCO/UNICEF/World Bank, 2021[13]). Rising geopolitical and economic instability have generated new setbacks for SDG 2 "End Hunger": the World Food Programme (2022[14]) estimates that up to 47 million additional people could face acute hunger as a result of Russia's

war in Ukraine – a 17% increase over the pre-war baseline of 276 million people who already face acute food insecurity.

Figure 4. Failure to address multidimensional impacts of successive crises across the SDGs could lock in the Great Divergence for the long term



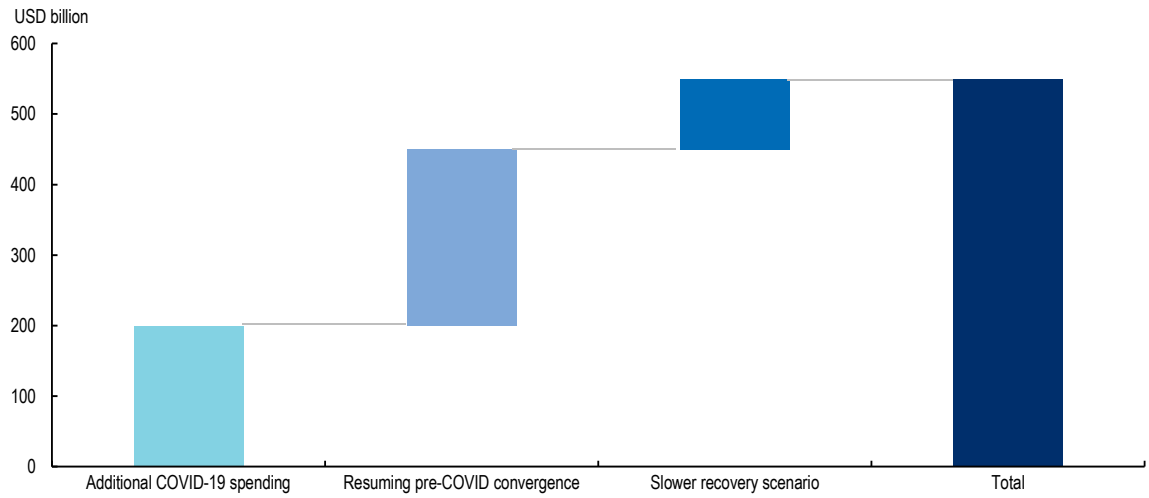
Source: Authors' design.

Financing needs are particularly high in the poorest countries. The additional COVID-19 financing required by LICs between 2021 and 2025 is estimated at USD 450 billion (IMF, 2021[15]).[1] This amount includes USD 200 billion of additional COVID-19 spending to step up the response to the crisis and build financial buffers as well as USD 250 billion to put LICs back on their pre-

pandemic trajectory of convergence with advanced economies. An additional USD 100 billion could be required if some risks – such as slower-than-expected vaccine rollouts or a worsening of the pandemic due to new variants – materialise and lead to an even slower recovery in LICs (Figure 5).

Figure 5. The pandemic led to an increase of low-income countries' financing needs over the short and long term

Additional financing required in LICs



Source: IMF (2021[15]), *Macroeconomic Developments and Prospects in Low-Income Countries—2021*, https://www.imf.org/en/Publications/Policy-Papers/Issues/2021/03/30/Macroeconomic-Developments-and-Prospects-In-Low-Income-Countries-2021-50312.

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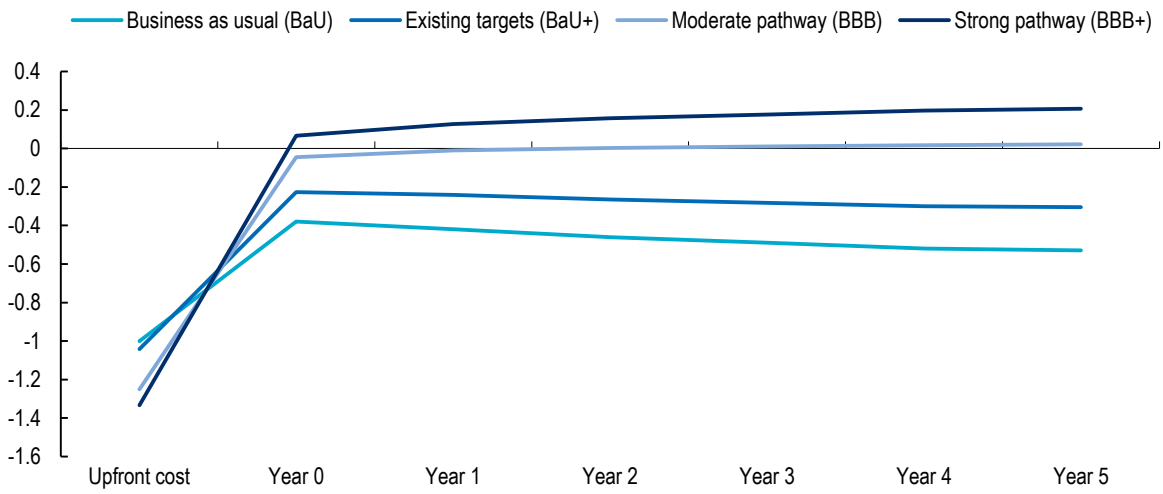
Amid historic development setbacks, developing countries will face difficult trade-offs to balance a growing number of SDG financing priorities. Given the limited resources available to them, this balance requires clear prioritisation of short-term rescue spending and longer-term investments (e.g. to build sustainable and resilient infrastructure, strengthen health and education systems, or restore financial buffers to preserve the credibility of their fiscal frameworks). The upfront costs of investing in green infrastructure could be up to 33% higher than for conventional energy infrastructure investment (Rozenberg and Fay, 2019[16]). However, the strong positive impact on GDP observed for green investment more than offsets the initial higher investment costs and provides a positive return for countries' GDP (Figure 6).

Figure 6. The economic benefits of building back better in the energy sector over the long term outweigh the higher upfront costs

Impact on GDP of additional investments in energy infrastructure (for each US dollar invested)



Note: Green and non-green output multipliers are calculated for a group of 14 countries, five of which are developing countries; costs of investment in energy infrastructure are calculated for low- and middle-income countries. Results are scaled based on USD 1 invested under the BaU scenario.

Source: Authors' calculations using green and non-green output multipliers from Batini et al. (2021[17]), "Building back better: How big are green spending multipliers?", https://doi.org/10.5089/9781513574462.001. For costs of investments in renewable and non-renewable energy infrastructure, authors' calculations based on Rozenberg and Fay (2019[16]), *Beyond the Gap: How Countries Can Afford the Infrastructure They Need while Protecting the Planet*, https://openknowledge.worldbank.org/handle/10986/31291

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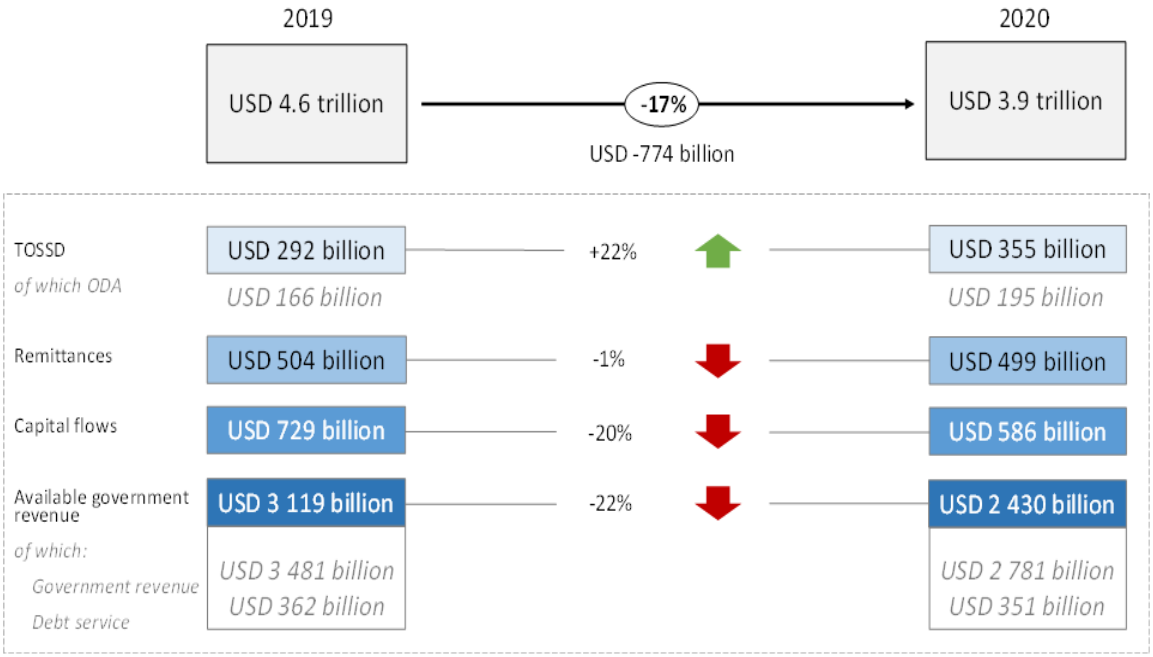
The sustainable development finance gap in developing countries keeps growing

The COVID-19 pandemic caused a significant drop in nearly all sources of financing for sustainable development (FSD) in 2019-20 (Figure 7**).** The total volume of FSD flows to developing countries, excluding the People's Republic of China (hereinafter China), declined by USD 774 billion, or 17%, from USD 4.6 trillion in 2019 to USD 3.9 trillion in 2020. The largest drop in absolute terms was in available government revenue (i.e. government revenue after debt service repayments), which shrank by USD 689 billion, or 22%, from USD 3.1 trillion in 2019 to USD 2.4 trillion in 2020. The decline over 2019-20 also was more significant than during the 2008-09 global financial crisis: three times greater in LICs, two times greater in LMICs and four times greater in UMICs.

Figure 7. Available financing for sustainable development in developing countries shrank by USD 774 billion, or 17%, in 2019-20

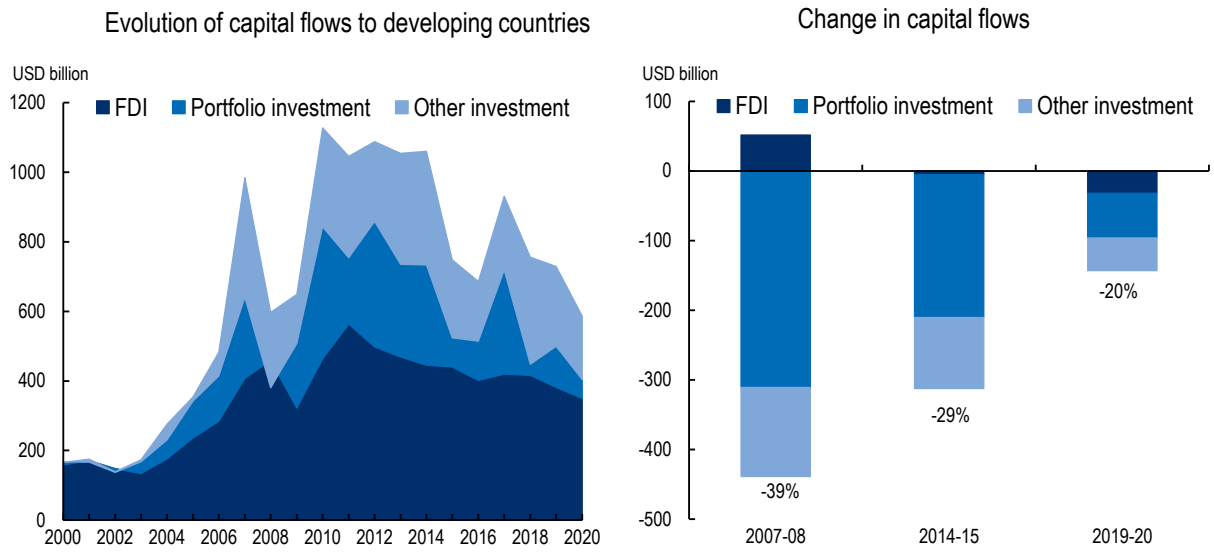


Note: TOSSD includes cross-border support to developing countries and global and regional expenditure for sustainable development (respectively, Pillars 1 and 2 of the TOSSD framework). Amounts mobilised from the private sector are not included in the TOSSD figures shown above. The definition and scope of Pillar 2 is currently under review and some of the activities contained may not be directly supporting developing countries. The increase observed in TOSSD flows between 2019 and 2020 is mainly due to an increase in the disbursements of multilateral organisations, in particular European Union (EU) institutions, the World Bank, the International Monetary Fund (IMF) (Concessional Trust Funds), and the Asian Development Bank Group and Asian Development Investment Bank as well as to better data coverage in 2020. All figures use the largest sample possible for official development assistance-eligible countries excluding China. The rationale to exclude China, as discussed, is based on its outlier status in terms of FSD trends, particularly private capital flows.

Source: Authors' design. Data on official resources are based on OECD (2022[18]), *TOSSD Total Official Support for Sustainable Development/Data Visualisation Tool*, https://tossd.online/. Remittances are based on KNOMAD (2022[19]), *Remittance inflows* (database), https://www.knomad.org/data/remittances. Capital flows are from IMF (2022[20]), *Balance of payments* (database), https://data.imf.org/bop.

The fear of a collapse in external private flows helped jolt global leaders into action, preventing even greater damage. Without a strong policy reaction, a major collapse of external private flows (e.g. FDI, remittances, etc.) seemed likely, based on the dire forecasts in the first months after the declaration of the pandemic. Despite a sudden stop in the first semester of 2020, capital flows rebounded once governments started easing the stay-at-home orders in the second semester of that year. The peculiar nature of the 2020 global recession, which was mainly transmitted to the economy by governments' containment measures (unlike the 2008-09 recession, which started as a financial crisis), explains the relatively swift recovery of cross-border capital flows by end 2020. The 20% decline in capital flows observed in 2020 is lower than the 39% and 29% shocks experienced by the same group of countries in 2008 and 2015, respectively (Figure 8).

Figure 8. The drop in capital flows in 2020 was less pronounced than in previous sudden stop episodes



Note: The data show cross-border capital flows to developing countries excluding China.
Source: IMF (2021[21]), *Balance of Payments and International Investment Position Statistics* (database), https://data.imf.org/?sk=7A51304B-6426-40C0-83DD-CA473CA1FD52.

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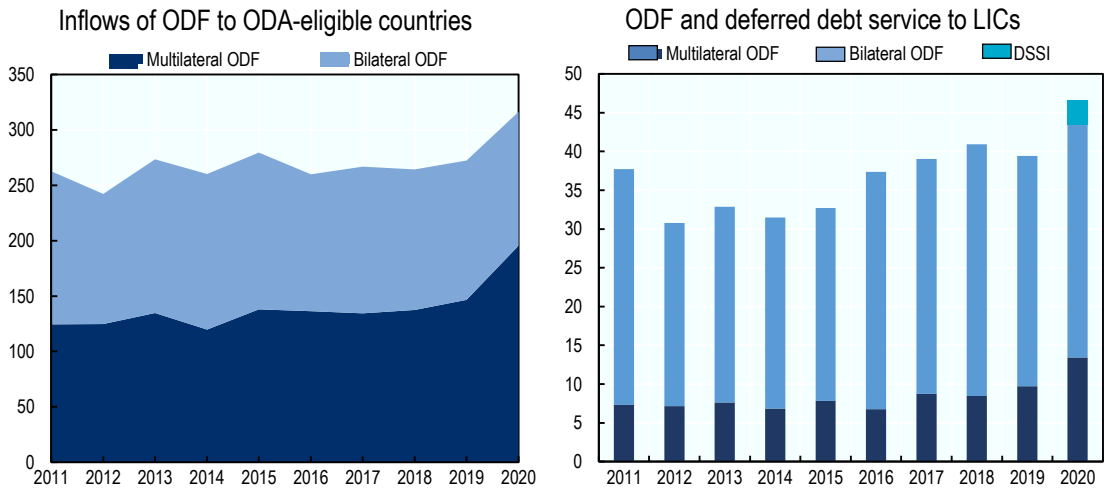
Total official development finance reached record levels in 2020, providing emergency relief where needs were greatest. ODA from DAC countries amounted to USD 162.2 billion that year, its highest level ever recorded, and a 7% increase over 2019 (Figure 9, left side). This effort reasserted the countercyclical role of ODA during a global crisis. Total ODF to developing countries, the combination of bilateral and multilateral ODA and other official flows (OOF), amounted to USD 307.7 billion, up by 8% from 2019. In April 2020, the Group of Twenty (G20) finance ministers agreed to a debt standstill for LICs as part of the Debt Service Suspension Initiative (DSSI). Between May 2020 and December 2021, debt service totalling USD 12.9 billion was suspended through the initiative to provide some breathing space to the 48 participating countries (of the 73 eligible). The effort came predominantly from bilateral development partners (Figure 9, right side).

Figure 9. Bilateral and multilateral providers' combined efforts ensured continued financial support to developing countries at the height of the crisis



Source: DSSI = Debt Service Suspension Initiative. ODF flows are measured as a sum of ODA and OOF and accessed from OECD DAC Table 2a (OECD, 2022[22]), *Aid (ODA) disbursements to countries and regions [DAC2a], OOF and export credits - disbursements [DAC2b),* https://stats.oecd.org/Index.aspx?DataSetCode=Table2A and Table 2b (OECD, 2022[23]), *OOF and export credits - disbursements [DAC2b],* https://stats.oecd.org/Index.aspx?DataSetCode=TABLE2B#. DSSI deferred debt service is calculated based on World Bank estimates as of 8 February, 2022: World Bank (2022[24]), *Debt Service Suspension Initiative* (webpage), https://www.worldbank.org/en/topic/debt/brief/covid-19-debt-service-suspension-initiative.

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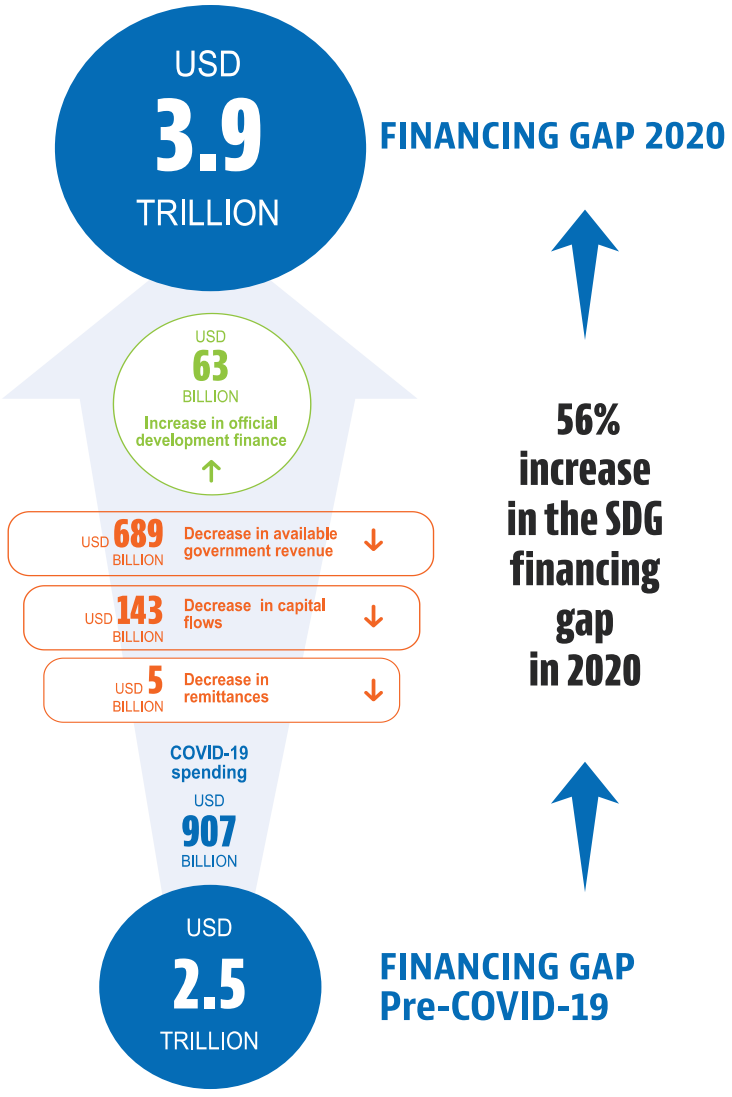
Although a collapse in FSD was avoided, the annual SDG financing gap in developing countries increased by 56%, to USD 3.9 trillion in 2020 (Figure 10**).** Government revenues remain the largest source of financing for sustainable development and accounted for more than 80% of the overall decline in FSD. The shutdown of global economic activity during the COVID-19 crisis resulted in significantly lower revenues for developing countries. The USD 907 billion increase in developing countries' government expenditure in response to the COVID-19 emergency represents nearly 30% of total government revenues available in developing countries in 2019. Taking into consideration the expected tightening of global financing conditions, projections by the UN Conference on Trade and Development and the IMF suggest that the SDG financing gap could reach USD 4.3 trillion per year from 2020 to 2025, an increase of USD 400 billion over OECD estimates in 2019-20 (UNCTAD, 2022[25]).

Figure 10. The SDG financing gap in developing countries increased by at least 56% in 2020



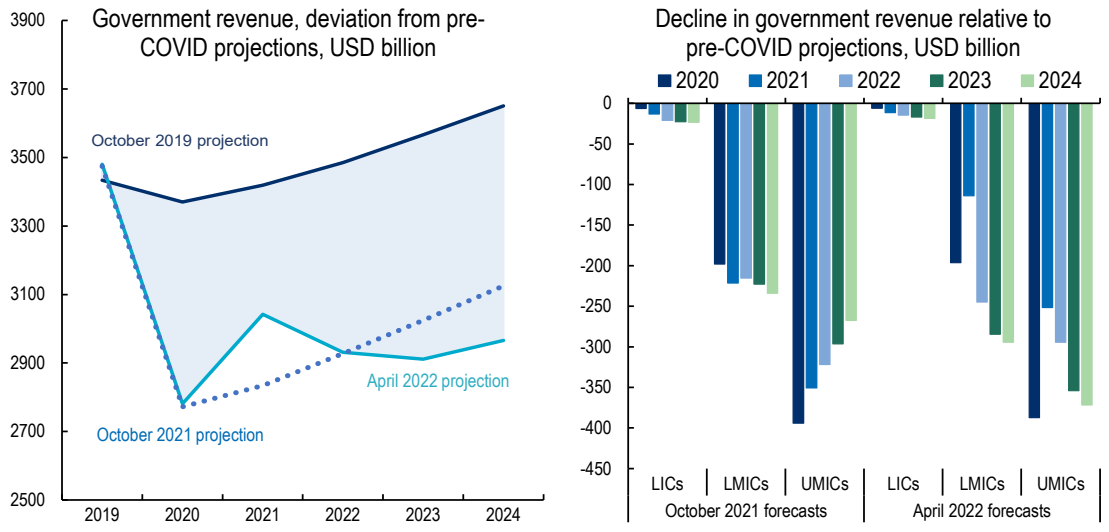
Source: Authors' design. ODF data are based on OECD (2022[18]), *TOSSD Total Official Support for Sustainable Development/Data Visualisation Tool*, https://tossd.online/. Remittances are based on KNOMAD (2022[19]), *Remittance inflows* (database) https://www.knomad.org/data/remittances. Capital flows are from IMF (2022[20]), *Balance of payments* (database), https://data.imf.org/bop.

Looking forward, the recovery is stifled and the system of financing for sustainable development increasingly unstable

The recovery of the FSD system from the COVID-19 crisis could be short-lived due to a tightening of global financing conditions and the impact of the war. While developing countries' financing sources started to recover in 2021, the gradual withdrawal of policy support measures and heightened global uncertainty generated by Russia's war against Ukraine has been weighing on their financing prospects. Additional financing is needed to address the humanitarian emergency and cover in-donor refugee costs. However, increasing the allocation of aid to crisis response poses a risk that resources may be diverted from longer-term development priorities, including investments necessary for a just and sustainable recovery.

Russia's war in Ukraine has stopped the recovery of government revenue in developing countries and could result in significantly lower volumes of these revenues in the coming years. It is expected to remain almost 20% below pre-pandemic projections into the foreseeable future (Figure 11, left side). Government revenue is expected to decrease in 2022 and 2023, with MICs particularly affected (Figure 11, right side). At the current pace of recovery, it may not reach pre-pandemic levels before 2030.

Figure 11. The war in Ukraine has stopped the recovery in government revenue in developing countries and will result in significantly lower volumes of government revenue in the coming years



Note: The grey area in the chart on the left represents the volume of the decline in government revenue due to the successive crises. The chart on the left also shows the deviation of government revenue from pre-pandemic projections for all developing countries excluding China.

Source: Government revenue projections are drawn from the IMF World Economic Outlook databases: (IMF, 2019[26]), *World Economic Outlook - October 2021 edition* (database), https://www.imf.org/en/Publications/WEO/weo-database/2019/October; (IMF, 2021[27]), *World Economic Outlook - October 2021 edition* (database), https://www.imf.org/en/Publications/WEO/weo-database/2021/October; (IMF, 2022[28]), *World Economic Outlook - April 2022 edition* (database), https://www.imf.org/en/Publications/WEO/weo-database/2022/April.

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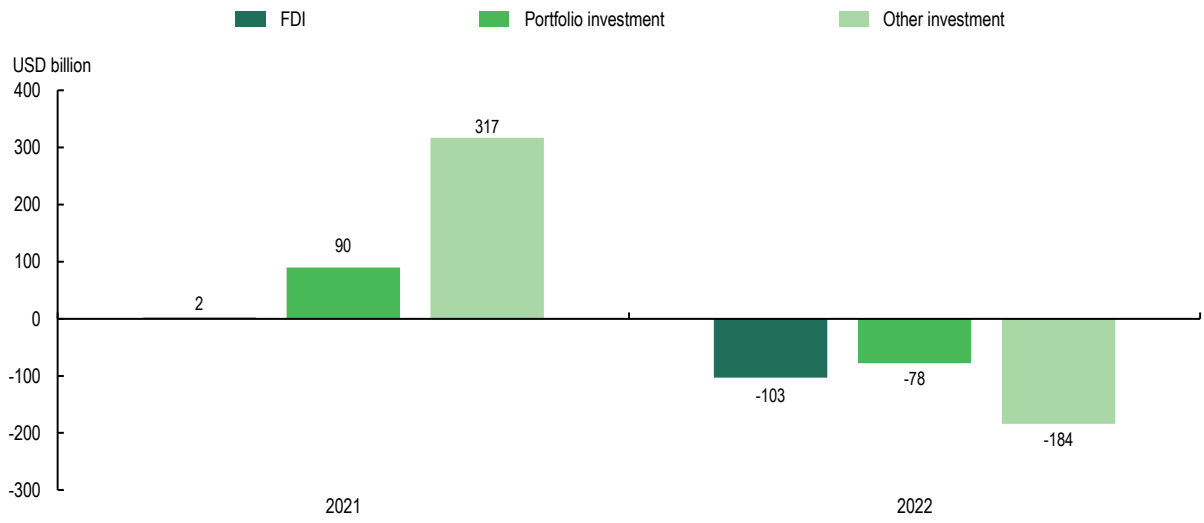
Developing countries face a "wall of debt service repayment" that could have enormous impacts on their debt sustainability and fiscal space (UNCTAD, 2020[29]). The accumulation of short-term debt during the COVID-19 crisis and the worsening global economic outlook foreshadow an increase in the cost of debt service, which could amount to USD 387 billion for developing countries in 2022. Between 2020 and 2025, it is projected to reach USD 375 billion on average, already a jump from the USD 330 billion on average between 2015 and 2019. The limitations of the Common Framework for Debt Treatments beyond the DSSI add to growing concerns about the sustainability of developing countries' sovereign debt. Announced by the G20 in November 2020 to deal with countries' insolvency and protracted liquidity problems, it has not produced the expected results (Ahmed and Brown, 2021[30]).

Following a rebound of cross-border capital flows to developing countries in 2021, a new drop is projected for 2022. Portfolio investment and other investment are expected to decline by

50% and 45%, respectively, in 2022, while FDI could drop by 23% (Figure 12). Even before the war in Ukraine, projections of capital flows to developing countries pointed to a fall in 2022 due to slower growth and inflationary pressures. The turmoil caused by the Russian invasion adds to the uncertainty and volatility in financial markets. These could erode investor confidence and spur another wave of capital flight from developing countries.

Figure 12. The threat of macroeconomic turbulence could hinder the recovery of cross-border capital flows to developing countries



Note: Values for 2022 are forecasts.
Source: Institute of International Finance (2022[31]), *Capital Flows Report May 2022: Rising Global Recession Risk*, https://www.iif.com/Research/Capital-Flows-and-Debt/Capital-Flows-to-Emerging-Markets-Report.

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Leakages in the FSD system continue to deprive developing countries from considerable resources. Even before the COVID-19 crisis, illicit financial flows (IFFs) were increasing the SDG financing gap. The IMF estimates that the annual cost of bribery alone is between USD 1.5 trillion and USD 2 trillion globally (IMF, 2016[32]). However, estimates of the amounts lost to bribery, corruption, theft and tax evasion in developing countries remain challenging to determine. Public spending inefficiency represents an important but often overlooked dimension of the SDG financing gap. Losses due to inefficient public spending across the SDGs could amount to USD 102 billion in LICs, USD 2.7 trillion in LMICs and USD 6.5 trillion in UMICs per annum (Cristóbal et al., 2021[33]).

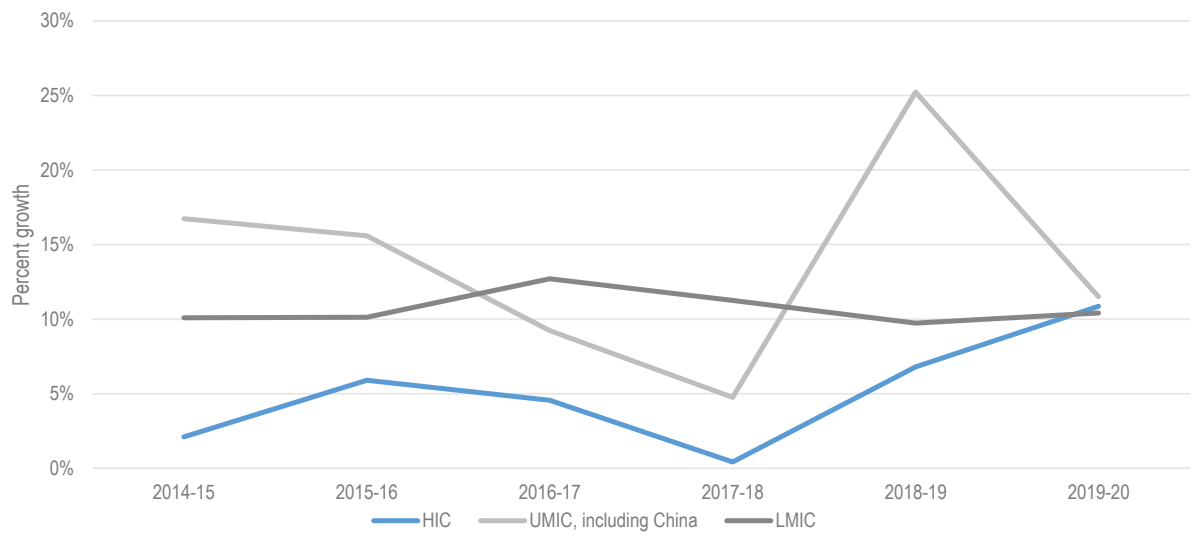
The sustainable finance equilibrium: No sustainability without equity

The pandemic amplified imbalances in the global financial system

The trillions of dollars in the global financial system are not SDG aligned and could exacerbate macro financial vulnerabilities in developing countries. Monetary policy, including quantitative easing by major economies, contributed to an 11% increase in the value of global financial assets, from USD 423 trillion to USD 469 trillion, in 2019-20.[2] The annual growth rate of assets held in

HICs continued to increase after the outbreak of the pandemic (Figure 13). However, developing countries hold less than 20% of global financial assets, valued at USD 469 trillion in 2020, yet these countries represent 84% of the world's population and 58% of global GDP. Only 5.7% of ODA-eligible countries (8 out of 140), none of which are LICs, are included in reporting on financial assets by the Financial Stability Board, evidence of a persistent barrier to deepening financial markets in these countries.

Figure 13. During the COVID-19 pandemic, the growth rate of financial assets held in developing countries declined or remained stagnant, but increased significantly in high-income countries



Note: The figure uses World Bank income categories.
Source: Authors based on Financial Stability Board (2021[34]), *Global Monitoring Report on Non-Bank Financial Intermediation 2021*, https://www.fsb.org/2021/12/global-monitoring-report-on-non-bank-financial-intermediation-2021/.

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Sustainable finance in developed countries reached a new high despite the global recession

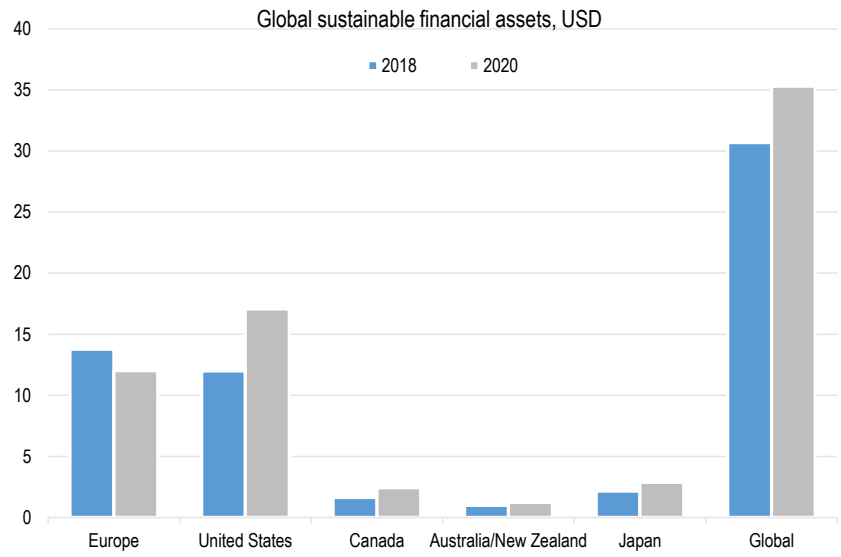
COVID-19 was a wake-up call to public and private actors about the impact of non-financial risk (i.e. global health) on financial performance. Investors recognise the need to reduce sources of market volatility (e.g. climate change, social unrest, geopolitical instability, etc.) and seize the related investment opportunities. Governments recognise that achieving the 1.5°C objective in global temperature increase relative to pre-industrial levels will not be possible if growth does not become more sustainable following the COVID-19 pandemic (Intergovernmental Panel on Climate Change, 2022[35]). The cost of failing to align investment to the SDGs is also significant: 10% of global GDP could be lost without investment in gender equality, and the same for not investing in biodiversity loss, or against violence and armed conflict (BlackRock, 2021[36]).

Over the past few years, developed countries have launched a series of frameworks, initiatives and stimulus packages to boost the recovery. Many of these initiatives, such as the Biden administration's proposed USD 1.9 trillion Build Back Better Act and the European Union's USD 2 trillion NextGenerationEU, include a focus on green investments and making societies more

inclusive and resilient. The OECD is calling for a "quality" recovery that responds to four criteria: strong, inclusive, green and resilient (OECD et al., 2021[37]). The EU has taken the lead in establishing the Sustainable Finance Taxonomy Framework and regulation on sustainability-related disclosures in the financial sector, to improve sustainability measurement and reporting. The EU taxonomy, which includes mandatory reporting by investors, aims to strengthen the sustainable finance market and shift investments where they can have greatest impact in support of a low-carbon transition, social objectives and economic prosperity (Platform on Sustainable Finance, 2022[38]).

The supply of investment labelled "sustainable" has registered unprecedented growth since 2018 in developed countries. Sustainability of business and finance has shifted from niche concerns (e.g. fair trade, impact investment, corporate social responsibility projects) to the mainstream. Total sustainable investment grew by 15% in just two years, from USD 30.7 trillion in 2018 to USD 35.3 trillion in 2020 (Figure 14).[3] Of the nearly USD 100 trillion total assets under management in 2020 from institutional investors, asset managers and asset owners, sustainable assets make up 35.9% (Global Sustainable Investment Alliance, 2021[39]). By recent estimates, ESG assets could exceed USD 53 trillion globally by 2025, more than double the 2020 level (Platform on Sustainable Finance, 2022[38]). Out of the 120 stock exchanges tracked by the Sustainable Stock Exchanges Initiative, 67 had published ESG reporting guidance for their listed companies in 2021 (Sustainable Stock Exchanges Initiative, 2022[40]).

Figure 14. Global sustainable investment in developed countries reached a new high in 2020 despite the global recession (USD trillion)



Note: The figure is based on currency exchange using 2019 prices. Reporting entities include US SIF: The Forum for Sustainable and Responsible Investment (US SIF), Japan Sustainable Investment Forum (JSIF), the Responsible Investment Association Canada (RIA Canada) and the Responsible Investment Association Australasia (RIAA). "Global" sustainable investment data is comprised of data reported by these entities. A regional comparison of growth rates is challenging due to a significant change in the definition of sustainable investment such as the new EU anti-greenwashing rulebook which resulted in the removal of assets labelled sustainable and contributed to the drop in European sustainable investment in 2018-20. Global Sustainable Investment Alliance reporting on financial assets includes sustainable investments such as impact investing and positive, sustainability-themed, norms-based and negative screening, ESG integration, and corporate engagement and shareholder action.
Source: Global Sustainable Investment Alliance (Global Sustainable Investment Alliance, 2021[39]), *Global Sustainable Investment Review 2020*, http://www.gsi-alliance.org/wp-content/uploads/2021/08/GSIR-20201.pdf.

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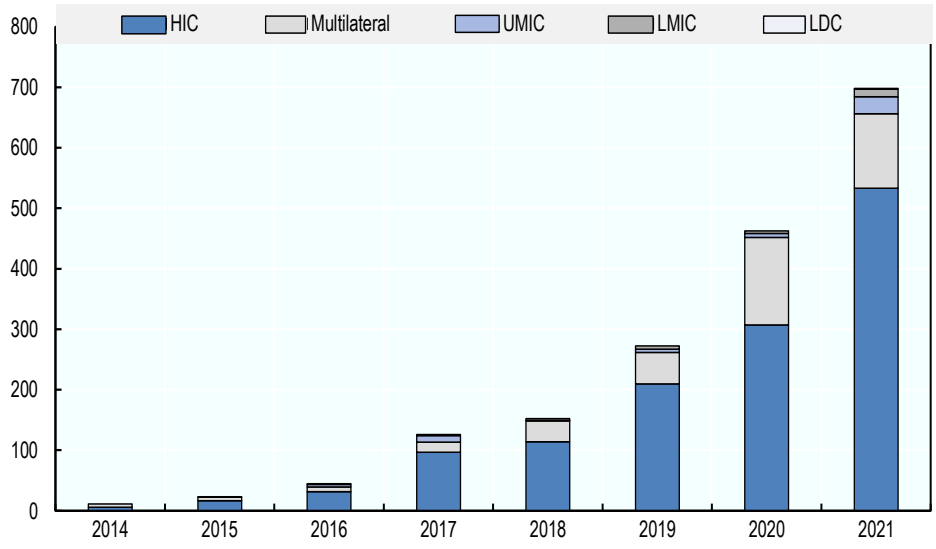
However, the sustainability boom has not reduced the risk of an equity shortfall

Developing countries have yet to fully harness the benefits of the sustainability boom. About 97% of the estimated USD 1.7 trillion in total sustainable investment funds are held in HICs (UNCTAD, 2021[41]). All ODA-eligible countries account for less than 7% and LDCs for less than 1% of cumulative total GSSS bonds issued since 2014 (Figure 15). Access to climate or green funds by SIDS and LDCs, which need them most, remained at 2% and 17%, respectively, between 2016 and 2020 (OECD, 2022[42]).

Broader access to sustainable finance in the poorest countries requires support for the implementation of new regulations, standards and norms (UNCTAD, 2021[43])**.** A significant barrier to accessing sustainable finance is a country's sovereign ESG score. The World Bank found that about 90% of it can be explained by national income, which disadvantages the poorest countries and those lacking accurate GDP data. It is estimated that 7% of the global economy is missing from GDP data, mainly in developing countries with low national statistical office capacities and large informal economies[4] (Ritchie, 2021[44]; OECD/ILO, 2019[45]). Evidence of the income bias, while developed countries' sovereign credit ratings remained stable throughout the COVID-19 crisis: more than 56% of rated African countries were downgraded in 2020, significantly above the global average of 31.8% (Fofack, 2021[46]).

Figure 15. Green social, sustainability and sustainability-linked bond issuances by HIC and multilateral agencies have increased significantly (EUR billion)



Note: Country classifications are based on the OECD Development Assistance Committee (DAC) ODA-eligibility list (2021).
Source: Authors' calculations based on Luxembourg Stock Exchange (2021[47]), DataHub, https://lgxhub-premium.bourse.lu. (OECD, 2022[48])

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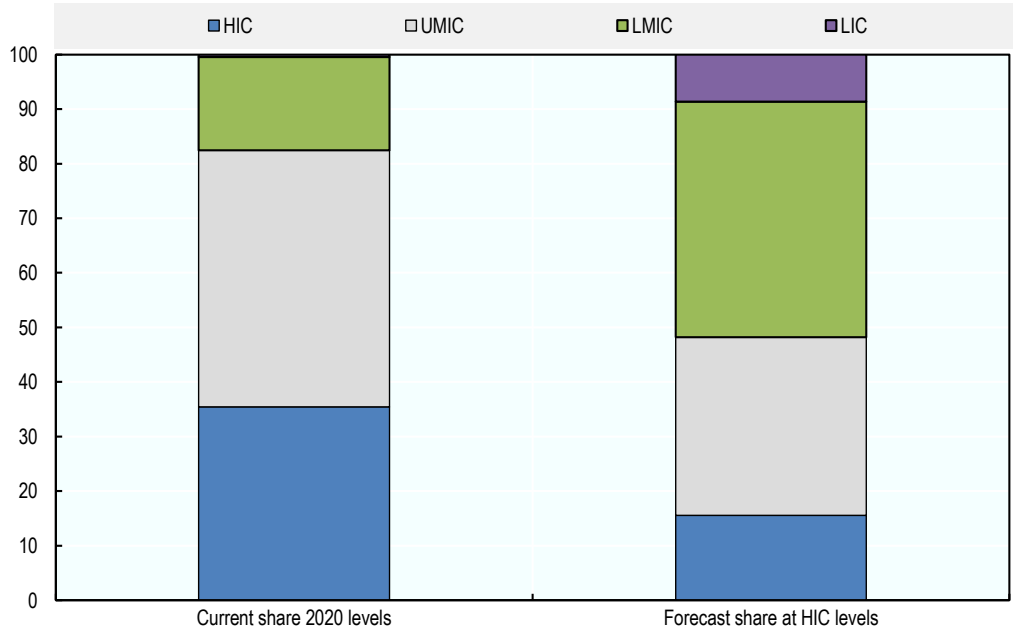
Soaring energy prices raise the value of stranded assets and threaten setbacks to clean energy finance in developing countries. Commitments to divest from carbon-intensive sectors were accelerating before Russia's war against Ukraine, including commitments to end public export guarantees for fossil fuel projects and DAC members' commitment to end new ODA for unabated international thermal coal power generation by the end of 2021 (OECD, 2021[49]). Divestment

decreases the value of assets by signalling a decrease in demand. As a result, clean energy financing needs in developing countries could increase from USD 150 billion to USD 1 trillion by the end of the 2020s, particularly for coal-fired power plants.[5] These countries hold 89% of the total capital globally at risk of being stranded.[6] Nearly 50% of sub-Saharan Africa's export value is composed of fossil fuels, or roughly USD 120 billion in 2019 (World Bank Group, 2020[50]). Without decoupling CO_2 emissions from economic growth, the CO_2 emissions per capita in developing countries could reach HIC levels in the next 70 years or by 2094[7] (Figure 16).

Figure 16. Based on current trajectories, the distribution of annual CO_2 emissions per capita will shift significantly (percent share of global emissions)



Note: The figure shows annual CO_2 emissions per person in HICs using the population in World Bank income categories in 2020. The scenario of no climate action estimates CO_2 emissions per capita if all countries reach emission levels equivalent to those of HICs in 2020, but it does not account for other factors such as the current rate of emissions growth, population growth, new climate policies, technologies or mitigation strategies.
Source: Author adapted from Ritchie (2018[51]), *Global Inequalities in CO_2 Emissions*, https://ourworldindata.org/co2-by-income-region; Global Carbon Project (2022[52]), *The Global Carbon Project* (webpage), https://www.globalcarbonproject.org/; World Bank (2022[53]), *World Development Indicators* (database), https://databank.worldbank.org/source/world-development-indicators.

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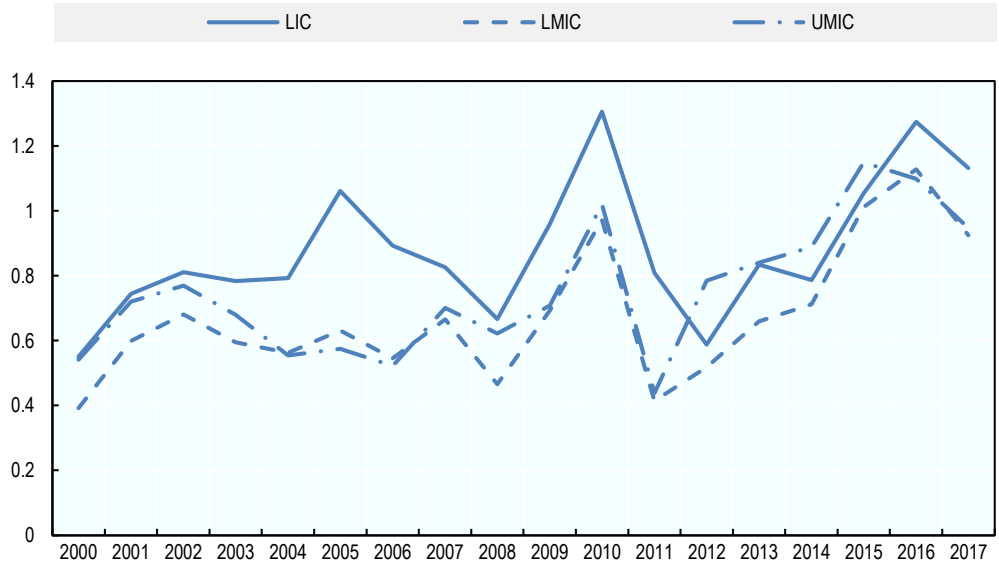
The recovery will be neither sustainable nor resilient if the poorest are left behind

No single country can achieve SDG alignment as long as the risk of negative spillovers exists in other countries (e.g. securing global value chains, limiting temperature increase, tackling the refugee crisis, etc.). For example, driven by the war in Ukraine, global forced displacement reached a historic high in 2022, with more than 100 million people displaced – more than double the number in 2021 (UNHCR, 2021[54]). As official development finance is shifted to address the growing refugee crises within donor countries' borders, there is a risk that less financing will be available to advance the SDGs in the poorest countries.

Future crises increase the risk of a great divergence in the poorest countries. Developing countries have contributed the least to climate change, yet they have lost 20-25% of cumulative GDP per capita since the turn of the 21st century due to temperature increase, with low-income countries (LICs) suffering the greatest losses (de Brandt, Jacolin and Lemaire, 2021[55]) As many as 132 million people could be pushed into extreme poverty due to climate change by 2030 (Jafino et al., 2020[56]). LICs have experienced the highest GDP per capita losses due to their geographical concentration in hotter climates, yet are the least prepared to carry out adaptation and the most vulnerable to climate-related shocks. The war in Ukraine will worsen hunger and food insecurity, particularly in LICs depending on agriculture, and thus most affected by temperature increases and biodiversity loss.

Figure 17. Low-income countries suffered the greatest economic losses due to temperature increase (percentage loss of GDP per capita annual growth)



Note: A sustained one-degree Celsius temperature increase lowers real GDP per capita annual growth by 0.74 to 1.52 percentage points, irrespective of levels of development. Country income groups are presented as an unweighted average of country-level data. Income categories correspond to 2019 World Bank classifications.
Source: Authors adapted from de Brandt, Jacolin and Lemaire (2021[55]), "Climate change in developing countries: Global warming effects, transmission channels and adaptation policies", https://publications.banque-france.fr/sites/default/files/medias/documents/wp822_0.pdf.

StatLink https://stat.link/oc7z1e

To achieve the equity objective of SDG alignment, more and better financing must be allocated where the needs are greatest. While USD 18.2 trillion was spent on COVID-19 economic relief by March 2022, less than 1% was spent in support of developing countries (i.e. USD 162.2 billion of bilateral ODA in 2020) ((IEA, 2022[57]) (WBG, 2022[58])). In 2020, total climate finance mobilised and provided by developed countries to developing countries amounted to USD 83.3 billion, an increase of 4% from 2019 (OECD, 2022[42]). This amount is less than the annual total of USD 150 billion required in 2020 to fill the gap left by potentially stranded assets in developing countries. African nations recently called for a tenfold increase in climate finance commitments, from USD 100 billion in public climate finance to USD 1.3 trillion in public and private finance annually, by 2030 (Rumney, 2021[59]) However, since the COVID-19 crisis, external

financing by donors has been reallocated away from climate change adaptation in favour of domestic emergency response (Richmond et al., 2021[60]).

Constrained fiscal space and high debt levels mean that developing countries are forced to choose between short-term costs or spending in support of long-term benefits. A paradox emerges as financing needs increase in developing countries. On one hand, these countries must mobilise more resources to build back better and invest in long-term climate resilience. For example, financing for adaptation and resilience can generate large returns in terms of avoided costs, as well as social and environmental benefits: for instance, global investments of USD 1.8 trillion for these purposes could result in USD 7 trillion in savings from 2020 to 2030 (Tall et al., 2021[61]). On the other hand, such financing should not result in debt distress, nor be made at the expense of investment in human capital and social protection (International Labour Organization, 2021[62]). External financing solutions and instruments must be tailored to integrated national financing strategies – for example grants, debt swaps, domestic savings and investment among others – to ensure debt sustainability and long-term achievement of the SDGs.

Shifting just 1% of global financial assets could fill the SDG financing gap but this requires engaging all public and private actors in the financial system. The 2021 *Global Outlook* and OECD-UNDP Framework for SDG Aligned Finance call for mutually reinforcing actions in support of alignment along the investment value chain (OECD, 2020[63]) (OECD/UNDP, 2020[2]). Achieving the 2030 Agenda and the Paris Agreement demand collective action at home and in support of the poorest countries. But a clear framework should guide actions along the SDG value chain, from countries of origin to financial intermediaries, on to countries at greatest risk of divergence.

In pursuit of better and more sustainable global development outcomes, the SDG alignment framework rests on two pillars: sustainability and equity. Both are needed to build resilience (OECD, 2020[63]). They complement one another and are equally important:

1. **To be *sustainable*, resources should avoid zero-sum trade-offs across the SDGs**. Investing in any one goal can represent an opportunity cost to invest in the other goals. Resources should aim to promote a triple bottom line within the sustainability equilibrium – that is, to leverage synergies across environmental, social and economic outcomes. Although sustainable finance increased by 15% in 2018-20, totalling USD 35 trillion, it lacks transparency and accountability for impact across the SDGs (i.e. SDG washing). Of the USD 1.8 trillion of so-called sustainable bond issuances since 2014, 56% focused on environmental goals, while only 18% targeted social objectives in areas such as quality education, hunger, poverty and gender equality.[8]
2. **Finance must be *equitable* to be sustainable.** The “shift” in the trillions should reduce inequalities in access to sustainable finance across countries, allowing for more efficient management and prevention of global risks. The growing financing gap means developing countries will have insufficient resources to address future shocks, e.g. rising temperatures, value chain disruption, refugee influx, etc. Likewise, maximising positive transboundary spillovers can help all countries reach the SDGs more quickly, including by reducing the cost of progress at home. However, the sustainability boom is not yet benefitting HICs and developing countries equally. Without new efforts to help the latter tap into the opportunities, the sustainability boom could bypass the countries furthest behind, leaving significant market gaps globally, with knock-on effects on the SDG financing gap.

Step 1: Reinforce the "equity" pillar of SDG alignment

Without support from developed countries, developing countries will not benefit from the sustainable finance boom, and a solution to containing the Great Divergence will be wasted. Here are recommendations for action in support of countries at risk of divergence.

Support domestic resource mobilisation to avoid the fiscal and credit crunch in developing countries

- **Support to domestic resource mobilisation (DRM) has increased, yet it falls short of commitments to help developing countries strengthen their tax base and increase tax compliance.** Between 2015 and 2020, DAC members invested approximately USD 1.9 billion in ODA for DRM, which corresponds to an average of USD 310 million per year. Despite the progress made and according to the data reported in the Creditor Reporting System, this is still far from the target set by the Addis Tax Initiative to double ODA to DRM in the period 2015-2020 to USD 441.1million (2020[64]).
- **Align support to national integrated financing strategies such as Medium-Term Revenue Strategies to ensure that DRM targets SDG alignment.** A study by the US Agency for International Development (2016[65]) found that rebuilding basic infrastructure, restoring public service and introducing modern digital tax systems helps developing countries, including fragile contexts, to improve revenue-to-GDP ratios.
- **Help developing countries implement country-led carbon pricing policies to generate additional domestic revenue aligned to a just and sustainable transition.** While revenue potential varies across countries, developing countries on average could generate revenue equivalent to about 1% of GDP if they set carbon rates on fossil fuels equivalent to EUR 30 per tonne of CO_2 (OECD, 2021[66]). In developing countries, where 70% of all employment is informal, carbon taxing is an important policy lever as direct taxes on personal or corporate income are more challenging to collect (OECD/ILO, 2019[45]).
- **Strengthen support for debt-to-SDG swaps.** A long-standing sustainable finance option, debt-to-climate swaps allow bilateral and multilateral actors to carry out debt forgiveness or restructuring with developing countries, freeing up financing for SDG action (Thomas and Theokritoff, 2021[67]). For example, a debt swap worth USD 2.9 million between Italy and the Philippines in 2012 had poverty reduction among its targets. This option is most effective in countries not in debt distress and able to service their debt. Future efforts could seek to engage the private sector in investing in climate change adaptation and mitigation debt swaps, in exchange for carbon emission offsets.
- **Design a global framework to strengthen the transparency and accountability of external debt financing.** A global response to debt sustainability is required to avoid situations in which debt forgiveness or restructuring from one creditor serves to finance debt on harsher terms and conditions from another, and jeopardises the debt sustainability of the borrower. For example, the OECD debt transparency initiative in LICs, with the support of the United Kingdom government and the Institute of International Finance, aims to provide greater transparency of creditors and borrowers in LICs to ensure debt sustainability and reduce financing costs, particularly in the context of monetary policy tightening that will result in a higher interest rate environment (OECD, 2022[68]).

Deepen domestic markets for sustainable finance and investment in countries most in need

- **Build absorptive capacities in developing countries to create a pipeline of sustainable finance projects.** At least 527 public development banks (PDBs) and development finance institutions (DFIs) were identified as holding a combined total of more than USD 13 trillion in financial assets (Xu, Marodon and Ru, 2021[69]). These multinational, national and subnational actors play a key role to align finance in support of the SDGs, including for climate change adaptation and resilience, gender equality, biodiversity, and agriculture among other areas. However, guidance on good practices is needed to unlock access to climate-related financing, and climate finance and services, notably in LDCs and SIDS (Casado Asensio, Blaquier and Sedemund, 2022[70]). One example is the support provided by the Green Climate Fund in its work with PDBs and DFIs in LDCs, SIDS and other developing countries to strengthen investees' operational efficiency and ESG compliance (Glemarec, 2021[71]).
- **Promote the implementation of frameworks and policy reforms to align external investment with the SDGs**. Developing countries with clean energy policies are, on average, seven times more likely to attract clean energy investment than those without such policies. The FDI Qualities Policy Toolkit, launched in June 2022, provides a framework for policy interventions to maximise the contribution of FDI to sustainable development (OECD, 2022[72]). Country-level implementations of these frameworks and indicators, such as investment policy reviews and FDI Qualities reviews, seek to assist governments in designing and implementing policy interventions to improve the investment climate and attract sustainable investment. The 2020 investment policy review carried out with Indonesia, for example, found that reducing regulatory restrictions on FDI could significantly increase the stock of FDI by up to 85% (OECD, 2020[73]).
- **Deepen financial markets in developing countries**, to create a buffer against future shocks. Strengthening financial markets helps improve individual access to financial services, increase financial reserves in times of crisis and lower financial services costs. For example, the IMF Resilience and Sustainability Trust created in April 2022 aims to channel special drawing rights (SDRs) (i.e. reserve assets housed in developed country central banks) to support structural reforms in LICs and the most vulnerable MICs (e.g. climate change and pandemic preparedness), while reducing risk to balance-of-payments stability. Continued support is crucial to ensure equitable channelling of special drawing rights, and build macro prudential stability, including through multilateral development banks.
- **Promote peer-to-peer exchange and technical support to strengthen standards and regulations**, so as to build sustainable finance markets in developing countries at risk of missing out. China and South Africa are among the only developing countries with an ESG taxonomy, the latter only since April 2022. Just 25 of 60 developing countries' stock exchanges require ESG reporting (IEA, 2021[74]) Financial actors can help pool expertise in support of better standards and regulations to improve the transparency and accountability of sustainable finance markets. For example, the Luxembourg Green Exchange is promoting sustainable finance on a global scale and builds capacity to address market gaps for SDG financing in developing countries.

Attract and monitor financing for development aligned to integrated national financing strategies

- **Strengthen country-led integrated national financing strategies** to better align development finance with development priorities, including on climate and gender equality**.** National financing strategies cover the full range of financing resources, support the bridging of short- to longer-term planning, and reinforce transparency and collective accountability. For example, Nigeria's Integrated National Financing Framework (INFF) process integrates a gender lens for all sources of financing.[9] This helps increase the return on investment and fosters women-owned and led enterprises, workplace equality, and products and jobs that improve the lives of women and girls (OECD, 2022[75]).
- **Help developing countries access affordable, neutral and quality advice on FSD,** aligned to integrated national financing strategies. The OECD, the UN Department of Economic and Social Affairs, and the UN Development Programme launched the INFF Facility in 2022 to help developing countries navigate the increasingly complex landscape of financing instruments. Pooled advisory services could also help developing countries gain access to global funds and innovative instruments that limit the risk of debt distress.
- **Explore the use of innovative instruments**, including investment based on results, to mitigate risk and attract external resources aligned to the SDGs**.** Several sovereign developing country issuers have recently developed sustainability bonds, a form of results-based financial instrument. Benin launched a USD 500 million SDG bond programme in 2021, the first SDG bond issuance in Africa, with investment grade ratings by Moody's and Standard & Poor's (Ministry of Economy and Finance of Benin, 2022[76]). The UN Sustainable Development Solutions Network will monitor the SDG impact of the bond proceeds and Moody's will assess ESG ratings. Nearly 75% of funds are allocated in support of social goods such as education, housing and health-related SDGs.
- **For innovative and blended finance to be effective, their SDG impact must be better measured and managed.** In addition to labelling, standards and frameworks are needed to ensure comparability across measures of development performance. For example, in 2020, 92% of funds and facilities aligned results-based measures with the International Financial Corporation performance standards which helps to improve management of performance metrics. The OECD-UNDP Impact Standards for Financing Sustainable Development (IS-FSD), adopted by the DAC in March 2021, further encourage a shift away from metrics and reporting, to embedding positive and negative impact considerations in the strategy, management approach and governance of an organisation (OECD/UNDP, 2021[77]).

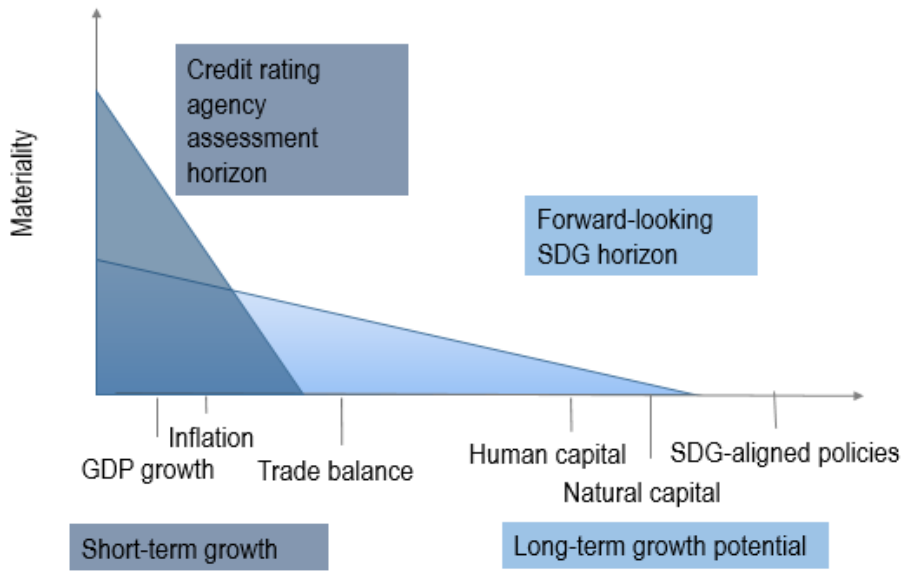
Step 2: Promote collective action along the investment value chain

SDG alignment of financing will largely depend on domestic policies in developed countries. Since financial assets are concentrated there, it falls to them to strengthen standards, regulations, policies and other incentives to improve risk management, prevent SDG-washing, and ensure that domestic policies avoid negative spillovers on FSD across borders. Here are recommendations, illustrated by best practices, to ensure an integrated approach across developed country governments and financial intermediaries.

Strengthen financial risk management standards and incentives, including risk perception criteria and ratings aligned to the SDGs

- **Working with asset managers, DFIs and other institutional investors, donors can help reduce real and perceived financial risk in developing countries, and better target blended finance risk mitigation instruments.** New types of collaborative and private sector-led public-private models, such as BlackRock's Climate Finance Partnership (with the *Agence française de développement*, KfW and the Japan Bank for International Cooperation), seek to remove bottlenecks between institutional investors and DFIs to mobilise financing for climate infrastructure in developing countries (BlackRock, 2021[78]).
- **Developed countries can work with credit rating agencies (CRAs) to enhance the transparency of sovereign credit ratings and create incentives to integrate long-term SDG rating criteria.** Developed countries can help revamp current sovereign ratings and investment models by integrating SDG progress as a key indicator. A higher sovereign credit rating score should be provided to encourage investment in countries making demonstrable efforts towards the SDGs. Criteria related to a country's long-term sustainability and SDG progress, such as indicators related to ESG ratings, are material to a country's credit rating (Figure 18). However, to date, only one CRA, Scope GmbH, includes ESG criteria as a standalone category (weighted at 20% of the total score) in its assessments (Gratcheva et al., 2022[79]). Over 170 investors (with nearly USD 40 trillion in collective assets under management) and 27 CRAs support the UN Principles for Responsible Investment initiative to integrate ESG into credit ratings (UN, 2022[80]). More work is required to ensure more granular reporting and disclosure of ESG ratings.

Figure 18. Move toward credit rating criteria with a forward-looking SDG horizon



Source: Authors' adapted from Gratcheva et al. (2022[79]), *Credit Worthy: ESG Factors and Sovereign Credit Ratings*, https://openknowledge.worldbank.org/handle/10986/36866.

Implement regulations to avoid green- and SDG-washing

- **Working with the multilateral system, developed countries can help improve the interoperability of sustainability standards.** Interoperability of standards and co-ordination of regulatory policy tools ensure a fair global playing field, and comparability across financial and capital markets. The Global Reporting Initiative and the International Financial Reporting Standards Foundation have also announced plans to co-ordinate and align their capital market and multi-stakeholder standards for sustainability disclosures. To advance co-ordination with the private sector, the OECD ESG Risk Policy Framework in 2023 will identify inefficient market practices and policies with the goal of better aligning capital flows with sustainable and climate-resilient growth.
- **Link ESG and SDG key performance indicators to direct financing towards SDG impact**. Comparable data and standards that make sense to the private sector are needed to avoid green washing and SDG-washing. For example, the European Commission's draft Corporate Sustainability Reporting Directive draws from both the SDGs and the Paris Agreement to establish a set of targets and indicators to achieve impact in support of sustainable development. With its adoption, EU sustainability reporting standards will become mandatory for a broader set of companies requiring double materiality assessment and ESG reporting (European Commission, 2021[81])
- **Donors can step up support for responsible business conduct.** Promotion of voluntary and mandatory compliance and disclosure of private sector activities, including financial sector activities, can help achieve meaningful impact for people and planet along the value chain. The OECD FDI Qualities Guide for Development Co-operation will be launched in 2022 and seeks to provides specific guidance to donors and other development co-operation actors on strengthening the role of development co-operation in mobilising FDI and enhancing its positive impact in developing countries (OECD, forthcoming[82]).
- **Developed countries and their financial intermediaries should advocate for the 1% SDG Alignment Club**, which advocates for 1% of global private sector capital to be put towards investments that directly promote SDGs in developing countries (Alam, 2021[83]). For example, J.P. Morgan's DFI launched in 2020, in collaboration with the International Finance Corporation, has introduced portfolio allocation criteria that require client countries to meet geographical targets based on the World Bank-eligible borrowing country lists (i.e. International Development Association, International Bank for Reconstruction and Development, or blend countries) to spur capital in favour of financing in frontier and emerging markets (J.P. Morgan Development Finance Institution, 2022[84]). It mobilised USD 124 billion with sustainable development impact in 2021 (J.P. Morgan, 2021[85]).

Promote coherent domestic and external policies for financing sustainable development

- **Strengthen international co-operation to achieve a framework for a low-carbon transition globally.** Carbon pricing can support a green recovery by shifting investment incentives and boosting public revenue, if designed in a progressive manner. However, currently some 60% of energy-related CO_2 emissions remain unpriced and some of the most polluting fuels remain among the lowest priced (OECD, forthcoming, 2022[86]). International co-operation is essential to strengthen the market and ensure a just redistribution of resources for a low-carbon transition in developing countries.

Support international co-operation on tax matters to strengthen fairer resource distribution, including to the benefit of the poorest countries. The two-pillar solution to taxation of the digitalising economy is a major breakthrough, including 60 developing

countries, that provides more effective taxation of enterprises. The global minimum tax (part of Pillar Two) provides a floor for international tax competition as well as new impetus for countries to review their tax incentives and eliminate those that are wasteful. The standards on base erosion and profit shifting, exchange of information and value-added tax on e-commerce all have potential benefits for developing countries. Pillar One is expected to help reallocate more than USD 125 billion of profit to market jurisdictions each year. Pillar Two is expected to generate about USD 150 billion in additional annual tax revenues globally (OECD, 2021[87]). Technical assistance is required for both legislative and administrative implementation of such international standards.

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Notes

[1] It should be noted that these studies on financing needs in LICs were published prior Russia's war against Ukraine and did not take into account the additional financing needs the war will engender.

[2] Stock-based measures capture fluctuations in the value of financial assets held by actors such as banks, central banks, financial auxiliaries, insurance corporations, other financial intermediaries, pension funds and public financial institutions. Asset valuations are counted in the measure of stocks or asset purchases rather than as a flow-based measure.

[3] It should be noted that the Global Sustainable Investment Alliance figures include an aggregation of amounts of sustainable investment reported by regions and that regions use a variety of different methodologies.

[4] In 2019, informal employment represented on average 63% of employment in African countries. In 15 African countries, more than 80% of employment was informal employment.

[5] The International Energy Agency defines stranded assets as "those investments which have already been made, though at a point in time prior to the end of their economic life (as assumed at the investment decision point), are seen to no longer earn economic returns as a result of changes in the market and regulatory environment brought about by climate policy".

[6] The figure reflects World Bank estimates. Costs would include the remaining financial value of the asset (although the economic value would be lower), the costs of decommissioning coal-fired power plants, and the costs of social and job dislocation. These will be country specific and require further analysis and specification; estimates vary widely.

[7] The median time lag for GDP per capita in developing countries to reach high-income country levels of GDP per capita was estimated in 2020 to be 74 years. For more information, see https://doi.org/10.1007/s11205-020-02488-4.

[8] These are author's calculations based on the Luxembourg Stock Exchange DataHub at https://lgxhub-premium.bourse.lu.

[9] The INFF concept was first introduced with the adoption of the Addis Ababa Action Agenda in 2015.

1 From the Great Lockdown to the Great Divergence

This chapter examines the contrasting impact on the global economy of the COVID-19 pandemic, Russia's war of aggression against Ukraine and other recent crises. While rich countries are beginning to turn the corner on the COVID-19 crisis, prospects of a strong and sustainable recovery in developing countries are vanishing – signs of an emerging two-track recovery that is widening inequalities between and within countries.

1.1. The uneven COVID-19 recovery and the impact of Russia's war against Ukraine are exacerbating global economic fault lines

1.1.1. A fragile "K-shaped" recovery is accentuating economic and financial disparities across countries in the wake of successive crises

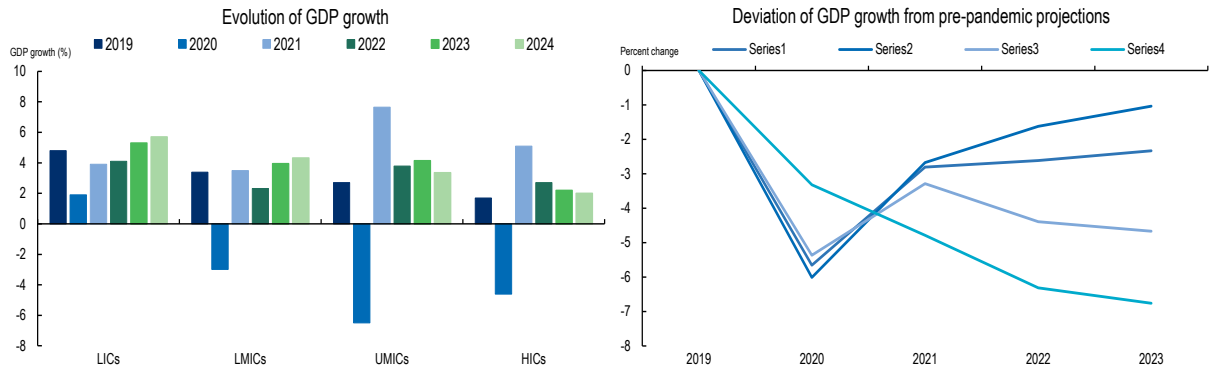
The pandemic triggered a global recession of a magnitude not seen since the Second World War. As described in the previous edition of the Global Outlook on Financing for Sustainable Development (hereinafter Global Outlook), the outbreak of the COVID-19 pandemic at the beginning of 2020 sent massive shockwaves through the global economy (OECD, 2020[63]). The quick propagation of the pandemic caught many countries off guard. As numerous countries locked down their populations in an effort to control the spread of the disease, a large part of the global economy came to a halt – a period now referred to as the Great Lockdown. By its nature, the COVID-19 crisis has had a complex and profound impact on the global economy and financial system. In contrast to previous crises that were triggered by either a demand shock (the 2008-09 global financial crisis) or a supply shock (the Hokkaido earthquake and tsunami), the Great Lockdown generated a simultaneous demand and supply shock by pushing a large share of the world's population into inactivity. The result was a massive contraction of the global economy, with world gross domestic product (GDP) growth falling by -3.4% in 2020 (OECD, 2021[88]).

The gradual reopening of countries in the second half of 2020 was the prelude to a swift but fragile global recovery. As government restrictions started to ease and businesses reopened, global economic activity picked up pace towards the end of 2020: world GDP was down by -10% between Q4 2019 and Q2 2020 but rebounded by 8% between Q2 and Q4 2020 (OECD, 2021[88]). Shortly afterwards, the progressive reopening of borders prompted a recovery of world trade, which increased by +9.3% in 2021 after a -8.2% slump the previous year (Intergovernmental Panel on Climate Change, 2022[4]). This recovery, combined with the entry into action of the stimulus packages launched by some major economies, contributed to shoring up world GDP by +5.6% in 2021. However, the incipient global recovery hid large disparities between countries at different levels of development. While high-income countries (HICs) and upper middle-income countries (UMICs) registered a larger drop in economic output in 2020, most of these countries were already experiencing a strong recovery by 2021, with economic growth exceeding pre-crisis levels due in part to a rebound effect. Low-income countries (LICs) and lower middle-income countries (LMICs) experienced a softer recession in 2020 but are now facing a weaker recovery (Figure 1.1, left side).

Since early 2022, the global economy has been facing significant headwinds due to Russia's war in Ukraine that further strain developing countries' prospects for a strong recovery. The sizeable fiscal stimulus and loose monetary policies put in place in the world's major economies since the start of the pandemic resulted in the injection of massive liquidity into the economy. While the stimulus helped sustain the global economy in the first stages of the crisis, it also led to a substantial rise in inflation, which reached 6.3% in 2021 compared to an average 4.8% in the previous decade. In addition, the start of Russia's war against Ukraine, coinciding with the withdrawal of government stimulus measures, contributed to the slowdown of global growth in 2022. The slowdown has widened existing inequalities both within countries (e.g. due to job losses and rising inflation) and across countries, notably increasing developing countries' divergence from pre-pandemic output projections (Figure 1.1, right side). Due to their specific vulnerabilities, developing countries are incurring the highest output losses from the successive crises. Their cumulated output losses between 2020 and 2023 represent 5% of their pre-pandemic GDP projections; the comparable figure for HICs is only 3%. According to the latest projections, developing countries lost an average USD 1.4 trillion in GDP annually between 2020 and 2023 due to the COVID-19 crisis (IMF, 2020[3]; Intergovernmental Panel on Climate Change, 2022[4]). Now, the war could result in an additional loss of approximately USD 718 billion in 2022 and 2023 (IMF, 2022[7]). The accumulating

damage wrought by successive crises to developing countries' economies is translating into significant revenue losses and affecting the composition of their government revenue (Chapter 2).

Figure 1.1. The multi-speed recovery shows an emerging Great Divergence between countries (2019-24)



Note: On the left, the values for 2021 are estimates and the values for 2022-24 are forecasts. The classification by income group follows the World Bank's guidance of 1 July 2021. On the left, the deviation is calculated as the percent deviation between June 2022 and January 2020 projections from the World Bank's Global Economic Prospects series.
Source: Left side: World Bank (2022[5]), *Global Economic Prospects, June 2022*, https://doi.org/10.1596/978-1-4648-1843-1. Right side: World Bank (2020[6]), *Global Economic Prospects, January 2020: Slow Growth, Policy Challenges*, https://openknowledge.worldbank.org/bitstream/handle/10986/33044/9781464814693.pdf and World Bank (2022[5]), *Global Economic Prospects, June 2022*, https://openknowledge.worldbank.org/handle/10986/37224/9781464818431.pdf.

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Before Russia's full-scale of Ukraine, limited access to vaccines and the relatively small size of their stimulus packages were already hampering the recovery in LICs. While COVID-19 left no country untouched, countries had diverging recovery trajectories in the first two years of the pandemic due to important differences in their response capacity to the health and economic crises. These two factors (access to vaccines and stimulus size) are short-term drivers of the uneven COVID-19 recovery and are correlated with countries' income levels, reflecting in large part the limited capacity of the poorest countries to confront new and emerging global threats (Table 1.1).

Table 1.1. Short-term drivers of the uneven COVID-19 recovery

	Access to vaccines (persons fully vaccinated)	Stimulus size (per capita COVID-19 fiscal spending)
LICs	1 in 9 people	USD 19
LMICs	1 in 2 people	USD 157
UMICs	2 in 3 people	USD 650
HICs	2 in 3 people	USD 13 466

Note: Data on access to vaccines correspond to persons fully vaccinated as of 16 March 2022. Data on stimulus size correspond to per capita COVID-19 fiscal spending between January 2020 and October 2021.
Source: Data on access to vaccines: World Health Organization (World Health Organization, 2022[89]) *WHO Coronavirus (COVID-19) Dashboard* (database), https://covid19.who.int/table. Data on per capita COVID-19 spending for fiscal measures: IMF (2021[90]), *Fiscal Monitor Database of Country Fiscal Measures in Response to the COVID-19 Pandemic* (database), https://www.imf.org/en/Topics/imf-and-covid19/Fiscal-Policies-Database-in-Response-to-COVID-19.

Low and partial vaccine access delayed the economic recovery in developing countries. Despite repeated calls by the World Health Organization (WHO) to ensure global, equitable access to COVID-19 vaccines, the purchase of vaccines was carried out in a largely uncoordinated fashion. By early 2021, HICs had signed purchase agreements to vaccinate their populations several times over while the combination of global supply shortages and vaccine nationalism hindered development partners' efforts to support developing countries' access to vaccines through the COVID-19 Vaccines Global Access (COVAX) facility. As a result, only 11% of the population of LICs were fully vaccinated by March 2022 versus more than two-thirds of the population of both HICs (73%) and UMICs (71%) and 47% of the population of LMICs. Countries most in need have been among those lagging furthest behind in terms of vaccine access, including for reasons outlined in Box 1.1. By June 2021, only 1.2% of global COVID-19 vaccine doses had been administered in least developed countries (LDCs) although they are home to 14% of the world's population (UN, 2022[91]). Recent research shows that had LICs been able to vaccinate their population at the same rate as HICs (i.e. 54% vaccinated by September 2021), they would have increased their GDP by USD 16.27 billion in 2021 (UNDP, 2022[92]) and could have used this foregone income to address the impact of the pandemic or other pressing development challenges.

Box 1.1. Developing countries lack the financing, technology and tools to close the vaccine divide

Already battered by successive shocks, developing countries cannot afford COVID-19 vaccines. It could cost as much as USD 8.4 billion to deliver COVID-19 vaccines to developing country populations, according to a recent report for the United Nations Children's Fund by (Griffiths et al., 2022[93]). This estimate includes all developing countries except for Bulgaria, the People's Republic of China (hereinafter China), Romania and Russia and is based on the WHO global vaccination strategy target of vaccinating 70% of the world's population. Despite the progress achieved through COVAX, which has delivered more than one billion doses of COVID-19 vaccines in developing countries, the funding gap for COVID-19 vaccines is significant. As of 13 June 2022, USD 2.3 billion has been contributed to support the vaccines pillar of the Access to COVID-19 Tools Accelerator – less than half the funding requested and less than a third of the USD 8.4 billion required to deliver COVID-19 vaccines to developing country populations.

Cost is not the only constraint: Developing countries' limited access to relevant tools and technology hinders COVID-19 vaccine delivery, and there are logistical barriers to local vaccine production (OECD, 2021[94]). Recognising these challenges, the WHO and other partners launched the COVID-19 Technology Access Pool, in May 2020 to allow the developers of COVID-19 vaccines, diagnostics and therapeutics to voluntarily share the intellectual property, knowledge and data. More recently, the June 2022 Ministerial Conference of the World Trade Organization adopted a waiver of certain procedural obligations under the Agreement on Trade-Related Aspects of Intellectual Property Rights to allow the manufacture of COVID-19 vaccines without the consent of the patent owner.

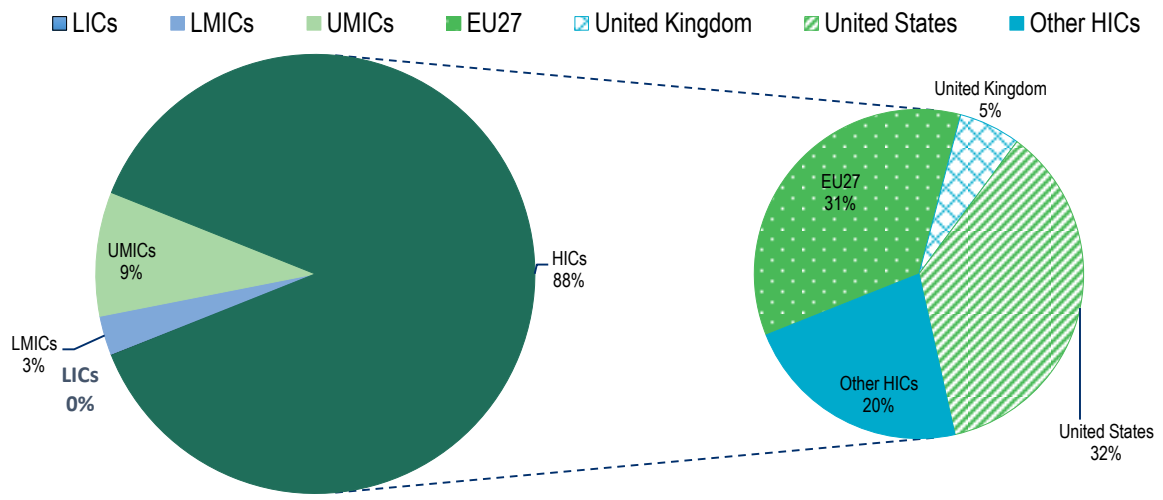
Source: Griffiths et al. (2022[93]), *Costs and Predicted Financing Gap to Deliver COVID-19 Vaccines in 133 Low- and Middle-income Countries*, https://www.unicef.org/media/114216/file/Costs-and-Predicted-Financing-Gap-to-Deliver-COVID-19-Vaccines-in-133-Low-and-Middle-Income-Countries.pdf; OECD (2021[94]), "Coronavirus (COVID-19) vaccines for developing countries: An equal shot at recovery", https://www.oecd.org/coronavirus/policy-responses/coronavirus-covid-19-vaccines-for-developing-countries-an-equal-shot-at-recovery-6b0771e6/.

Many developing countries also lacked the fiscal and monetary policy space to respond to successive shocks through economic policy support. In the decade prior to the COVID-19 pandemic, many developing countries experienced a deterioration of their fiscal positions as they confronted the

successive shocks of the 2008-09 global financial crisis and the 2014 plunge in commodity prices. As a result, many developing countries entered the pandemic with little to no fiscal leeway or spare capacity in their public finances, resulting in wide disparities in countries' fiscal responses (Figure 1.2). High-income countries were able to mitigate the twin demand and supply shocks by deploying stimulus packages 700 times greater than those of LICs on per capita basis, 86 times greater than in LMIC and 20 times greater than UMICs as shown in Table 1.1. Similarly, strong central bank interventions have mainly occurred only in HICs and UMICs. (Chapter 3 discusses central bank asset purchases following the pandemic in greater detail.) Central banks in many LICs and LMICs, however, had limited margin for manoeuvre to implement accommodative monetary policies due to their lower policy credibility, inability to use quantitative easing and weaker macroeconomic fundamentals.

Figure 1.2. Developing countries had limited fiscal space to implement stimulus measures

Share of COVID-19 fiscal measures by income group since January 2020



Note: The estimate for the 27 post-Brexit European Union countries (EU27) includes the additional measures implemented by the European Commission (USD 1.361 billion) on top of the EU member states' average.
Source: IMF (2021[90]), *Fiscal Monitor Database of Country Fiscal Measures in Response to the COVID-19 Pandemic* (database), https://www.imf.org/en/Topics/imf-and-covid19/Fiscal-Policies-Database-in-Response-to-COVID-19.

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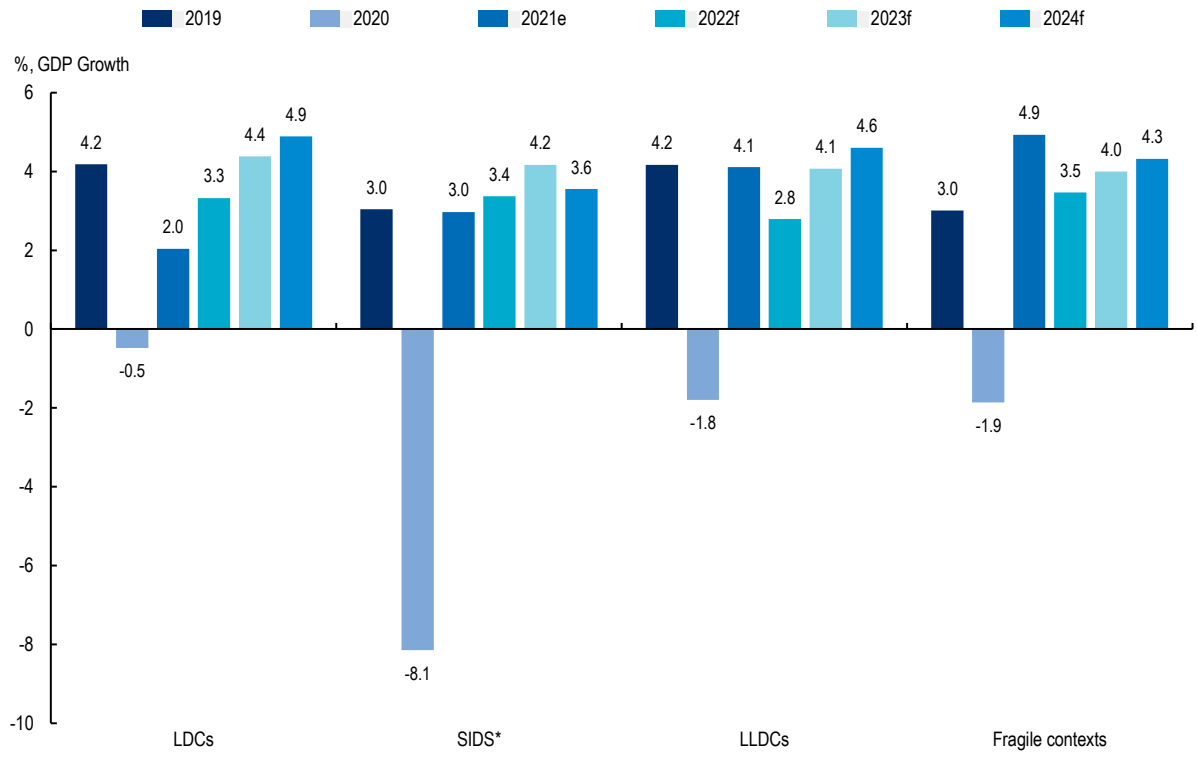
Among countries most in need, small island developing states (SIDS) faced the most severe recession in 2020 as a result of the COVID-19 pandemic but also were able to recover faster than other countries. The GDP of SIDS dropped by -8.6% in 2020, in large part because their economies depend heavily on the tourism sector, which was directly impacted by the travel restrictions and the lockdowns (Figure 1.3). In the same period, GDP dropped -1.9% in fragile contexts, -1.7% in landlocked developing countries (LLDCs) and just -0.5% in LDCs – a less severe impact from the crisis that can be partially explained by the fact they are less connected to the global economy. For example, only 1% of LDCs were in global trade in 2020. On the other hand, SIDS have since been experiencing a stronger recovery than other countries most in need and are forecast to exceed their pre-pandemic growth level in 2022 while GDP growth in LDCs and landlocked countries is not expected to return to pre-pandemic levels before the end of 2023.

Figure 1.3. Small island developing states registered a larger drop in GDP in 2020 but least developed countries and landlocked developing countries are expected to take longer to return to pre-pandemic growth levels

Percentage change (and projected change) in GDP growth (2019-24)



Note: The figure shows simple averages. The 2021 data correspond to estimates (e) and 2022 and 2023 data correspond to forecasts (f). Guyana, a SIDS, is excluded from the analysis, though its GDP grew by +43% and +21% in 2020 and 2021 (estimated), respectively, because of its new oil industry.

Source: Authors' calculations based on World Bank (2022[95]), *Global Economic Prospects, January 2022*, https://openknowledge.worldbank.org/handle/10986/36519.

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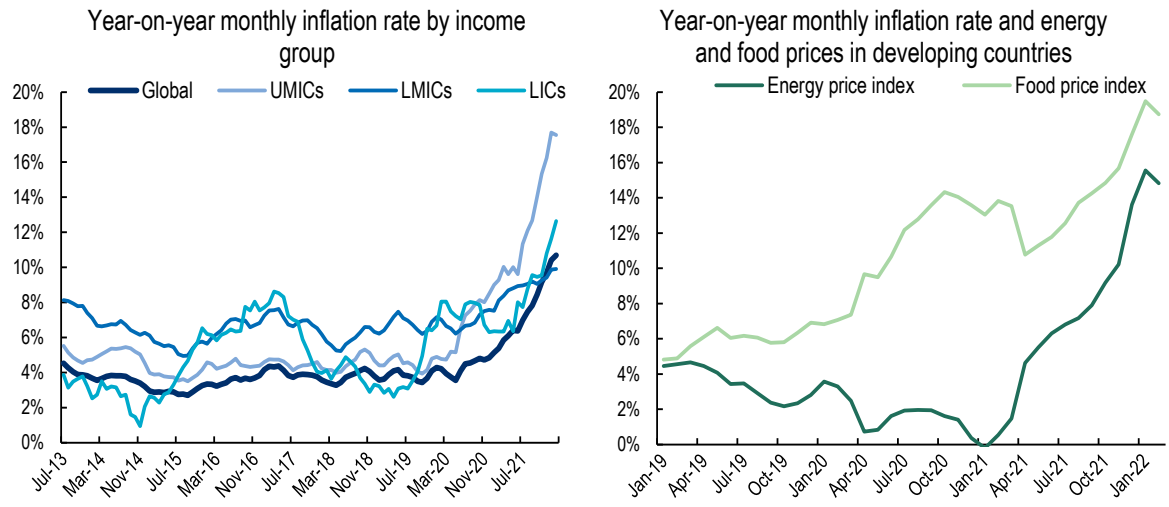
The global and country-level economic consequences of the war in Ukraine are further widening disparities between developed and developing countries. Russia's war against Ukraine is first and foremost a humanitarian catastrophe that has resulted in thousands of casualties and millions of refugees. Chapter 2 describes the implications of this humanitarian crisis for the financing for sustainable development landscape. The conflict has derailed economic projections, which were expected to return to pre-pandemic levels by 2023, while also impacting the livelihoods of people around the world. The war is now expected to reduce global GDP growth by more than 1.5 percentage points in its first full year (OECD, 2022[96]). Recent estimates also suggest the war could increase the global output loss by USD 5.5 trillion between 2020 and 2025 in addition to the International Monetary Fund's earlier estimate of a USD 12.5 trillion global output loss resulting from the COVID-19 pandemic over this period. LICs stand to lose the most from the effects of the war, as shown in Figure 1.4 (right side), widening the deviation of their GDP growth from pre-pandemic projections. Developing countries are most affected due to the volatility of food and fuel prices as well as by the increased financial uncertainty, which signals risk to investors. At the other end of the income spectrum, the GDP growth of HICs will have nearly caught up with pre-pandemic

projections by 2023 despite the war, thanks in large part to massive fiscal and monetary stimulus that have buoyed financial markets.

The war is exacerbating global inflationary pressures and contributing to soaring food and energy prices in developing countries. Even before Russia's full-scale invasion, global consumer prices were on the rise due to supply-demand imbalances caused by the pandemic and the accommodative fiscal and monetary policies put in place in response to the COVID-19 crisis. Inflation in developing countries rose sharply from 2.7% in 2020 to 4.3% in 2021 compared to a milder in global inflation from 2.2% to 3.4% over the same period (Figure 1.4, left side). The war added to these upward pressures due to the weight of Russia and Ukraine as exporters of key commodities. Russia is the world's largest gas exporter as well as a large global supplier of fertilisers, and the two countries, taken together, account for about one-third of global cereal exports and 44% of Africa's wheat imports (UNCTAD, 2022[97]). The OECD estimates that, due to the impacts of the Russian invasion, global consumer prices could increase by 2.5 percentage points in the first 12 months of the Ukraine war (OECD, 2022[96]). Moreover, the increased cost of fertilisers and other agricultural inputs means that the surge in food prices could spill over to future years.

Figure 1.4. Inflation is particularly impacting developing countries through increases in food and energy prices



Note: The year-on-year monthly inflation rate corresponds to a simple average of the Headline Consumer Price Index growth rate for a sample of 59 developing countries and 45 high-income or unclassified countries for which all monthly figures between July 2012 and February 2022 are available. The year-on-year monthly inflation rate for energy prices corresponds to a simple average of the Energy Price Index growth rate for a sample of 26 developing countries for which all monthly figures between January 2018 and February 2022 are available. The year-on-year monthly inflation rate for food prices corresponds to a simple average of the Food Price Index growth rate for a sample of 63 developing countries for which all monthly figures between January 2018 and February 2022 are available.
Source: Ha, Kose and Ohnsorge (2021[8]), "One-stop source: A global database of inflation", https://openknowledge.worldbank.org/handle/10986/36037.

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Rising consumer prices will hit vulnerable populations the hardest. LICs are especially vulnerable to rising inflation from external shocks. A recent assessment by United Nations Conference on Trade and Development notes that the products likely to cost more due to the war in Ukraine make up more than 5% of the poorest countries' import baskets but less than 1% of richer countries' imports (UNCTAD, 2022[97]). In addition, the poorer segments of the world's population are experiencing larger welfare losses because

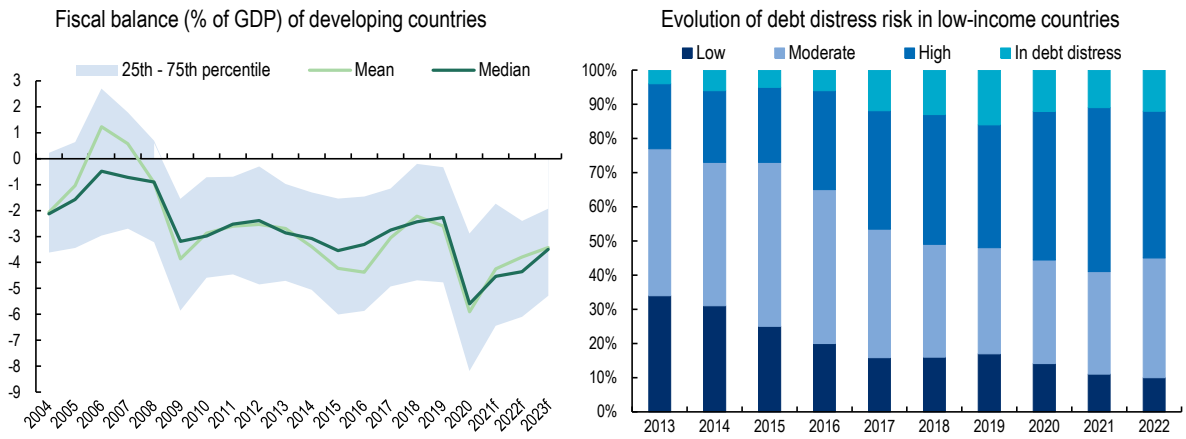
the war-induced price increases have a greater impact on their real disposable income. Rising global inflation also has implications on the financing for sustainable development landscape (Chapter 2).

1.1.2. Developing economies face heightened financial risks and volatility over the medium to long term

The economic and financial uncertainty generated by mounting geopolitical tensions and the risk of transmission of new adverse shocks to the global economy translate to parallel uncertainty for developing economies. Against this backdrop, business confidence and investor sentiment are likely to remain fragile, possibly depressing investment in developing countries in the medium to long term. The fallout from the war and quantitative tightening are already generating volatility in the financial markets and could ultimately lead to new episodes of capital flight from the poorest countries, with foreign investors turning to safe-haven assets in developed countries. Global market distortions generated by stimulus packages could compound this volatility. As discussed in Chapter 2, these challenges could ultimately translate into higher borrowing costs for developing countries and add to their risk of debt distress. The war and persistent threat of new COVID-19 variants also pose downside risks for global economic activity and could lead to new supply chain disruptions that impact global trade. Countries with insufficient economic diversification – for instance, many LDCs that remain highly dependent on primary commodity exports such as food and fuel – are particularly exposed should the global economy decelerate and affect global demand for certain commodities.

The risk of financial instability in developing countries is at a historic high following multiple economic shocks. The shock of the COVID-19 crisis has further worsened the fiscal vulnerabilities and risk profile of developing countries by adding new pressures on government finances from both the revenue and expenditure sides. The median fiscal balance, or ratio of government revenues to expenditures, in developing countries reached a 20-year low in 2020 of -5.9% of GDP, lower even than these countries' -3.86% median fiscal balance in the aftermath of the global financial crisis (Figure 1.5, left side). While fiscal balances in developing countries have increased since 2021, owing in part to the increase in certain commodity prices (e.g. food and energy prices), the crash following COVID-19 has hindered an increase to pre-pandemic levels. The accelerating pandemic-era budgetary deficits in developing countries have emerged as a major public policy concern due to the threat they pose to countries' financial stability, with the risk of debt distress in LICs increasing since the pandemic and some countries at risk of losing access to financial markets or experiencing liquidity crises or sovereign defaults. As shown in Figure 1.5 (right side), the share of LICs in debt distress or at high risk of debt distress has more than doubled since 2013-14 and including between 59% and 55% of LICs in 2021-22. Chapter 3 examines this trend in further detail, in particular the bottlenecks to access sustainable finance in the poorest countries.

Figure 1.5. Successive shocks have hurt fiscal balances in developing countries, which reached historic lows during the pandemic



Note: Fiscal balance is defined as general government net lending or borrowing. Fiscal balance values for 2021, 2022 and 2023 are forecasts. The evolution of the risk of debt distress is calculated as a percentage of countries with a debt sustainability analysis.
Source: Left side: IMF (2022[7]), *World Economic Outlook, April 2022: War Sets Back the Global Recovery*, https://www.imf.org/en/Publications/WEO/Issues/2022/04/19/world-economic-outlook-april-2022. Right side: IMF (2022[98]), *Debt Sustainability Analysis Low-Income Countries* (interactive guide), https://www.imf.org/en/Publications/DSA.

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Russia's war against Ukraine casts a shadow over the financing outlook for LICs and other countries most in need. LICs and LDCs are overrepresented in the caseload of countries with macro-fiscal vulnerabilities and excessive exposure to external risks. For example, more than half of LICs (55%) are at high risk of debt distress or already in debt distress as of end of April 2022 (Figure 1.5, right side) and only seven LICs are considered at low risk of debt distress.[1] Due to their structural characteristics, LICs are also more vulnerable to external shocks such as the commodity price volatility that followed Russia's full-scale invasion of Ukraine. Many LICs and LDCs are commodity exporters, tend to derive a significant portion of their revenue from commodity exports and had high levels of debt prior to the pandemic, making them particularly vulnerable to fluctuations of the global economy. In addition, a future acceleration of the green transition may lead to global demand shifting to or away from certain commodities and changes in the valuation of productive assets that would benefit some commodity export-dependent developing countries and harm others.

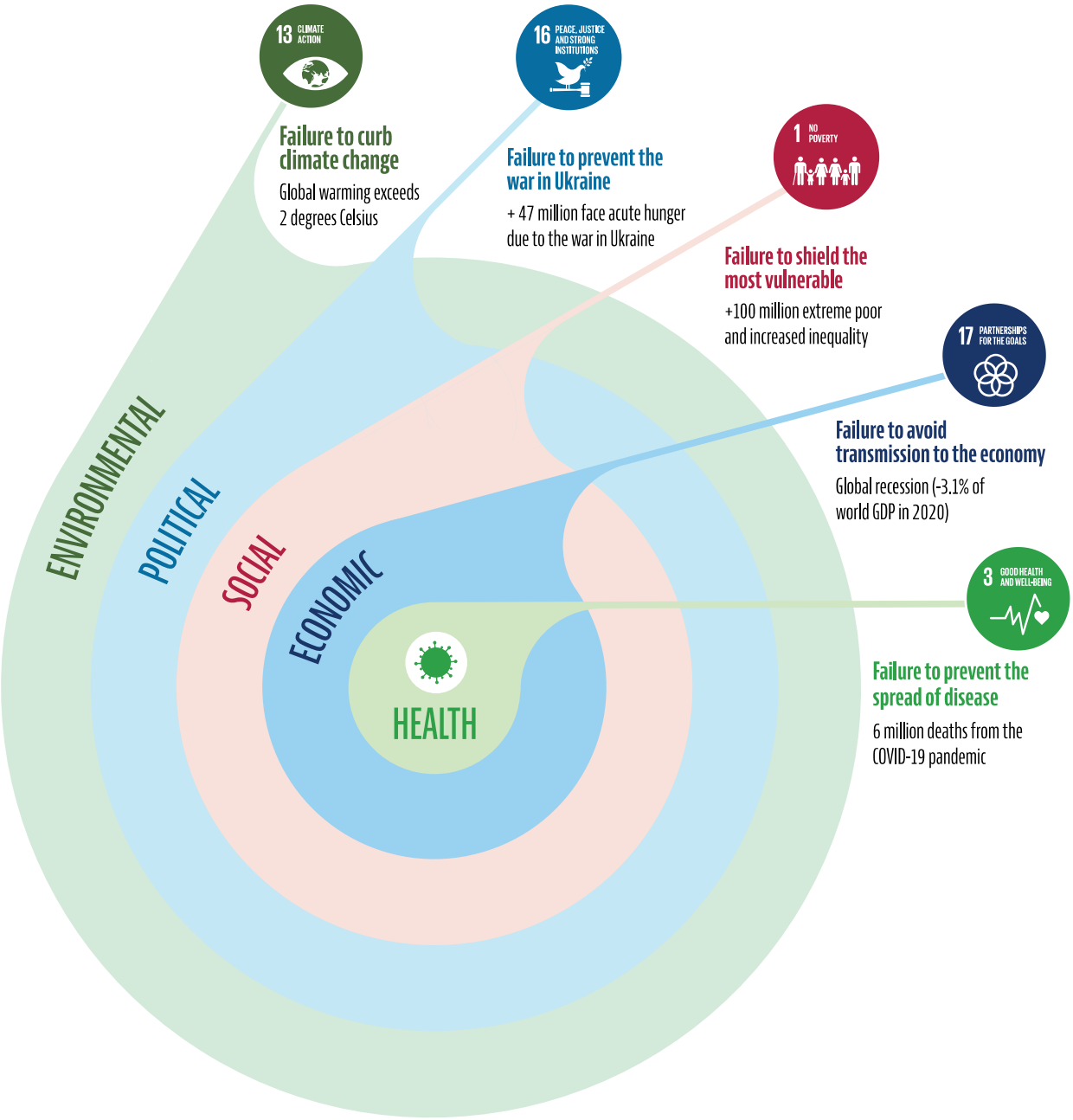
1.2. The Great Divergence threatens to turn the Decade of Action into a Decade of Divides

Prior to the COVID-19 crisis, progress on the 2030 Agenda was insufficient, but low-income and middle-income countries were on a path of slow convergence towards developed countries. In the years prior to the pandemic, developing countries made progress in some key development areas such as poverty reduction, maternal and child health, access to electricity and gender equality, although most countries were off track to achieve the Sustainable Development Goals (SDGs) by 2030. In other areas such as reducing inequality, lowering carbon emissions, protecting nature and tackling hunger, progress was stalling and, in some cases, even backsliding. For example, the world remained off track to stay at or below the 1.5°C target set by the 2015 Paris Agreement, and the number of undernourished people at global level increased by 7%, representing an additional 43 million people, between 2014 and 2019 (UN, 2019[99]). Nevertheless, developing countries were on a trend of income convergence towards developed

countries, as demonstrated by the upward shift of the growth distribution observed in developing countries since the early 1990s, which contrasts with the stable distribution of growth rates among developed countries.

The impact of successive crises could generate a ratchet effect in developing countries, effectively locking them into a protracted recovery. The significant economic and financial effects of the COVID-19 crisis and Russia's war against Ukraine could impede a return to pre-pandemic development trajectories in developing countries. The pandemic generated a shockwave with huge health, economic and social impacts. Due to the multidimensional nature of the crises, the magnitude of each shock depends on a country's ability – or failure – to have contained the previous one (Figure 1.6). Governments' failure to contain the spread of COVID-19 in the early stages of the pandemic, for example, led to a health crisis of global proportions that brought the world economy to a halt, resulting in large economic losses. Governments' incapacity to shield the most vulnerable from the economic shockwave is now accentuating inequalities and translating into a social crisis. The social wave is likely to have long-run consequences, setting back hard-won SDG progress achieved in the fight against extreme poverty and in the areas of health and education. By straining social and community ties, the social wave of successive crises could turn into a political wave as citizens lose trust in public institutions to provide public goods.

Figure 1.6. Inaction to address multidimensional impacts of successive crises across the Sustainable Development Goals could lock in the Great Divergence for the long term



Source: Authors' design.

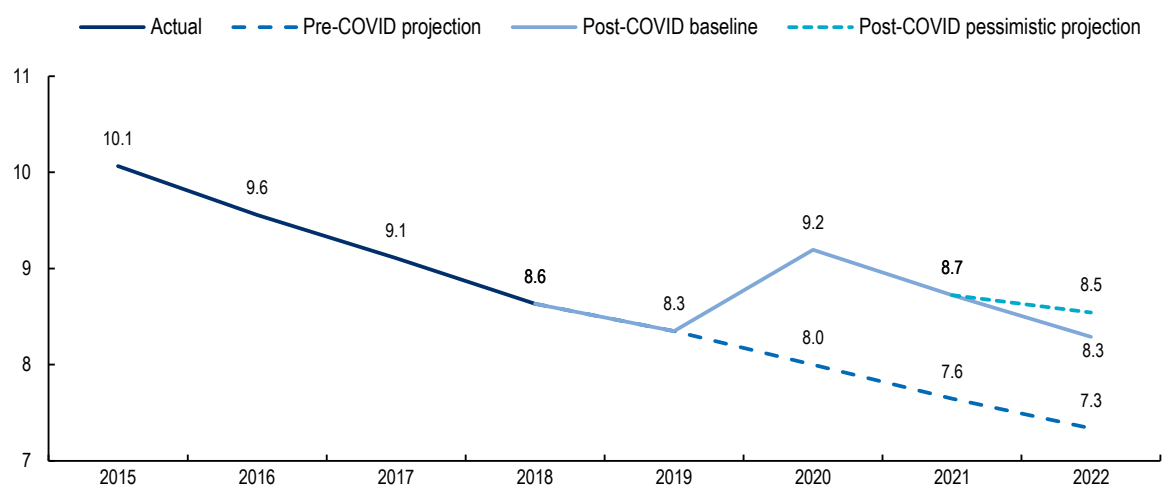
Inaction to avoid the Great Divergence – for instance, failing to stem rising poverty and address inequalities – will increase financing needs to achieve global sustainable development. Front-loading enough resources to curtail the magnifying effect of each crisis wave is the most effective way to avoid future crises. However, the financing needs of developing countries are likely to far exceed the resources available to them. By January 2022, for example, LICs spent on average only USD 8 per capita in social assistance and labour market programmes in response to the COVID-19 pandemic, while the spending of HICs was almost 90 times higher (Gentilini et al., 2022[100]).

1.2.1. Major recent external shocks will leave long-lasting scars on global development and increase the financing needs of the most vulnerable

The pandemic and the war in Ukraine mark the end of two decades of decreasing extreme poverty. The pandemic has thrown an additional 97 million people into extreme poverty and jeopardises years of development progress (Gerszon Mahler et al., 2021[101]). While the extreme poverty rate is estimated to have resumed its downward trend in 2021, decreasing from 9.2% in 2020 to 8.7%, the rate remains well above pre-pandemic projections – setting back progress to end global extreme poverty by at least three years – with the rate in 2017 equivalent to the 2020 post-COVID baseline rate (Figure 1.7). The increase in food prices due to the war could push an additional 40 million people into extreme poverty (Center for Global Development, 2022[102]). For example, in Latin America, despite a decrease in total poverty levels between 2020 and 2021, these are projected to increase in 2022 due to rising inflation, especially in food prices. By 2022, 33.7% of the Latin America and the Caribbean (LAC) population could be in poverty and 14.9% in extreme poverty (OECD, forthcoming[103]). Setbacks in the fight against extreme poverty have direct negative consequences at the country and global levels and erode the social, political and economic foundation necessary to achieve other targets. For instance, 98% of respondents to a recent survey, among them experts from 34 developing countries, reported that poverty is a threat to the implementation of other SDGs, with SDGs 3 (good health and well-being), 2 (zero hunger), and 4 (quality education) cited as the most endangered of the goals (Leal Filho et al., 2021[104]). Consequently, extreme poverty stands as an important measure to address the impact of the pandemic, although other indicators provide insightful and necessary information to better assess its implications. In particular, alternative approaches such as multidimensional poverty indices go beyond monetary deprivation and thus place otherwise-overlooked groups and issues at the forefront. This subsection examines the impact on developing countries' financing needs of successive crises, rising poverty, and soaring between and within-country inequality.

Figure 1.7. Following years of decline, global extreme poverty rose in 2020, setting back at least three years of progress

Extreme poverty rate (%)



Note: Extreme poverty is measured as the number of people living on less than USD 1.90 per day. Data for 2015 to 2018 are official global poverty estimates cited in Gerszon, Mahler et al. (2022[10]). Data for 2019 to 2022 are World Bank projections.
Source: Gerszon, Mahler et al. (2022[10]), "Pandemic, prices, and poverty", https://blogs.worldbank.org/opendata/pandemic-prices-and-poverty.

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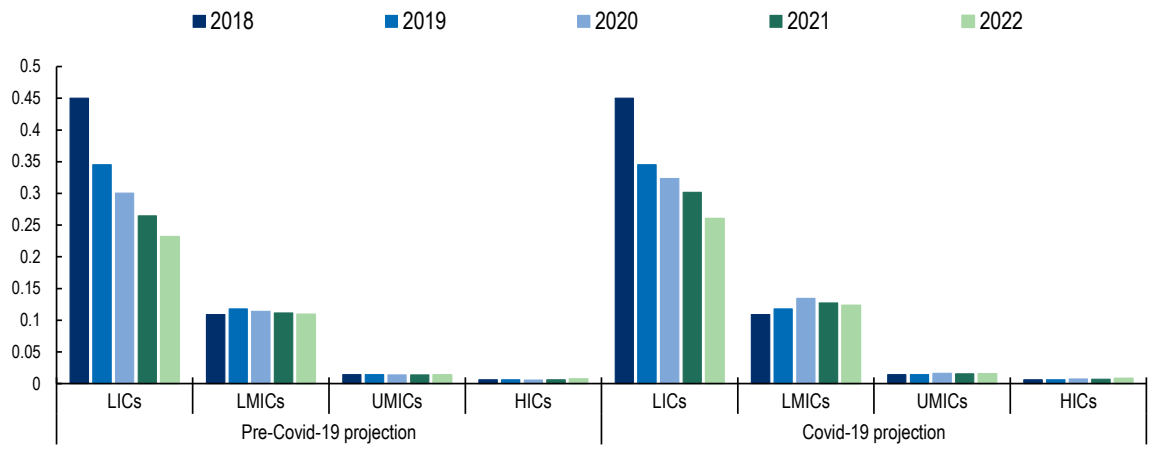
LICs are among the hardest hit by the rise in extreme poverty and the reversal of development gains. The COVID-19 crisis has reversed progress in the fight against extreme poverty by eight to nine years in LICs compared to four to five years in LMICs, five to six years in UMICs and only two to three years in HICs (World Bank, 2021[105]). Despite signs of improvement in 2021 and global poverty decreasing by 2.9% (Gerszon Mahler et al., 2021[101]), the picture remains grim and progress is highly uneven across income groups. The gap between post-COVID poverty levels and pre-COVID projections is largest in LICs, at slightly below four percentage points in the downside scenario for 2022 (Figure 1.8). The main reason for this difference is that expectations of significant poverty reduction did not materialise as a consequence of the pandemic. Although LMICs registered the largest increase in terms of the percentage of population living in extreme poverty in 2020 (+21%), pre-pandemic expectations in terms of poverty reduction were also lower for this income group. The increase in extreme poverty was more limited in UMICs and negligible in HICs, although the use of the poverty threshold at USD 1.90 per day masks the deterioration of living conditions in higher-income countries. Indeed, a recent study of poverty in early 2021 estimated that an average of 69.1 million people would be added to the global poverty headcount for every USD 0.10 per day increase in the USD 1.90 poverty threshold (Summer and Ortiz-Juarez, 2022[106]).

Figure 1.8. Low-income countries registered the largest increase in the percentage of the population living in extreme poverty over pre-pandemic forecasts

Percentage of the population living in extreme poverty by country income group



Note: The figure shows the poverty headcount ratio at USD 1.90 a day (USD 2011 PPP) as a percentage of the population. Figures are available until 2019 (and complete until 2018). The estimates for 2019-22 assume that the share of each income group of the world's poverty headcount ratio is the average of the 2015-18 period. The world's poverty headcount ratio uses the projections cited in Gerszon, Mahler et al. (2022[10]).
Source: Gerszon, Mahler et al. (2022[10]), "Pandemic, prices, and poverty", https://blogs.worldbank.org/opendata/pandemic-prices-and-poverty; World Bank (2022[107]), *DataBank – Population estimates and projections* (database), https://databank.worldbank.org/source/population-estimates-and-projections#.

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Financing needs in human development such as health and education are growing due to the pandemic and Russia's war against Ukraine. The priority to respond to COVID-19 left health services saturated, impacting other health outcomes. A WHO review in late 2021 of the continuity of essential health services during the pandemic found substantial disruptions in 90% of countries surveyed (World Health Organization, 2022[108]). More than half the surveyed countries (53% of 80 countries) reported that large shares of the population were still unable to access primary care at the end of 2021. The shift to remote learning when schools closed in the pandemic highlighted digital divides. Students in developing countries

– especially girls – lack meaningful connectivity beyond access to the internet (OECD, 2021[109]). Foregone schooling and learning not only negatively affects children's current well-being but also increases the burden of caring responsibilities, predominantly borne by women. This also is expected to negatively affect human capital accumulation for years to come, with important consequences on future income. Recent estimates suggest that the current generation of students could experience a USD 17 trillion loss of lifetime earnings and that the share of children in low- and middle-income countries with learning poverty, or the percentage of the population with sub-par reading skills at age ten, could rise from the pre-COVID estimation of 50% to 70% (UNESCO/UNICEF/World Bank, 2021[13]). In addition, the combination of income losses and recent food price spikes is threatening food security in many countries. The World Food Programme (2022[14]) estimates that up to 47 million additional people could face acute hunger as a result of the war in Ukraine – a 17% increase over the pre-war baseline of 276 million people who already face acute food insecurity.

At the country level, long-term development setbacks due to income loss will disproportionately affect the financing needs of the most vulnerable, turning the COVID-19 crisis into a pandemic of inequality. The uneven recovery has serious implications for inequalities within developing countries. Due to the skewed impacts of the pandemic on income losses that affect especially low-skill workers, youth and women, inequality in lower-income and middle-income countries is likely to increase. Overall, the shock of the pandemic has had the largest impact on the lowest quintiles of the world's population. By 2021, the average income of the bottom 40% of the population in developing countries was estimated to be about 2% lower than before the pandemic, with persons with a per capita income between USD 1.99 and USD 5.50 per day being hit the hardest; by 2021, however, the average income of the top 60% of the population in developing countries should return to almost pre-COVID levels (Narayan et al., 2022[12]). Further exacerbating inequalities are differences in access – some of them gender-based – to employment, health care, education, housing and digital technology. Ultimately, the rise of within-country inequalities could become a drag on developing countries' recovery, spurring a vicious cycle of lower growth and ever-increasing poverty and higher inequalities. Gender-based inequalities risk a similar cycle (Box 1.2). When half of the population is unable to fully contribute to the economy, overall economic recovery and development are hampered.

Box 1.2. The COVID-19 crisis has accelerated the feminisation of poverty

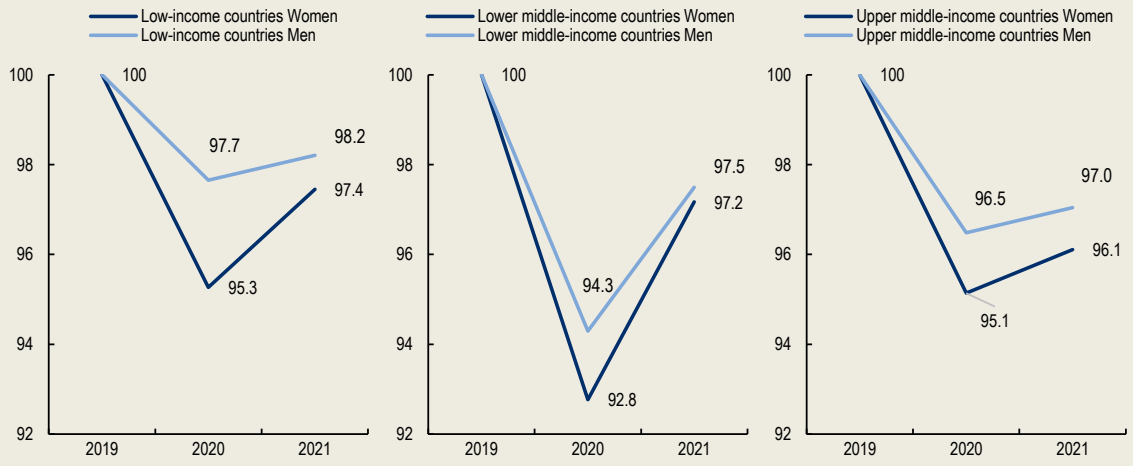
The pandemic has thrown 42 million women into extreme poverty. Between 2019 and 2021, the number of women living in extreme poverty increased by 11.9%, from 352 to 394 million (UN Women, 2022[110]). This increase is only slightly higher than the one observed for men over the same period (11.5%). However, several studies warn that gender gaps could widen in many development areas, including livelihoods, employment, health and education (UNESCO, 2021[111]).

The COVID-19 crisis has disproportionately impacted women's employment. One reason is that women are over-represented in low-skill labour activities, especially in the sectors most affected by the pandemic such as accommodation, food services and manufacturing. Furthermore, women were subject to additional pressures given that they represent a large share of the health and care workforce and usually shoulder an additional unpaid care work burden in the household (Azcona et al., 2020[11]). Women working in the informal economy lost 60% of income during the first month of the pandemic (Azcona et al., 2020[112]). Between 2019 and 2020, women's employment declined by 4.2% at the global level (representing the loss of 54 million jobs) compared to a 3% decline in men's employment (International Trade Union Confederation, 2021[113]). The gender gap in the employment-to-population ratios increased most in LICs in 2020 (Figure 1.9), and the employment gender gap is expected to persist in the long term. It is now estimated that by 2030, for every 100 men aged 25 to 34 living in

extreme poverty, 121 women will be living in similar conditions; prior to the COVID-19 pandemic, the difference was 118 women for every 100 men living in extreme poverty (Azcona et al., 2020[11]).

Figure 1.9. In 2020, low-income countries registered the largest increase of the gender gap in employment-to-population ratios

Changes in employment-to-population ratios across country income groups, by gender, 2019-21



Source: Figure 9 is adapted from International Labour Organization (2021[113]), *An Uneven and Gender-unequal COVID-19: Update on Gender and Employment Trends*, https://www.ilo.org/wcmsp5/groups/public/---ed_emp/documents/publication/wcms_824865.pdf.

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The crisis will also deepen the gender divide in terms of human development. A recent study estimates that between 11 and 20 million girls will not return to school after the COVID-19 pandemic due to sexual and gender-based violence, unintended pregnancies, forced marriage, and early transitions to work (Kwauk, Schmidt and Ganju, 2021[114]).

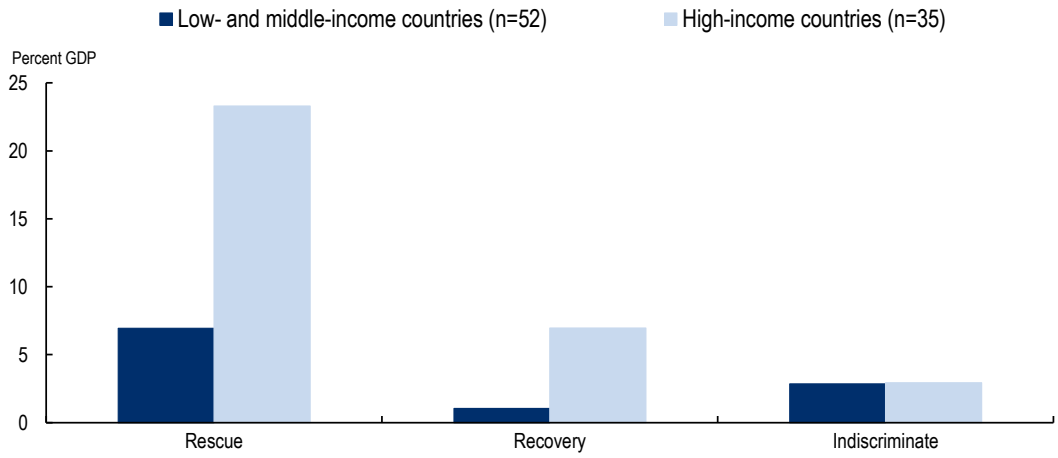
Source: UN Women (2022[110]), "Stories: Poverty deepens for women and girls, according to latest projections", https://data.unwomen.org/features/poverty-deepens-women-and-girls-according-latest-projections; (UNESCO, 2021[111]), *#HerEducationOurFuture: Keeping Girls in the Picture During and After the COVID-19 Crisis*, https://unesdoc.unesco.org/ark:/48223/pf0000375707; (Azcona et al., 2020[11]), *From Insights to Action: Gender Equality in the Wake of COVID-19*, https://www.unwomen.org/sites/default/files/Headquarters/Attachments/Sections/Library/Publications/2020/Gender-equality-in-the-wake-of-COVID-19-en.pdf; Azcona et al., (2020[112]), *Will the Pandemic Derail Hard-won Progress on Gender Equality?*,https://www.unwomen.org/sites/default/files/Headquarters/Attachments/Sections/Library/Publications/2020/Spotlight-on-gender-COVID-19-and-the-SDGs-en.pdf; International Labour Organization (2021[113]), *An Uneven and Gender-unequal COVID-19: Update on Gender and Employment Trends*, https://www.ilo.org/wcmsp5/groups/public/---ed_emp/documents/publication/wcms_824865.pdf; Kwauk, Schmidt and Ganju (2021[114]), "What do we know about the effects of COVID-19 on girls' return to school?", https://www.brookings.edu/blog/education-plus-development/2021/09/22/what-do-we-know-about-the-effects-of-covid-19-on-girls-return-to-school/.

1.2.2. Achieving a recovery aligned with the Sustainable Development Goals will require financing for both rescue and recovery measures

Developing countries lack both short-term rescue and long-term recovery financing to achieve sustainable development. Developing countries faced acute challenges to deliver emergency financing and support to respond to COVID-19 as well as to commit to longer-term investments to build back better

(BBB). As a percentage of GDP, fiscal support measures in 2021-22 for rescue and recovery were on average 3 and 6 times lower respectively in low- and middle-income countries than in HICs (Figure 1.10). Rescue-type measures include short-term emergency support such as liquidity support, welfare transfers, and tax relief to the households and firms most impacted by the successive health, economic, climate and geopolitical crises. Recovery-type measures, including policy incentives and investments, provide long-term support to boost economic growth.

Figure 1.10. Uneven fiscal measures for rescue and recovery in response to COVID-19 by country income category (percent GDP, 2021-22)



Note: Figures for low- and middle-income countries exclude China, as its support package alone is almost 1.5 times the total amount disbursed by all developing countries in the sample. For a complete description of fiscal measures and their categorisation as either rescue or recovery, see https://recovery.smithschool.ox.ac.uk/wp-content/uploads/2021/03/20210201-Global-Recovery-Observatory-Draft-Methodology-Document-.pdf.

Source: O'Callaghan, Murdoch and Yau (2021[115]), *Global Recovery Observatory: Draft Methodological Document*, https://recovery.smithschool.ox.ac.uk/global-recovery-observatory-draft-methodology-document/.

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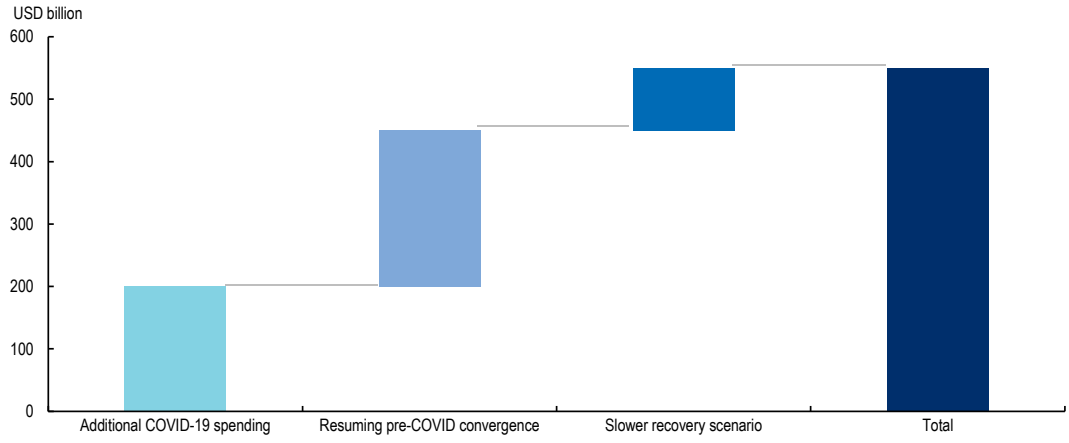
Rescue and recovery financing needs are particularly high in the poorest countries. The additional COVID-19 financing required by LICs between 2021 and 2025 is estimated at USD 450 billion (Figure 1.11) (IMF, 2021[15]). This amount includes USD 200 billion of additional COVID-19 spending to step up the response to the crisis and build financial buffers as well as USD 250 billion to put LICs back on their pre-pandemic trajectory of convergence with advanced economies. An additional USD 100 billion could be required if some risks – such as slower-than-expected vaccine rollouts or a worsening of the pandemic due to new variants – materialise and lead to an even slower recovery in LICs. The amount of financing required by Cambodia, Nigeria, Pakistan and Rwanda in five SDG sectors (education, health, roads, electricity, and water and sanitation) increased by 21% on average as a result of the COVID-19 crisis (Benedek et al., 2021[116]). It should be noted that these studies on financing needs in LICs were published prior to Russia's full-scale invasion of Ukraine and did not take into account the additional financing needs the war will engender. Chapter 2 provides a more detailed overview of the SDG financing gap in terms of financing flows and addresses the two-fold impact of the successive crises through increased government spending and lower domestic and external financing.

Figure 1.11. The pandemic led to an increase of low-income countries' financing needs over the short and long term

Additional financing required in LICs



Source: IMF (2021[15]), *Macroeconomic Developments and Prospects in Low-Income Countries—2021*, https://www.imf.org/en/Publications/Policy-Papers/Issues/2021/03/30/Macroeconomic-Developments-and-Prospects-In-Low-Income-Countries-2021-50312.

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The sustainability boom in HICs could lead to a sustainability crunch in the developing world. Over the past two years, developed countries have launched a series of initiatives and stimulus packages to boost the recovery and put their economies on a sustained growth path. Many of these initiatives, such as the Biden administration's proposed USD 1.9 trillion Build Back Better Act and the European Union's USD 2 trillion NextGenerationEU, include a specific focus on green investments and aim to make their societies more inclusive and resilient to future shocks. The OECD is also calling for a "quality" recovery that responds to four criteria: strong, inclusive, green and resilient (OECD et al., 2021[37]). However, caution is required to ensure that the proliferation of regulations, standards and norms does not further increase inequalities in access to financing for sustainable development. Early evidence suggests that in the absence of a clear strategy to ensure that developing countries benefit from the BBB agenda, a number of developing countries could be left behind due to a lack of capacity to demonstrate compliance with increasing sustainability standards (OECD/WBG, forthcoming[117]). Chapter 3 discusses in depth the need for policy coherence and concrete actions to ensure a sustainable and equitable recovery.

Limited fiscal space in developing countries may further prevent them from BBB. Amid historic development setbacks, widening inequalities, a lingering pandemic, and new adverse shocks such as the surge in food and commodity prices, developing countries need to balance a growing number of priorities. Given the limited resources available to them, this balance requires clear prioritisation of short-term spending (e.g. to deploy emergency support measures) and longer-term investments (e.g. to build sustainable and resilient infrastructure, strengthen health and education systems, or restore financial buffers to preserve the credibility of their fiscal frameworks). Due to the limited fiscal space of developing countries and their need to respond to successive crises, there is a risk that short-term relief measures could end up crowding out much-needed investment necessary for a green, resilient and inclusive recovery. A short-sighted view could also prompt governments to favour investments with lower upfront costs to the detriment of better economic returns in the long run. Box 1.3 examines the cost-efficiency returns of financing BBB strategies in developing countries.

Box 1.3. The economic case for building back better in developing countries

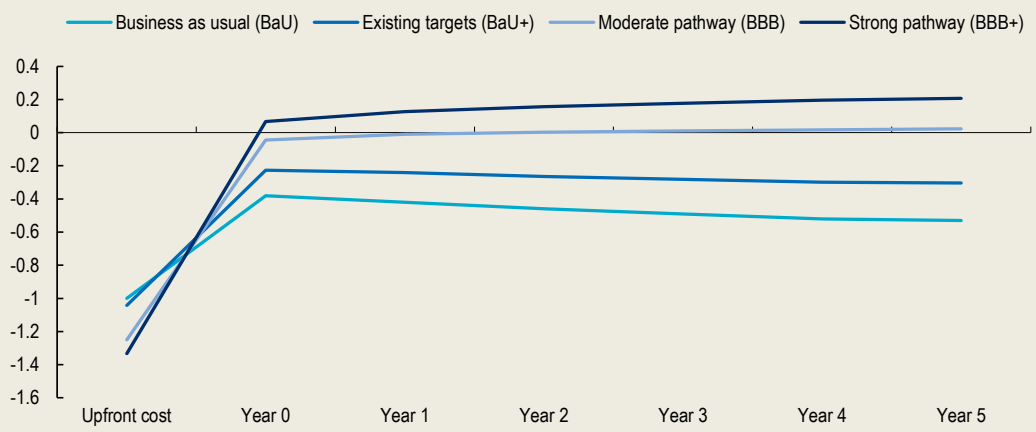
The resource-constrained environment facing developing countries in the aftermath of the COVID-19 crisis calls for consideration of the cost-effectiveness of BBB strategies. Investing in the green, resilient and inclusive recovery called for by world leaders requires a shift in the allocation of resources. The green transition, for example, requires more capital-intensive technologies (e.g. renewable energy and climate-resilient infrastructure) and is thus likely to result in higher upfront costs. The question is whether this higher cost is compensated for by better returns over time or whether the cost may lead to trade-offs among developing countries' goals of economic development, sustainability, inclusiveness and resilience.

The energy sector provides an illustration of the economic benefits that can result from investing in a sustainable recovery. Recent research shows that investments in green (renewable) energy infrastructure have a stronger and more sustained impact on countries' GDP than investments in non-renewable energy infrastructure (Batini et al., 2021[17]). The results indicate that each additional US dollar invested in green energy infrastructure crowds in another 53 cents over a period of four years following the investment. On the other hand, additional investment in non-renewable energy infrastructure appears to crowd out other GDP components (consumption, investment, net exports) in the medium term.

Evidence from the energy sector points to the cost-effectiveness of BBB despite its higher upfront costs. Depending on the climate objective scenario used, the upfront costs of investing in green infrastructure could be up to 33% higher than for conventional energy infrastructure investment (Rozenberg and Fay, 2019[16]). In other words, for each US dollar invested under a business-as-usual (BaU) scenario, the cost of a similar investment in green energy infrastructure could amount to as much as USD 1.33. However, the strong positive impact on GDP observed for green investment more than offsets the initial higher investment costs (Figure 1.12) and provides a positive return for countries' GDP (unlike in the BaU scenarios).

Figure 1.12. The economic benefits of building back better in the energy sector over the long term outweigh the higher upfront costs

Impact on GDP of additional investments in energy infrastructure (for each US dollar invested)



Note: Green and non-green output multipliers are calculated for a group of 14 countries, five of which are developing countries; costs of investment in energy infrastructure are calculated for low- and middle-income countries. Results are scaled based on USD 1 invested under the BaU scenario.

Source: Authors' calculations using green and non-green output multipliers from Batini et al. (2021[17]), "Building back better: How big are green spending multipliers?", https://doi.org/10.5089/9781513574462.001. For costs of investments in renewable and non-renewable energy infrastructure, authors' calculations based on Rozenberg and Fay (2019[16]), *Beyond the Gap: How Countries Can Afford the Infrastructure They Need while Protecting the Planet*, https://openknowledge.worldbank.org/handle/10986/31291.

StatLink https://stat.link/sjkp4x

These results confirm the importance of ensuring that developing countries with the fewest resources benefit from the cost-efficiency gains of the BBB agenda. HICs will likely need to consider how to support a sustainable recovery abroad (i.e. in their partner countries). Despite the economic benefits of BBB, recent research suggests that some new BBB policies (e.g. for climate mitigation) could impose a financial burden on the global poor through increased energy and food prices (Soergel et al., 2021[118]). This burden could be offset through redistributive policies at the country and international level – for example, by meeting the commitment made during the 15th session of the Conference of the Parties to provide USD 100 billion per year of climate finance to developing countries. Chapter 3 assesses the extent to which financing and BBB strategies to ensure sustainability are aligning to the SDGs to avoid zero-sum trade-offs across the goals and promote equity to mitigate transmission of risks across countries.

Source: Batini et al. (2021[17]), "Building back better: How big are green spending multipliers?", https://doi.org/10.5089/9781513574462.001; Rozenberg and Fay (2019[16]), *Beyond the Gap: How Countries Can Afford the Infrastructure They Need while Protecting the Planet*, https://openknowledge.worldbank.org/handle/10986/31291; Soergel et al. (2021[118]), "Combining ambitious climate policies with efforts to eradicate poverty", https://doi.org/10.1038/s41467-021-22315-9

The economic shock of successive crises have increased the SDG financing needs and call for concerted effort to ensure sufficient financing to BBB and avoid the Great Divergence in the poorest countries. The uneven recovery from the COVID-19 pandemic and the consequences of the war in Ukraine place unprecedented pressure on policy makers already struggling to balance short- and long-term financing for sustainable development priorities. Pre-existing constraints exacerbated by successive crises have further reduced the availability of financing in countries most in need of resources to invest in a just and sustainable recovery. Chapter 2 points to a growing SDG financing gap and potential tipping point in the financing for the sustainable landscape. It outlines the state of domestic, external, public and private financing flows to developing countries and the resources that are available to meet the growing financing needs discussed in Chapter 1.

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Notes

[1] These figures are based on the April 2022 debt sustainability analyses of the World Bank and International Monetary Fund. See https://www.imf.org/en/publications/dsa.

2 Financing for sustainable development at a tipping point

Although a major collapse of financing for sustainable development was avoided after the COVID-19 pandemic in 2020, developing countries' government revenue did drop significantly and the SDG financing gap got wider. In the wake of Russia's war against Ukraine, many of them face reduced access to financing, increased volatility of private investment, and limited fiscal space to invest in a just and sustainable recovery. Improved mobilisation of domestic resources, sustained efforts by official providers, and reducing illicit financial flows and public sector inefficiencies will be critical to avoid a prolonged divergence in countries' capacity to finance their development.

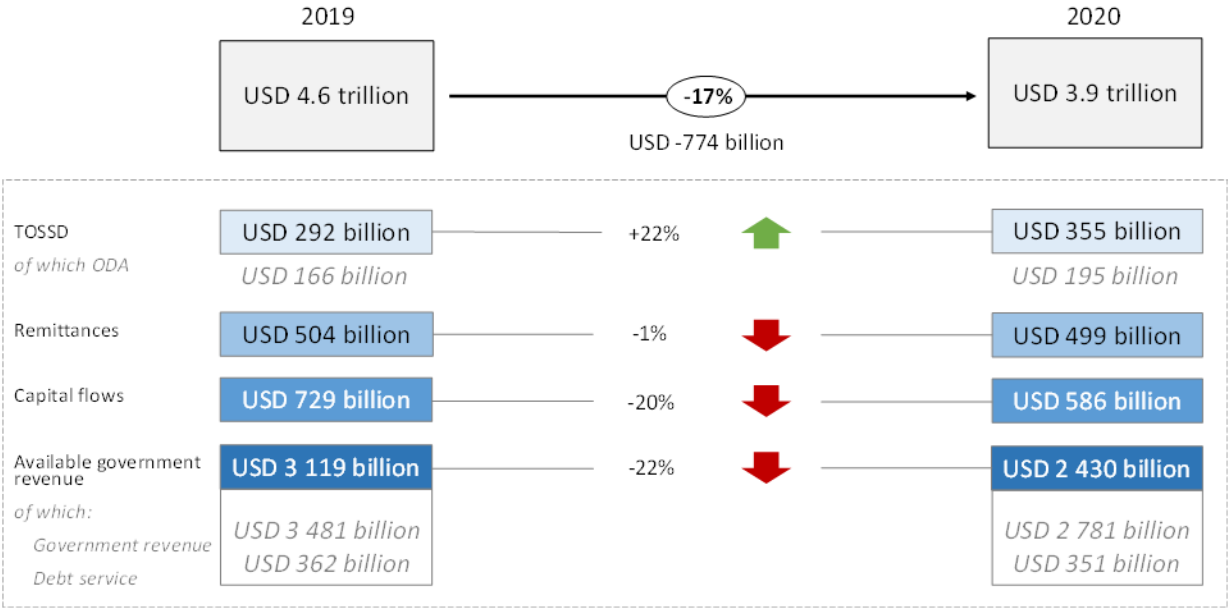
2.1. The financing for sustainable development landscape was on the brink of a major collapse during the COVID-19 crisis

2.1.1. Despite swift policy responses, the COVID-19 pandemic triggered a significant drop in nearly all sources of financing for sustainable development in 2019-20

The lockdowns put in place by some of the world's major economies in the first half of 2020 brought the global economy to a halt, with a direct and sudden impact on developing countries' revenue and financing sources. The total volume of financing for sustainable development (FSD) flows to developing countries, excluding the People's Republic of China (hereinafter China), declined by USD 774 billion, or 17%, from USD 4.6 trillion in 2019 to USD 3.9 trillion in 2020 (Figure 2.1). The largest drop in absolute terms was in available government revenue, which shrank by USD 689 billion, or 22%, from USD 3.1 trillion in 2019 to USD 2.4 trillion in 2020. (Subsection 2.1.2 discusses the drop in government revenues is greater detail.) Private capital flows including foreign direct investment (FDI), portfolio inflows and other investments declined by 20%, equivalent to USD 143 billion, the second largest fall in relative terms in 2019-20.

Despite its steep decline as a consequence of the pandemic, government revenue remains the largest source of financing in developing countries. In 2019, government revenue in developing countries excluding China amounted to USD 3.5 trillion (IMF, 2022[28]), of which USD 2.8 trillion came from tax revenue. This total is more than twice the amount of all major external finance flows combined (Total Official Support for Sustainable Development, or TOSSD, as well as cross-border capital inflows and remittances), which stood at USD 1.5 billion in 2019. Following the outbreak of the pandemic in 2020, government revenue amounted to USD 2.9 trillion, still more than double the total amount of all external financial flows (i.e. USD 1.4 trillion in 2020). Government revenue comprises different components, including tax and non-tax revenue, whose relative weights and structures vary widely with diverse policy implications – an example being how tax structures in developing countries can contribute to increased inequalities and impede the green transition.

Figure 2.1. Available financing for sustainable development in developing countries shrank by USD 774 billion, or 17%, in 2019-20



Note: TOSSD includes cross-border support to developing countries and global and regional expenditure for sustainable development (respectively, Pillars 1 and 2 of the TOSSD framework). Amounts mobilised from the private sector are not included in the TOSSD figures shown above. The definition and scope of Pillar 2 is currently under review and some of the activities contained may not be directly supporting developing countries. The increase observed in TOSSD flows between 2019 and 2020 is mainly due to an increase in the disbursements of multilateral organisations, in particular European Union (EU) institutions, the World Bank, the International Monetary Fund (IMF) (Concessional Trust Funds), and the Asian Development Bank Group and Asian Development Investment Bank as well as to better data coverage in 2020. All figures use the largest sample possible for official development assistance-eligible countries excluding China. The rationale to exclude China, as discussed, is based on its outlier status in terms of FSD landscape trends, particularly private capital flows.
Source: Authors' design. Data on official resources are based on OECD (2022[18]), *TOSSD Total Official Support for Sustainable Development/Data Visualisation Tool*, https://tossd.online/. Remittances are based on KNOMAD (2022[19]), *Remittance inflows* (database), https://www.knomad.org/data/remittances. Capital flows are from IMF (2022[20]), *Balance of payments* (database), https://data.imf.org/bop.

The fear of a collapse in external private flows helped jolt global leaders into action, preventing even greater damage. Without a strong policy reaction, a major collapse of external private flows (e.g. FDI, remittances, etc.) seemed likely, as demonstrated by the dire forecasts in the first months after the declaration of the pandemic. However, the unprecedented macroeconomic policy reaction led by the world's major economies supported to a great extent the global economy and financial markets, preventing the feared collapse from materialising. Central banks and governments of both developed and emerging countries mobilised large policy packages to ease financing conditions, provide income support, and protect domestic firms and sectors. In addition, China succeeded in stopping the spread of the first wave of the virus by mid-2020 and limiting the direct consequences to its economy. However, successive lockdowns and its subsequent zero-COVID approach are having protracted negative impacts on Chinese economic growth.

As a result of the policy response, the drop in external private flows (including remittances) to developing countries was more moderate than anticipated. The policy measures put in place by the world's major economies and the gradual lifting of containment measures contributed to the return of external private flows to developing countries in the second semester of 2020. Ultimately, external private flows to developing countries excluding China declined by 13% (USD 148 billion) thanks to a milder-than-anticipated decline of capital flows (-20%) and an almost complete recovery of remittance flows (-1%) by

the end of that year. These trends in external private flows during and after the outbreak of the pandemic are further detailed in section 2.2.

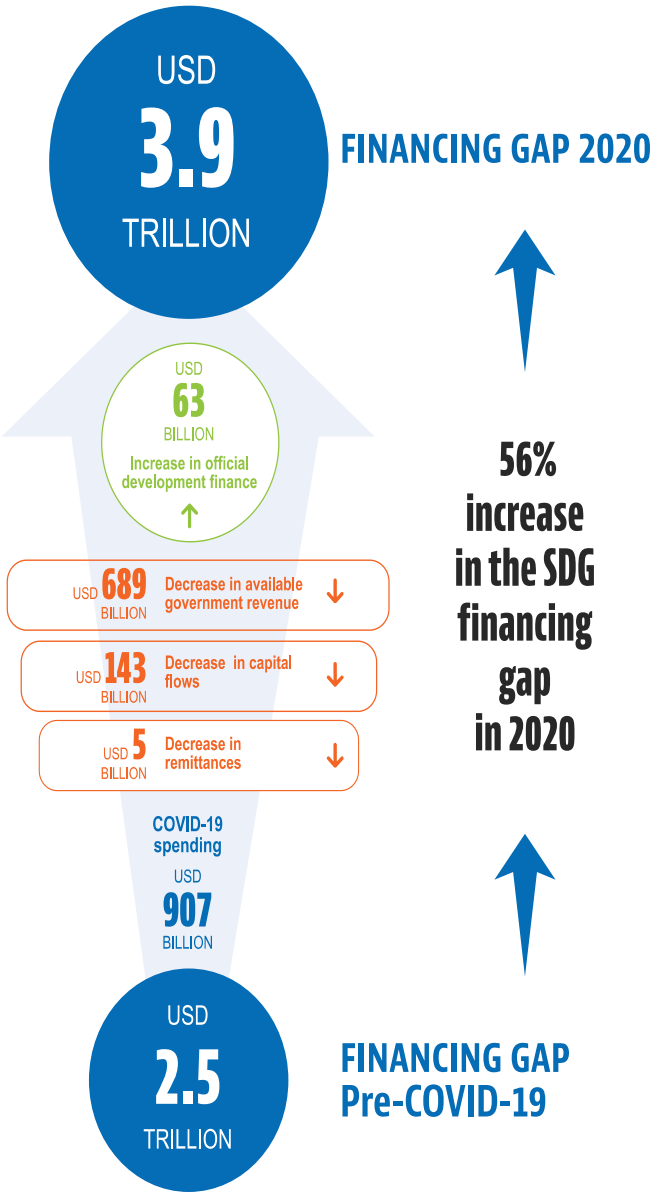
The countercyclical response of official development finance (ODF), including official development assistance (ODA), counteracted the shortfall of other external financing flows but could not fully compensate for losses. Between 2019 and 2020, TOSSD, a new measure of resources that are provided by public sector actors in support of developing countries, grew by 22%, reaching a total of USD 355 billion, of which total bilateral and multilateral ODA is estimated at USD 195 billion in 2020. The TOSSD figure, based on the two pillars of the TOSSD framework, includes bilateral, multilateral and South-South cross-border support to developing countries (Pillar 1) as well as global and regional expenditure with substantial benefits to developing countries (Pillar 2). As its name indicates, the TOSSD framework aims to provide a more comprehensive picture of official resources, including actors beyond the Development Assistance Committee (DAC), in support of sustainable development and is therefore particularly relevant in the analysis of total FSD. These trends in ODF are further explored in section 2.2.

2.1.2. The Sustainable Development Goal financing gap increased due in large part to the severe decline in government revenues

Recent FSD data confirm the forecasted 56% increase in the Sustainable Development Goal (SDG) financing gap in 2020. Due to the unprecedented magnitude of the COVID-19 pandemic, which increased financing needs and decreased available financing flows, the impact of the crisis was difficult to anticipate accurately. Looking back with the benefit of hindsight, initial forecasts tended to overestimate the impact on capital flows (which recovered swiftly in the second half of 2020) and did not account for the extent of the drop in available government revenue (for which there were no estimates at the time). However, the annual SDG financing gap in developing countries did indeed widen by 56%, to USD 3.9 trillion, in 2020 (Figure 2.2). Taking into consideration the expected tightening of global financing conditions, projections by the UN Conference on Trade and Development and the IMF suggest that the SDG financing gap could reach USD 4.3 trillion per year from 2020 to 2025, an increase of USD 400 billion over OECD estimates in 2019-20 (UNCTAD, 2022[25]).

Two factors drove the growth in the SDG financing gap over 2019-20. First, government revenue in developing countries suffered the most severe decline of any FSD source. Available government revenue (i.e. government revenue after debt service repayment) fell by USD 689 billion in 2020, accounting for more than 80% of the overall decline in FSD. This drop reflects the importance of government revenue, which represented over 50% of developing countries' financing mix before the COVID-19 crisis. Once the debt service of developing countries is factored in, the volume of government revenue available to finance sustainable development is reduced by 8%. Second, the USD 907 billion increase in developing countries' government expenditure in response to the COVID-19 emergency represents nearly 30% of total government revenues available in developing countries in 2019. Emergency spending added to the financing burden in countries already struggling to mobilise domestic revenues as well as other external private flows.

Figure 2.2. The Sustainable Development Goal financing gap increased by 56% in 2020 due to the combined effect of the drop in available financing for sustainable development and an increase in government expenditure



Source: Authors' design. ODF data are based on OECD (2022[18]), *TOSSD Total Official Support for Sustainable Development/Data Visualisation Tool*, https://tossd.online/. Remittances are based on KNOMAD (2022[19]), *Remittance inflows* (database) https://www.knomad.org/data/remittances. Capital flows are from IMF (2022[20]), *Balance of payments* (database), https://data.imf.org/bop.

The following sections examine the uneven impact of COVID-19, first, on all external sources of FSD that demonstrated relative stability, and second, on the larger drop in domestic public and private resources.

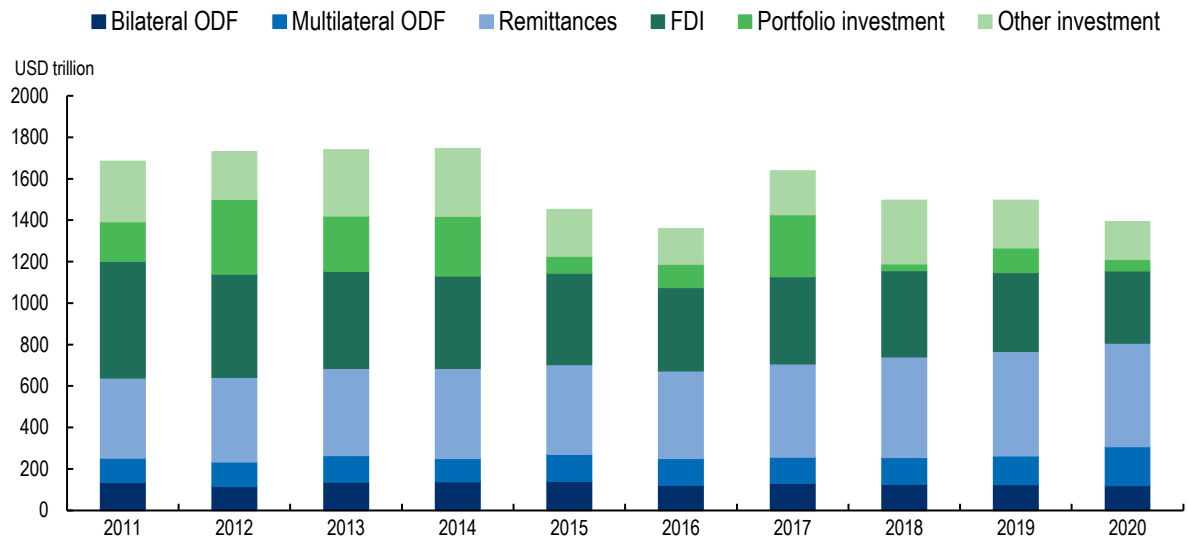
2.2. The recovery in advanced economies and the countercyclical role of official resources helped sustain external financing flows

In the first half of 2020, the pandemic threatened to halt private capital flows to developing countries. In May 2020, the OECD had estimated, based on several outside forecasts, that external private flows might decline by up to 40% (or about USD 700 billion) in 2020 compared to the previous year. The experience of previous crises suggested that external flows were particularly vulnerable to adverse shocks to the global economy, as was the case in 2014-15 when portfolio and other investments dropped to their lowest level since the 2008-09 global financial crisis due to the oil price collapse and subsequent end of the commodity price boom. Figure 2.3 illustrates the evolution of external finance since 2011.

The rebound of private capital flows in the second part of the year and the surge in ODF contributed to keeping external finance afloat. Total external flows remained relatively stable year on year, decreasing only slightly from USD 1.5 trillion in 2019 to USD 1.4 trillion in 2020 (-7%). However, the magnitude of the impact differed considerably across the various sources of external finance. For example, external private investment to developing countries excluding China declined by 12% between 2019 and 2020, while ODF grew by 22% over the same period.

Figure 2.3. Total external flows to developing countries remained relatively stable in 2020

Evolution of external finance (2011-20)



Note: The largest sample possible for ODA-eligible countries excluding China was used for each year.
Source: ODF flows are measured as a sum of ODA and OOF and accessed from OECD DAC Table 2a (OECD, 2022[22]), *Aid (ODA) disbursements to countries and regions [DAC2a], OOF and export credits - disbursements [DAC2b],* https://stats.oecd.org/Index.aspx?DataSetCode=Table2A and Table 2b (OECD, 2022[23]), *OOF and export credits - disbursements [DAC2b],* https://stats.oecd.org/Index.aspx?DataSetCode=TABLE2B#. Remittances are based on KNOMAD (2022[19]), *Remittance Inflows* (database), https://www.knomad.org/data/remittances. FDI, portfolio investment and other investment data refer to net incurrence of liabilities and are from IMF (2022[20]), *Balance of payments* (database), http://data.imf.org/bop. Missing data on FDI are imputed using World Bank (2022[119]), *World Development Indicators* (database), https://datacatalog.worldbank.org/dataset/world-development-indicators.

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2.2.1. External capital flows were a major channel of transmission of the COVID-19 shock to the financing for sustainable development landscape

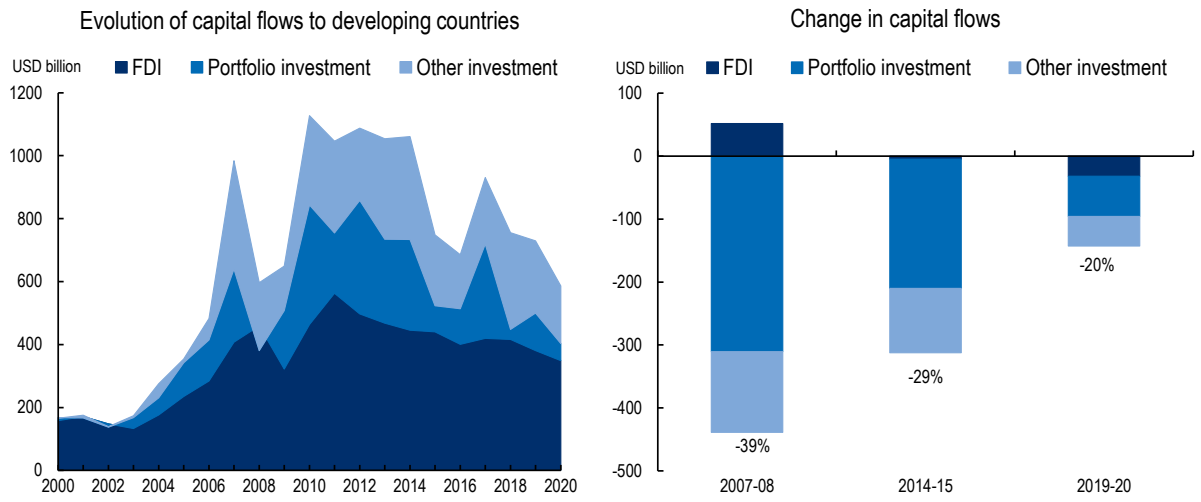
The COVID-19 crisis resulted in a sharp but temporary retrenchment of capital flows to developing countries excluding China in the first half of 2020 (Box 2.1). Despite their sudden stop in the first semester of 2020, capital flows were able to rebound once governments started easing the stay-at-home orders in the second semester of that year. The peculiar nature of the 2020 global recession, which was mainly transmitted to the economy by governments' containment measures (unlike the 2008-09 recession, which started as a financial crisis), explains the relatively swift recovery of cross-border capital flows by end 2020.

Box 2.1. An outlier in the financing for sustainable development landscape, China registered record inflows of external private investment in 2020

More than USD 544 billion in external private investment flowed to China in 2020 compared to only USD 313 billion in 2019. This increase of about USD 231 billion in inflows to China is larger than the decline observed in the inflows to all other developing countries. In other words, external private investment flows to developing countries including China increased by 10%, from USD 1 trillion in 2019 to USD 1.1 trillion in 2020. This is the reason that the analyses in this chapter exclude China unless explicitly stated otherwise. The main explanatory factor for the Chinese exception is the strong rebound of the Chinese economy in 2020, which itself was due in large part to the control of the domestic health situation in early 2020. The effects of the pandemic on cross-border capital flows to China were further mitigated by China's policy efforts to increase capital inflows and to allow the Yuan renminbi to appreciate after China had kept the currency comparatively low for years to retain export competitiveness.

From a historical perspective, the decline in external capital flows observed in 2020 was sharp but not unprecedented. Since 1980, the FSD landscape evolved in a cyclical manner, with sharp declines often linked to economic and financial crises. These include the debt crisis of the 1980s, the economic crisis in emerging markets in the 1990s (Asia, Mexico and Russia), the global financial crisis of 2008-09, and the combination of the appreciation of the US dollar and China's slowdown in 2015, which led to a fall in commodity prices. The 20% decline in capital flows observed in 2020 is lower than the 39% and 29% shocks experienced by the same group of countries in 2008 and 2015, respectively (Figure 2.4). Following the pattern observed in previous crises, portfolio equity presented a high volatility and was the most impacted among external capital flows to developing countries. In 2020, portfolio investment to developing countries dropped by USD 64 billion (-54%) compared to the previous year. However, the decline in portfolio investment between 2019 and 2020 was less pronounced than in the 2008-09 period.

Figure 2.4. The drop in capital flows in 2020 was less pronounced than in previous sudden stop episodes



Note: The data show cross-border capital flows to developing countries excluding China.
Source: IMF (2021[21]), *Balance of Payments and International Investment Position Statistics* (database), https://data.imf.org/?sk=7A51304B-6426-40C0-83DD-CA473CA1FD52.

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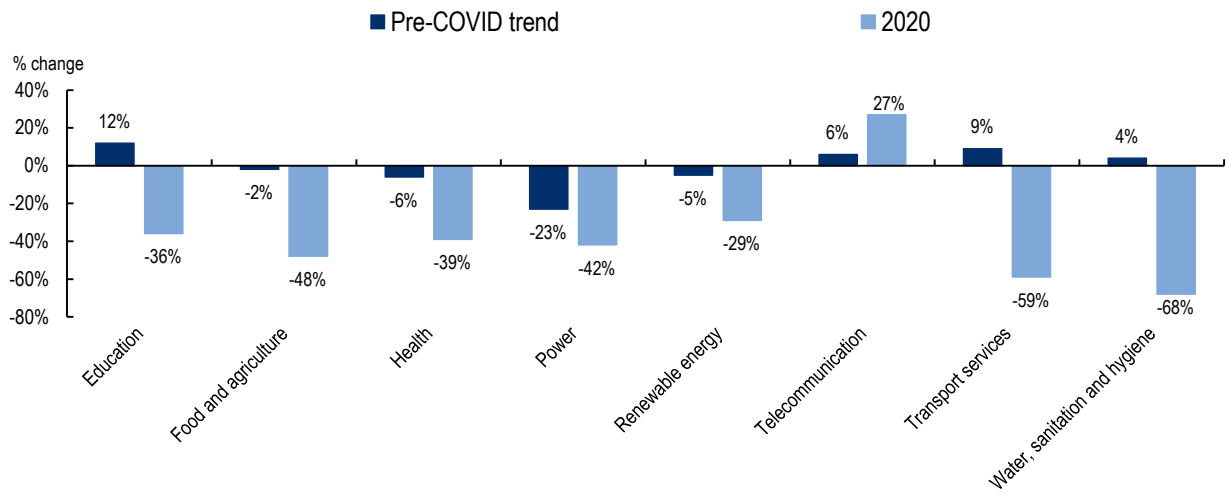
Even a temporary decline in external capital flows impedes progress in developing countries towards achieving the SDGs. External capital flows include FDI, portfolio investments and other investments. FDI – investment that establishes a substantial stake or lasting interest in a foreign company – is generally perceived as a factor of economic development and modernisation that brings various benefits to host countries, including in the form of enhanced productivity, job creation, technology transfer and improved integration in global value chains. Recent research suggests that policy practices can help strengthen the positive impact of FDI on key areas of sustainable development such as human capital development, gender equality, job quality and the green transition (OECD, 2022[120]). Portfolio investments – stock investments in a foreign business – are another type of foreign investment, although their benefits to the host economy are usually deemed to be relatively small due to the passive nature of their ownership and their more volatile and cyclical nature. The COVID-19 pandemic, as discussed elsewhere in this chapter, affected other investments including a residual category of countries' balance of payments consisting primarily of bank loans and trade credits.

FDI flows to developing countries, while less volatile than other sources of external capital flows, were already on a downward trend in the decade leading up to the COVID-19 crisis and shrank by a further 8% in 2020. After increasing markedly between 2000 and 2011 from USD 159 billion to USD 563 billion, equivalent to a yearly average increase of 15%, annual FDI flows to developing countries experienced a slow but steady decline in the decade leading up to the outbreak of the COVID-19 pandemic, standing at USD 381 billion in 2019. FDI flows dropped by a further 16% in the first semester of 2020 compared to the previous year, mainly due to a slowdown in the implementation of existing investment projects and the reassessment of new ones (UNCTAD, 2020[121]). The relatively modest 8% decline in FDI flows to developing countries in the second half of 2020 contrasts with the more dire 35% drop in FDI initially predicted in the early stages of the pandemic (Institute of International Finance, 2020[122]) and with the 30% drop in FDI to developing countries observed in 2009.

The decline in FDI particularly affected greenfield projects in developing countries and FDI to SDG-relevant sectors. New greenfield project announcements, which are considered one of the most beneficial forms of investment for development, were down by 46% in 2020, compared to the drop of only -7% for international project finance and just -4% for cross-border mergers and acquisitions (UNCTAD, 2021[43]). The swift recovery of greenfield projects in OECD countries contrasts with the situation in developing countries, where recovery still lags. In addition, SDG-relevant sectors appear to have been highly impacted by the crisis (Figure 2.5), as demonstrated by the severe contraction from the pre-pandemic trend in the volume of announced greenfield projects in water, sanitation and hygiene (-68%); transport services (-59%); food and agriculture (-48%); health (-39%); and education (-36%). The pandemic also negatively affected job creation by diverting FDI away from labour-intensive industries that were the most impacted by the restrictions (e.g. manufacturing or tourism) and towards more capital-intensive investments.

Figure 2.5. Foreign direct investment to Sustainable Development Goal-relevant sectors contracted substantially in 2020

Percent change in volume of announced greenfield projects to SDG-relevant sectors in developing countries



Note: The pre-COVID-19 trend refers to the compound annual growth rate for the period 2015-19. Figures shown for the power sector exclude investments in renewable energy.
Source: UNCTAD (2021[123]), *World Investment Report 2021: Investing in Sustainable Recovery*, https://unctad.org/system/files/official-document/wir2021_en.pdf.

StatLink https://stat.link/3gmvar

The global FDI recovery masks important declines across regions and countries. Latin America registered the largest drop in FDI flows (-37%) of any region in 2020, followed by Africa (-18%). Asia experienced a milder contraction (-4%). FDI to Africa was trending downward before the pandemic, and in 2020, the African continent's global share of FDI shrank to its lowest level since 2004 (AUC/OECD, 2022[124]). The performance of China and India, which attracted significant inflows of FDI during the COVID-19 crisis, explains in part the milder contraction observed in Asia. In 2020, FDI flows to China increased by 4%, to USD 163 billion, largely thanks to the rebound of the Chinese economy in the second semester (UNCTAD, 2021[43]). China surpassed the United States in 2020 as the first destination for new FDI. New FDI to India, another notable exception, increased 13% in 2020, reflecting increased foreign investment in the digital economy, mainly in the form of cross-border mergers and acquisitions.

2.2.2. Remittances demonstrated resilience in the face of the pandemic

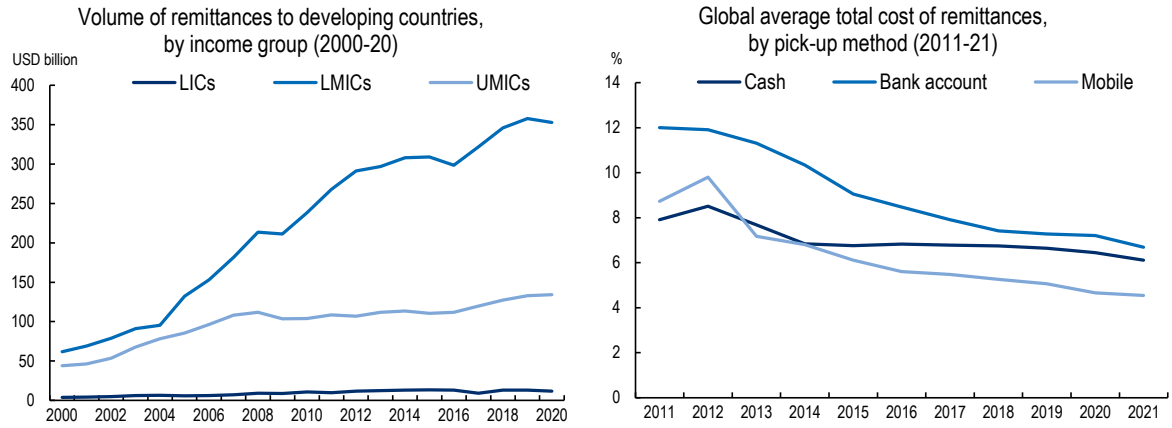
Remittances recovered quickly after the onset of the pandemic. In the first months, lockdowns in host countries and closure of remittance services severely hit the flow of migrants' remittances. Initial estimates published in the first half of 2020 predicted a 20% drop in remittances, corresponding to a loss of USD 110 billion (World Bank, 2020[125]). However, the gradual lifting of restrictions by host governments in the second half of the year allowed year-on-year remittance inflows to remain stable. Between 2019 and 2020, remittance flows to developing countries registered only a slight decrease of USD 5 billion (-1%), from USD 504 billion to USD 499 billion. Low-income countries (LICs) registered the largest decrease (-9%), while remittance inflows to lower middle-income countries (LMICs) and upper middle-income countries (UMICs) remained stable at -1% and 1%, respectively (Figure 2.6, left side).

Migrants' remittances benefitted from positive spillovers from unprecedented fiscal policy support in advanced economies. The deployment of fiscal stimulus by host countries, discussed in Chapter 1, helped safeguard migrants' income and contributed to the resilience of remittance flows to their countries of origin. Another contributing factor to the stability of remittance flows to developing countries in 2020 was the shift to more formal and often digital channels. For example, over the course of 2020, the use of mobile technology to send remittances increased by 65% (International Fund for Agricultural Development, 2021[126]).

The resilience of remittances also helped safeguard consumption-related investments and shield some populations from poverty. The recovery of remittance flows in the second half of 2020 provided a welcome lifeline to many developing countries and acted as a stabiliser, partly mitigating the drop in other external private resources such as cross-border capital flows. This effect is in line with earlier assessments of remittances as a countercyclical economic stabilising force. Thanks to their rising trend in recent years and the resilience they exhibited during the COVID-19 crisis, remittance flows to developing countries have surpassed FDI in volume terms since 2016.

Despite a steady decline over the past decade, the transaction cost of remittances remains more than double the SDG target, depleting the resources of both households and governments. At the global level, the average cost of sending USD 200 in remittances stood at 6.5% in 2020, more than double the 3% target in SDG 10 (reduce inequalities within and among countries). The cost of sending can be significantly higher in certain remittance corridors. Since 2015, the use of mobile technology offers a slightly lower-cost alternative, bringing down the average cost in 2020 to 4.66% of the amount sent versus 6.45% for cash and 7.21% for bank accounts and, by the end of 2021, to a record low of 4.03% of the amount sent (Figure 2.6, right side). While some of the factors driving the cost of remittances are structural, among them the scale of a remittance market or the distance between the sending and receiving country, specific policy action to promote digitalisation and increase competition among service providers could yield substantial results. According to the World Bank, bringing down the cost of remittances by a further 2 percentage points could generate an additional USD 12 billion per year for migrants from low- and middle-income countries (World Bank, 2022[127]).

Figure 2.6. Remittances to developing countries remained relatively stable across all income groups



Source: For left side, remittances are based on KNOMAD (2022[19]), *Remittance inflows* (database), https://www.knomad.org/data/remittances. For right side, remittances costs are based on World Bank (2022[95]); remittance prices worldwide on (World Economic Forum, 2022[95]), *Remittance Prices Worldwide* (database), http://remittanceprices.worldbank.org/.

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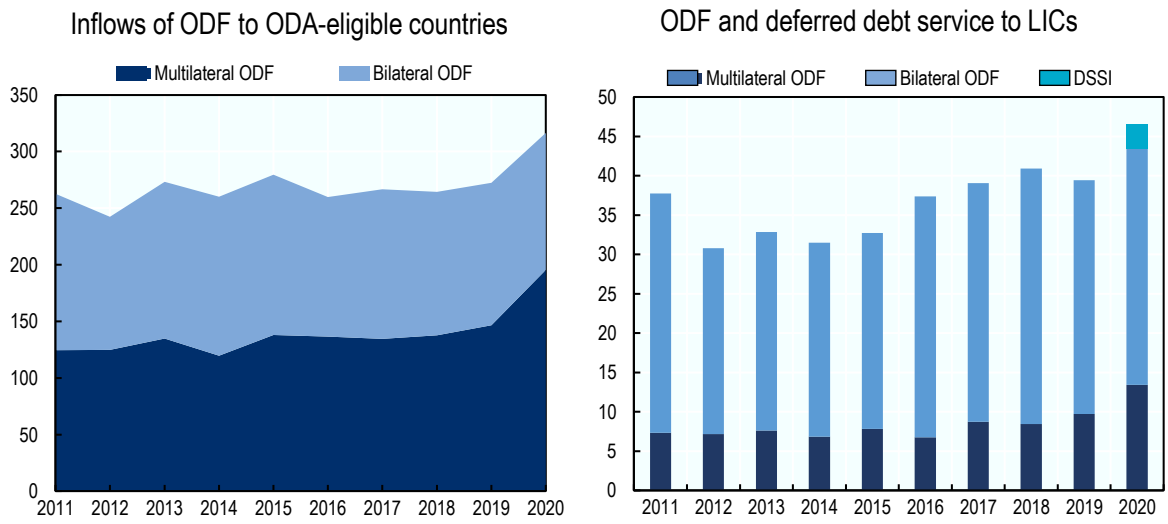
2.2.3 Official development finance reached record levels in 2020 yet did not fully compensate for the loss of other resources during the pandemic

Despite predictions to the contrary, total ODF reached record levels in 2020. ODA from DAC countries amounted to USD 162.2 billion in 2020, its highest level ever recorded and a 7% increase over 2019 (Figure 2.7, left side). Total ODF to developing countries, the combination of bilateral and multilateral ODA and other official flows (OOF), amounted to USD 307.7 billion in 2020, up by 8% from 2019. The increase of total ODA during a global crisis demonstrates the significant effort of ODA providers and reasserted the countercyclical role of ODA as a reliable form of international solidarity. Most donors had adopted their ODA budgets for 2020 by the time the pandemic hit and were able to maintain their planned ODA commitments. In addition, some donors were able to rapidly mobilise additional funding to support developing countries facing exceptional circumstances. However, recent analysis shows that COVID-19 spending was responsible for most of the increase in bilateral ODA, meaning that bilateral ODA to all but UMICs actually fell in 2020 once COVID-19 spending is stripped out (OECD, 2022[128]).

Figure 2.7. Bilateral and multilateral providers' combined efforts ensured continued financial support to developing countries at the height of the crisis



Source: DSSI = Debt Service Suspension Initiative. ODF flows are measured as a sum of ODA and OOF and accessed from OECD DAC Table 2a (OECD, 2022[22]), *Aid (ODA) disbursements to countries and regions [DAC2a], OOF and export credits - disbursements [DAC2b],* https://stats.oecd.org/Index.aspx?DataSetCode=Table2A and Table 2b (OECD, 2022[23]), *OOF and export credits - disbursements [DAC2b],* https://stats.oecd.org/Index.aspx?DataSetCode=TABLE2B#. DSSI deferred debt service is calculated based on World Bank estimates as of 8 February, 2022: World Bank (2022[24]), *Debt Service Suspension Initiative* (webpage), https://www.worldbank.org/en/topic/debt/brief/covid-19-debt-service-suspension-initiative.

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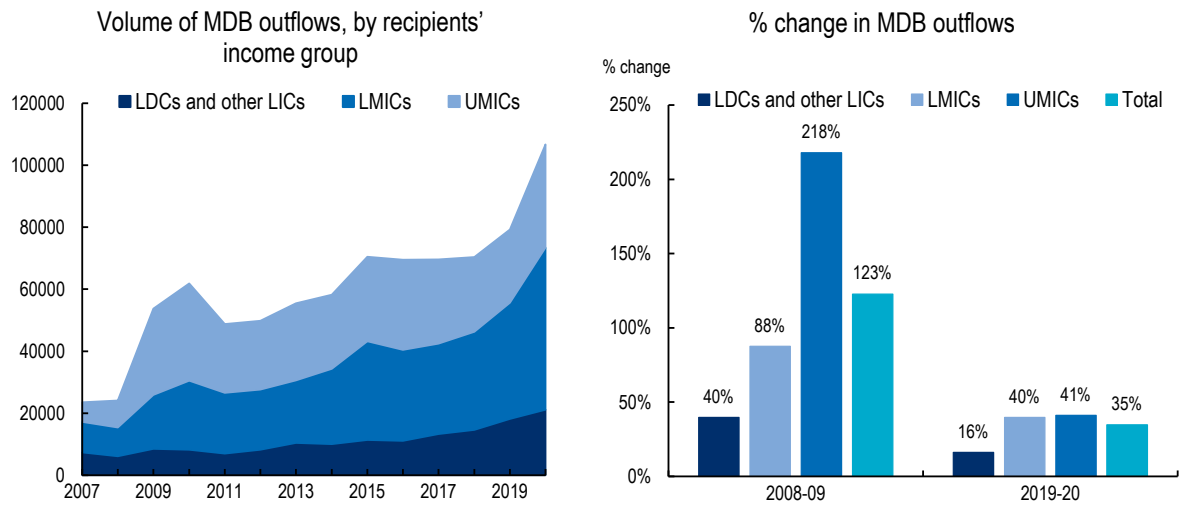
Bilateral development partners took historic action as creditors through the Debt Service Suspension Initiative (DSSI). In April 2020, the Group of Twenty (G20) finance ministers agreed to a debt standstill for LICs as part of the DSSI. Between May 2020 and December 2021, debt service totalling USD 12.9 billion was suspended through the initiative to provide some breathing space to the 48 participating countries (of the 73 eligible) (Figure 2.7, right side). The effort came predominantly from bilateral development partners. Multilateral creditors did not take part in the initiative to safeguard their credit ratings, and despite repeated calls by the G20, only one private creditor consented to participate. In November 2020, the G20 reached an agreement to establish a Common Framework for Debt Treatment with the aim of helping DSSI-eligible countries facing insolvency and protracted liquidity problems.

Multilateral development finance was instrumental in providing liquidity and financial support to help developing countries cope with the devastating impact of the COVID-19 pandemic. Multilateral ODF reached USD 195.4 billion in 2020, up from USD 146.7 billion the previous year. This 33% increase in multilateral disbursements was mainly driven by the rapid reaction of the international financial institutions and was accompanied by a similar increase of multilateral commitments. The World Bank and the regional development banks were able to significantly increase their lending by repurposing parts of their existing programmes and fast-tracking financial support to developing countries. Despite this significant effort, the increase in lending from multilateral development banks (MDBs) did not match the increase observed during the 2008-09 financial crisis (Figure 2.8), leading to renewed calls for reassessing the lending capacity of these institutions (Humphrey and Prizzon, 2021[129]). It should be noted, however, that the baseline for the 2020 increase in multilateral ODF was higher, owing to the rising trend of multilateral ODF in the decade preceding the COVID-19 crisis. The IMF was also highly active in 2020 in helping developing countries weather the storm of the COVID-19 crisis, most notably through emergency

financing, liquidity support, grants for debt relief and a general Special Drawing Rights (SDR) allocation of USD 650 billion, although only a fraction of the SDR allocation went directly to developing countries.

Figure 2.8. The increase in official development finance from multilateral development banks is larger than ever, though less than the increase in response to the global financial crisis



Note: LDCs = least developed countries. MDBs include the World Bank Group and all regional development banks for which data are available. ODF flows are measured as the sum of ODA and OOF. The numbers in the figure on the right correspond to the total year-on-year percentage change.
Source: OECD (2022[130]), *Creditor Reporting System*, https://stats.oecd.org/Index.aspx?DataSetCode=crs1.

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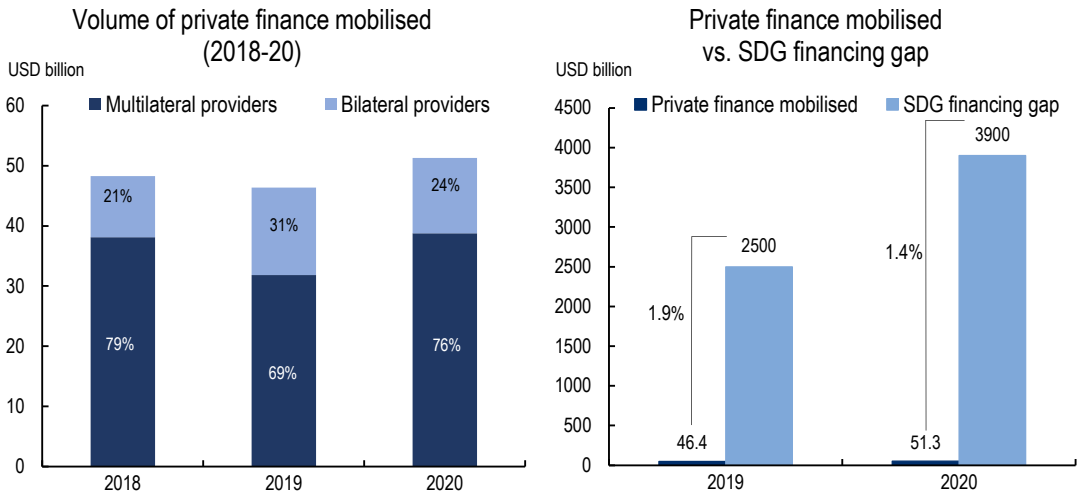
Despite some progress, the mobilisation of private finance for sustainable development remains below the ambition of the 2030 Agenda. The need to mobilise private resources is at the heart of the 2030 Agenda and has been clearly established as a priority in the Addis Ababa Action Agenda. Official providers have made significant efforts to increase the measurement of private finance through official interventions since the first survey on mobilisation carried out in 2013 by the OECD. Today, the OECD DAC measures private finance mobilised through six financial instruments: credit lines, guarantees, simple co-financing, direct investment in companies and special-purpose vehicles, shares in collective investment vehicles, and syndicated loans. Unlike the broader concept of blended finance, the DAC measure of mobilisation uses a restrictive definition, in that it only considers the amounts of private finance that would not have been mobilised without the use of ODF. According to the latest OECD (2022[131]) data collected, private finance mobilised by official providers grew by 11% in 2020 from USD 46.4 billion to USD 51.3 billion, following a 4% drop in 2019. Multilateral organisations continued to be the largest contributors to the mobilisation of private finance, accounting for 76% of the total, up by 7% from 2019 (Figure 2.9, left side). While this increase is positive news, the amounts involved remain far from the order of magnitude established by the Addis Ababa Action Agenda for private finance and can only contribute marginally to fill the SDG financing gap (Figure 2.9, right side).

Figure 2.9. The amounts of private finance mobilised through official interventions remain largely insufficient to meet the needs despite a slight increase in 2020



Source: For amounts mobilised from the private sector for development: OECD (2022[131]), *Amounts Mobilised from the Private Sector for Development* (webpage), https://www.oecd.org/dac/financing-sustainable-development/development-finance-standards/mobilisation.htm; OECD (2022[18]), *TOSSD Total Official Support for Sustainable Development/Data Visualisation Tool*, www.tossd.org.

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The increase in total ODF in 2020, however, does not compensate for the drop in other sources of FSD. It is noteworthy that the increase in ODA flows observed in 2020 follows a trend of slow but steady decline. ODA decreased by 3% between 2017 and 2019, from USD 170.9 billion to USD 166.2 billion. Initial estimates suggest that DAC countries spent USD 12 billion (or 7% of total ODA) on COVID-19-related activities in 2020 (OECD, 2021[132]). However, the USD 63 billion rise in ODF observed in 2020 makes up for less than half the USD 148 billion decline in total external private finance flows in the same year.

2.3 Domestic public and private resources in developing countries are increasingly stretched

2.3.1. Government revenue registered a steep decline in 2020, leading to a significant fiscal crunch

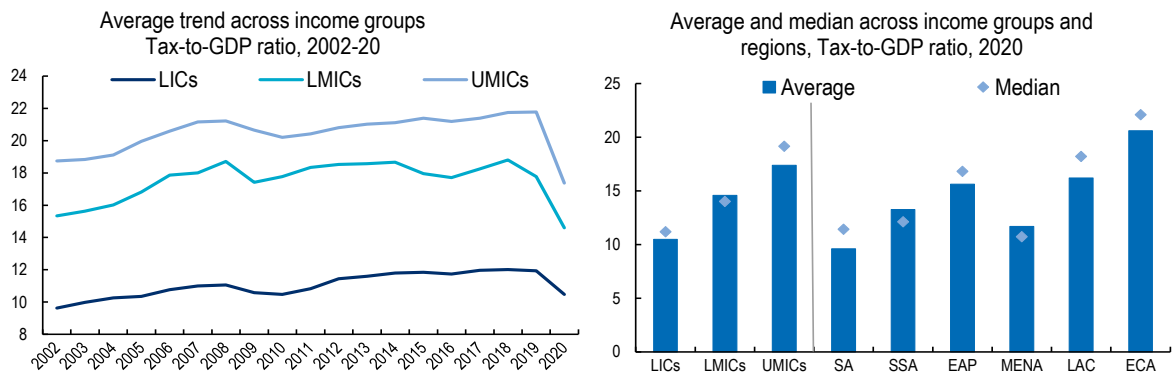
Before the COVID-19 crisis, the growth in developing countries' tax revenue was levelling off. Following a big spike in the early 2000s and a slight contraction in the aftermath of the 2008-09 global financial crisis, developing countries' tax revenue started to increase again in 2010, growing by 6% annually until 2015. However, from 2015 and 2019, even before the pandemic, tax revenue in developing countries excluding China grew by less than 1% annually.

During the pandemic, developing countries' tax revenues fell further than gross domestic product (GDP) and registered a steeper decline than during the global financial crisis. As noted in Chapter 1, developing countries' GDP fell as a consequence of COVID-19 lockdowns. While tax revenues also fell, the decline in the 2020 tax-to-GDP ratios indicates that tax revenues fell further than GDP in most developing countries. As shown in Figure 2.10 (left side), the decline in their tax-to-GDP ratios following

the outbreak of the pandemic was of historic magnitude and the opposite of what happened in high-income countries. The decline over 2019-20 also was more significant than it was during the 2008-09 global financial crisis: three times greater in LICs, two times greater in LMICs and four times greater in UMICs. The tax-to-GDP ratio of seven of 47 developing countries fell below the 15% threshold for economic growth and poverty reduction, or an increase of 17.5% in 2020.

The huge drop in government revenue experienced by developing countries is in large part attributable to the massive decline in economic activity and existing constraints on domestic resource mobilisation (DRM). The shutdown of global economic activity during the COVID-19 crisis resulted in significant revenue decline for developing countries due to the combined effects of a shrinkage of their tax base, proactive fiscal policy measures put in place by governments to provide relief to households and companies, and reduced tax compliance. As discussed in detail in Chapter 1, developing countries' macroeconomic vulnerabilities left them with insufficient space for the fiscal support packages that could have indirectly helped soften the blow to revenues (especially taxes on goods and services) by keeping household consumption and corporate activity afloat. Moreover, measures to prevent workers moving to the informal sector or dropping below the tax return threshold as a consequence of the pandemic could also have helped mitigate the shrinkage of the tax base. Another key explanation for the divergence of developing countries and high-income countries is the former's relatively low reliance on direct taxes due to tax collection issues. To a lesser extent, the drop in revenue in developing countries is also due to their comparatively greater reliance on temporary tax and payment relief measures in response to the crisis. Temporary tax and payment relief measures accounted for 15% of developing countries' COVID-19 fiscal packages, compared to just a 1% share of the packages of high-income countries (Oxford University Economic Recovery Project, 2021[133]).

Figure 2.10. Developing countries experienced a historic drop in tax-to-GDP ratios due to the COVID-19 crisis



Note: Unweighted averages are calculated for a sample of 105 developing countries. Regional groupings are South Asia (SA), sub-Saharan Africa (SSA), East Asia and Pacific (EAP), Middle East and North Africa (MENA), Latin America and the Caribbean (LAC), and Europe and Central Asia (ECA). Tax revenue includes social contributions.

Source: Authors based on OECD (2022[134]), *Global Revenue Statistics Database*,, https://stats.oecd.org/Index.aspx?DataSetCode=RS_GBL; IMF (2022[135]), *World Revenue Longitudinal Data (WoRLD)* (database), https://data.imf.org/?sk=77413f1d-1525-450a-a23a-47aeed40fe78&sid=1390030341854; UNU-WIDER (2021[136]), *GRD - Government Revenue Dataset*, https://www.wider.unu.edu/project/grd-%E2%80%93-government-revenue-dataset.

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In developing countries, non-tax revenue remained more stable on average than tax revenue. According to data from the United Nations University World Institute for Development Economics Research for a sample of 48 developing countries, non-tax revenue dropped by 3.3% between 2019 and 2020, while

total government revenue dropped 8.4% and GDP dropped 1.8% (UNU-WIDER, 2021[136]). These figures mask wide differences across income groups, with non-tax revenue down by 13.7% in UMICs, for example, and by 1% in LICs but up by 0.6% in LMICs. However, the values of non-tax revenue in 2020 remained close to or higher than 2018 levels across all income groups. Non-tax revenues are easier to collect and not affected by high levels of informality, as is often the case for tax revenues, and thus represent a sizeable source for developing countries. However, as non-tax revenues are often linked to economic activity, they also are subject to greater volatility. The greater volatility would explain the particularly significant drop in non-tax revenue in UMICs, since their exposure to global markets is higher, as explored in Chapter 1.

The pandemic has strengthened the need for digitalisation of tax administration to enable resilience in tax collection and ensure that e-commerce is effectively taxed. The pandemic has increased the urgency for tax administrations to digitalise. While some developing countries have digitalised their tax systems, further support is needed to reap the full benefits of implementation of the digital transformation of their tax administrations. Digitalisation of tax administration not only offers greater ease of use to taxpayers. It also reduces opportunities for corruption, increases the ease of data analysis to identify avoidance and evasion, and can improve the efficiency of tax administrations. The process of digitalisation presents a number of challenges related to the technology itself as well as to the change management process and the education of taxpayers on the new systems. *Supporting the Digitalisation of Developing Country Tax Administrations* (OECD, 2021[137]) examines the common elements of successful digitalisation. In addition, the OECD *Digital Transformation Maturity Model* (OECD, 2020[138]) provides a tool for countries to self-assess their current level of maturity and facilitate future strategy development. There is also largely untapped revenue potential from the rapid growth of e-commerce. For example, the African e-commerce market is already worth USD 27 billion and expected to grow by around 13% a year to reach USD 46 billion by 2025 (OECD, 2021[139]). As most African countries have not yet updated their value-added tax (VAT) rules to account for digital trade, they are missing out on significant tax revenues. International standards for VAT on e-commerce provide a proven tool to effectively levy VAT on the sector. A series of regional toolkits – for LAC (OECD et al., 2021[37]); Asia-Pacific (OECD/WBG/ADB, 2022[140]); and Africa (OECD/WBG, forthcoming[117]) – are being produced to help countries in the process of implementing these standards as part of VAT reform. There are broader challenges with how to effectively levy corporation tax in a digitalised global economy. The historic developments in this area are discussed in subsection 2.4.1.

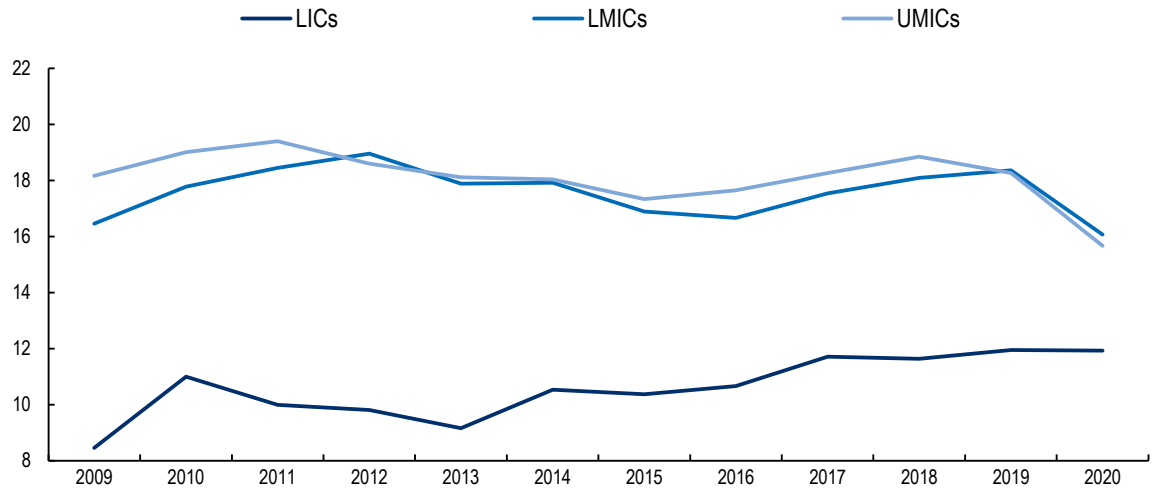
2.3.2. Domestic private investment can play an essential role in countries' resilience to external shocks, but it remains scarce in many developing countries

Domestic savings are a key determinant of economic growth and long-term sustainable development. Research suggests that domestic savings by households, corporates and governments are positively correlated with investment levels (Tagem and Kunal, 2021[141]). As a source of finance for investment, domestic savings can also reduce countries' vulnerability to sudden drop-offs in international capital flows and effectively insulate countries against certain external shocks.

The pandemic led to a decrease of gross domestic savings in middle-income countries (MICs) after several years of increases across all income groups. Between 2015 and 2017, domestic savings increased across all income groups, growing by 13% in LICs, 4% in LMICs and 5% in UMICs (Figure 2.11). Their performance was mixed over the next two years, with domestic savings reaching a plateau in LICs and, after three consecutive years of growth, decreasing in UMICs between 2018 and 2019. In 2020, the pandemic led to a sharp drop of domestic savings in MICs in large part due to increased government spending, which offsets potential increases in household and corporate savings. In LICs, where the fiscal response of governments was limited, domestic savings remained stable in 2020, although their low levels (at around 12% of GDP) remain largely insufficient to reduce these countries' dependence on external financing sources.

Figure 2.11. Gross domestic savings declined significantly in middle-income countries and plateaued at low levels in low-income countries

Average gross domestic savings as % of GDP (2009-20), by income group



Note: Unweighted averages are calculated for a sample of 106 developing countries.
Source: Authors based on World Bank (2022[119]), *World Development Indicators* (database), https://datacatalog.worldbank.org/dataset/world-development-indicators.

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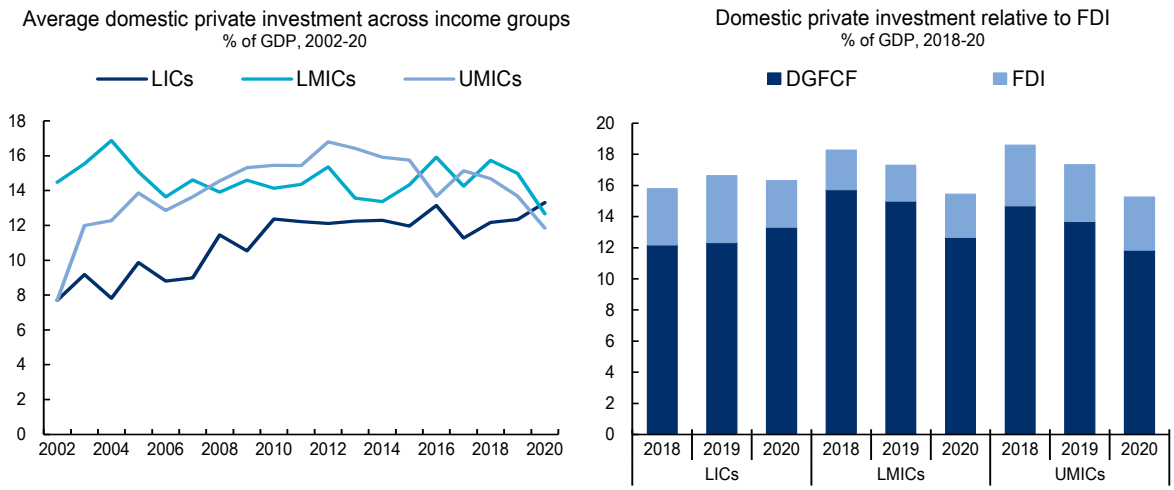
MICs experienced a shock to levels of domestic private investment. Domestic private investment is a critical financing source for all developing countries. In 2020, the volume of domestic gross fixed capital formation (DGFCF), used in Figure 2.12 as a proxy for domestic private investment in developing countries, was more than four times the volume of FDI. Between 2019 and 2020, domestic private investment decreased by 15.5% and 13.5%, respectively, in LMICs and UMICs (Figure 2.12, left side), accelerating a pre-existing downward trend. The implementation of containment measures to limit the spread of the coronavirus had a severe impact on economic activity in MICs, resulting in a drop in investment in fixed assets. In LICs, however, domestic private investment continued its long-term upward trend, reaching a 20-year peak in 2020.

Figure 2.12. Domestic private investment, a key financing source for developing countries, has declined, especially in middle-income countries



Note: Unweighted averages calculated for a sample of 46 developing countries. Domestic private investment (shown as DGFCF on the right side) is proxied by private gross fixed capital formation minus FDI. It should be noted that FDI may not accurately represent the foreign component of gross fixed capital formation.
Source: Authors based on World Bank (2022[119]), *World Development Indicators* (database), https://datacatalog.worldbank.org/dataset/world-development-indicators; IMF (2022[20]), *Balance of payments* (database), http://data.imf.org/bop.

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There is still little evidence available on the role played by public development banks (PDBs) to support long-term investment in developing countries during the COVID-19 crisis. PDBs of developing countries are important actors in these countries' FSD landscape. PDBs and development finance institutions from developing countries excluding China held total assets amounting to USD 1.4 trillion in 2020. Although significant, these assets represent only 6.2% of the total assets held by PDBs worldwide (including multinational PDBs and development finance institutions) (Xu, Marodon and Ru, 2021[69]). Moreover, while early research suggests that the PDBs of several developing countries played an important countercyclical role in the first year of the COVID-19 pandemic (McDonald, Marois and Barrowclough, 2020[142]), a thorough assessment of their contribution to the crisis response is not yet complete.

2.4. The risk of growing imbalances in the financing for sustainable development landscape has increased over the medium to long term

2.4.1. The financing outlook remains grim for developing countries

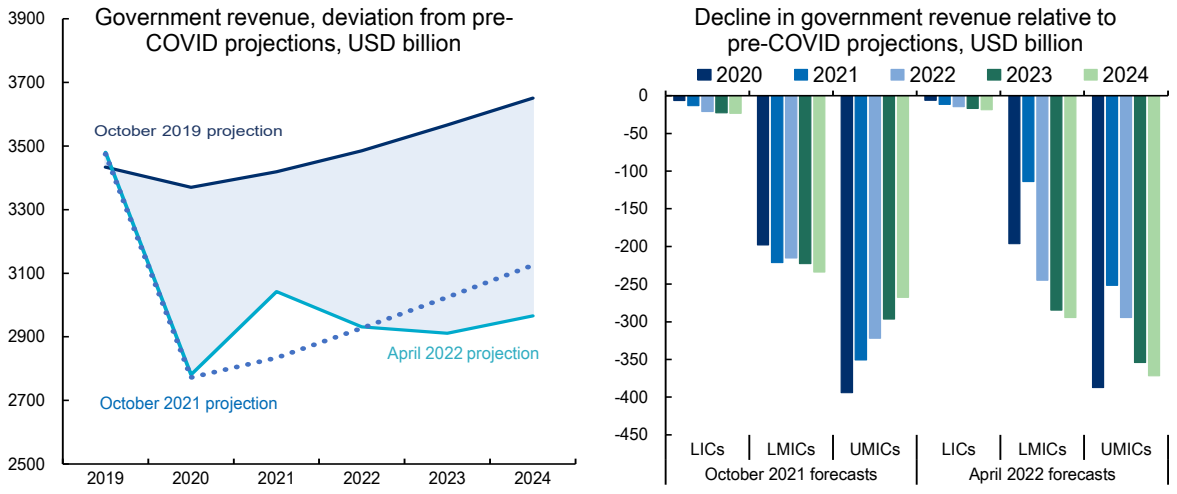
The recovery of the FSD landscape from the COVID-19 crisis could be short-lived due to a tightening of global financing conditions and the impact of the war in Ukraine. While developing countries' financing sources experienced a nascent recovery in 2021, the gradual withdrawal of policy support measures and heightened global uncertainty generated by Russia's full-scale invasion of Ukraine weigh on developing countries' financing prospects. This deteriorated global context is exerting downward pressures on private financing flows to developing countries and translating into new risks and growing imbalances in the FSD landscape. At the same time, successive crises are putting external public finance

under pressure. As a result of Russia's aggression against Ukraine, additional financing is needed to address the humanitarian emergency and cover in-donor refugee costs. However, increasing the allocation of aid to crisis response poses a risk that resources may be diverted from longer-term development priorities, including investments necessary for a just and sustainable recovery. Taking into consideration the expected tightening of global financing conditions, projections by the UN Conference on Trade and Development and the IMF suggest that the SDG financing gap could reach USD 4.3 trillion per year from 2020 to 2025, an increase of USD 400 billion over OECD estimates in 2019-20 (UNCTAD, 2022[25]). This section examines the outlook for the FSD landscape.

Successive crises, including Russia's war in Ukraine, could stifle the government revenue of developing countries for years to come

The stifled recovery is lowering government revenues and increasing debt servicing costs, which impede financing for the SDGs over the long term. Developing countries' government revenue is expected to remain almost 20% below pre-pandemic projections into the foreseeable future (Figure 2.13, left side). Russia's full-scale invasion of Ukraine upended pre-war projections of a slow but steady recovery of developing countries' government revenue. At the current pace of recovery, government revenue may not reach pre-pandemic levels before 2030. Government revenue now is expected to decrease in 2022 and 2023, with MICs particularly affected (Figure 2.13, right side). Projections for 2022-24 for MICs suggest government revenue decline will amount to about USD 95 billion annually in the current geopolitical and economic context. Box 2.2 looks at the potentially severe repercussions for developing countries with limited government revenue of rising external debt service costs to self-finance long-term SDG strategies.

Figure 2.13. The war in Ukraine stopped the recovery in government revenue in developing countries and will result in a durable shortfall in government revenue



Note: The grey area in the chart on the left represents the drop in the projected volume of government revenue due to the successive crises. The chart on the left also shows the deviation of government revenue from pre-pandemic projections for all developing countries excluding China.

Source: Government revenue projections are drawn from the IMF World Economic Outlook databases: (IMF, 2019[26]), *World Economic Outlook - October 2021 edition* (database), https://www.imf.org/en/Publications/WEO/weo-database/2019/October; (IMF, 2021[27]), *World Economic Outlook - October 2021 edition* (database), https://www.imf.org/en/Publications/WEO/weo-database/2021/October; (IMF, 2022[28]), *World Economic Outlook - April 2022 edition* (database), https://www.imf.org/en/Publications/WEO/weo-database/2022/April.

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Box 2.2. Rising external debt service costs relative to total government revenue jeopardise countries' ability to invest in long-term development goals

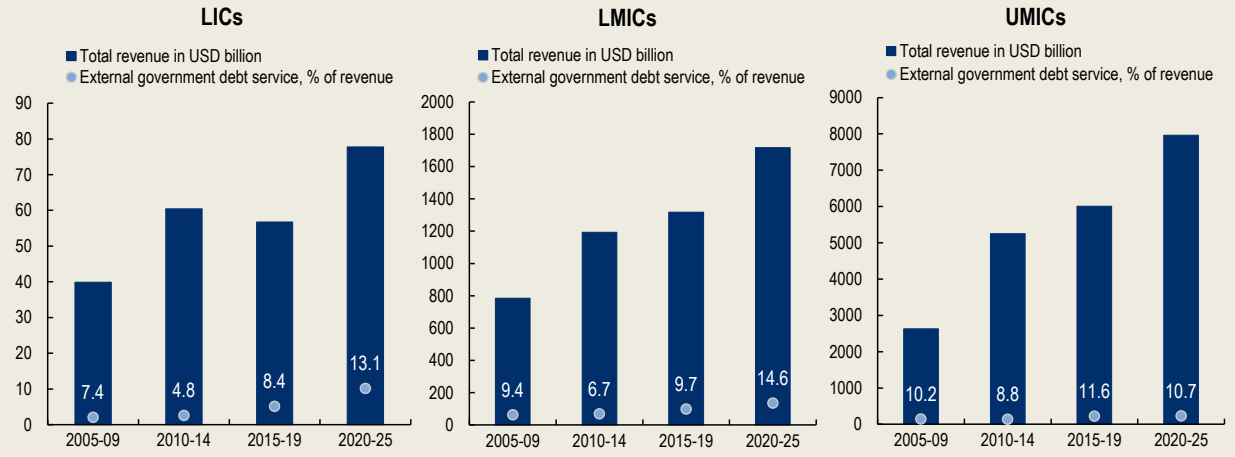
Developing countries face a "wall of debt service repayment" that could have enormous impacts on their debt sustainability and fiscal space (UNCTAD, 2020[29]). The average public and publicly guaranteed (PPG) external debt service ratio to total government revenue is expected to reach its highest level in 2020-25 across all income groups. PPG external debt service could represent 13.1% of government revenue in LICs, 15% in LMICs and 11% in UMICs (Figure 2.14). This sudden increase resulted from the simultaneous drop in government revenue and increase in external debt service. While the DSSI offered the 73 eligible LICs a welcome but temporary respite in 2020, it did not provide a long-term solution for developing countries' debt solvency issues. Developing countries also accumulated large amounts of short-term debt during the pandemic that require repayment or refinancing by 2024.

A considerable share of domestic resources in developing countries could be diverted from public spending to service external debt. The accumulation of short-term debt during the COVID-19 crisis and the worsening global economic outlook foreshadow an increase in the cost of debt service. External debt service for developing countries could amount to USD 387 billion in 2022. Between 2020 and 2025, it is projected to reach USD 375 billion on average, already a jump from the USD 330 billion on average between 2015 and 2019. Besides the risk of debt distress mentioned in Chapter 1, the rise in debt service costs also affects the available revenue that countries can invest in their long-term development goals. This implies that future improvements in DRM may yield lower returns in terms of development impact since a substantial share of the new revenue may have to be used to service debt rather than carry out productive investments.

In many developing countries, debt service already surpasses government expenditure in key SDG sectors. Even before the COVID-19 pandemic, one in eight developing countries spent more on debt service than on health, education and social protection combined (UNICEF, 2021[143]). The higher borrowing costs faced by developing countries may also prevent them from effectively investing in a fair and sustainable recovery. A recent study, noting the importance of low financing costs to accelerate the energy transition in developing countries, found that nominal financing costs are currently up to seven times higher in developing countries than in the United States and Europe (IEA, 2021[74]).

Figure 2.14 Debt service takes up a sizeable share of government revenue in low-income and lower middle-income countries and will not return to pre-pandemic levels by 2022

Aggregate external debt service as a proportion of total government revenue, by income group



Note: Averages are calculated for a sample of 134 developing countries. Debt service is measured on PPG external debt. Total revenue includes social contributions and grants. Aggregate values for 2020 to 2025 are based on IMF country estimates.

Source: Authors based on IMF (2021[27]), *World Economic Outlook – October 2021 edition* (database), https://www.imf.org/en/Publications/WEO/weo-database/2021/October; World Bank (2022[53]), *International Debt Statistics* (database), https://databank.worldbank.org/source/international-debt-statistics; and IMF (2022[144]), *IMF Article IV Staff Reports*, https://www.imf.org/en/Publications/SPROLLs/Article-iv-staff-reports#sort=%40imfdate%20descending.

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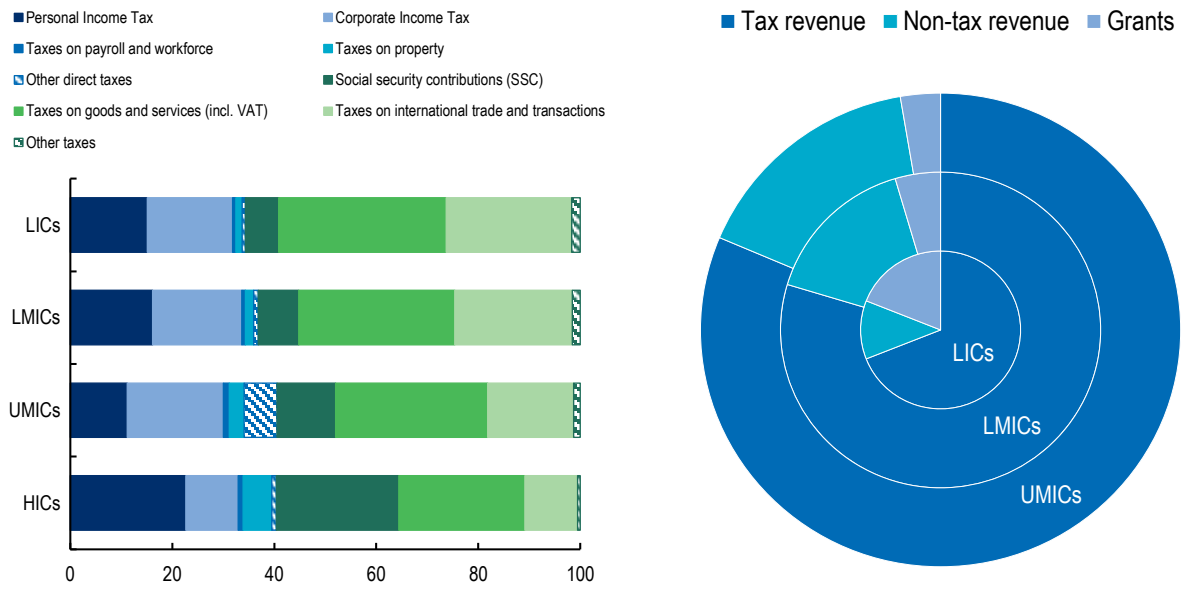
Dwindling government revenues could limit developing countries' redistributive capacities, further fuelling inequalities. Government revenue is a key enabler of the provision of social protection and public services. Reliable levels of tax revenue are also crucial for long-term policy planning. Therefore, developing countries faced with adverse shocks that ultimately translate to steep declines in tax revenues may struggle to maintain the quantity and the quality of their public services. The fraction of the population at the bottom of the income distribution could be the most affected as they are most dependent on the provision of social protection and public services, such as access to health or education.

The characteristics of developing countries' tax structures could hinder the implementation of more equitable taxation policies. The capacity of tax systems to reduce inequality is partly design-dependent, with tax progressivity and limited use of tax expenditures being relevant features. For instance, an over-reliance on indirect taxes (without compensatory transfers) can increase income inequality because these require low-income households to pay more as a share of their income than high-income households for the same taxed good or service. Indirect taxes, such as tax on goods and services and tax on international trade and transactions, play a prominent role in developing countries, with taxes on goods and services constituting on average 30% of total government revenue in UMICs, 31% in LMICs and 33% in LICs (Figure 2.15). By comparison, these taxes make up on average 25% of total government revenue in OECD countries. Income taxes, especially personal income tax, also offer much scope to increase government revenue in developing countries, as they now make up a smaller share (by 6 to 11 percentage points) of total tax revenue than in high-income countries. Such taxes would also improve distributional outcomes so long as progressive schedules are implemented. With regard to social security contributions, the gap is even wider and translates into weaker social protection systems in developing countries, a

vulnerability that is especially relevant in light of the impact of recent successive crises. Low personal income tax capture and low social security contributions are in part a reflection of low tax collection capacity and high informality in developing countries and demonstrate how the reform of tax structures can be a challenging process. Alternatively, insofar as indirect taxes remain an effective and prominent source of revenue, stronger ex post redistribution policies can be designed to address equity concerns.

Figure 2.15. Government revenue structure differs across income groups, with potentially large implications for income redistribution

Revenue components as % of total tax and government revenue, respectively, 2019, by income group



Source: Authors based on (for left side) OECD (2022[134]), *Global Revenue Statistics Database*, https://stats.oecd.org/Index.aspx?DataSetCode=RS_GBL and on (for right side) UNU-WIDER (2021[136]), *GRD - Government Revenue Dataset*, https://www.wider.unu.edu/project/grd-%E2%80%93-government-revenue-dataset.

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In addition to government revenue mobilisation, developing countries will continue to rely on fiscal policies to shield vulnerable populations from the impacts of crises. The COVID-19 pandemic showed the importance of government revenue as a key financing source to both sustain the economy during adverse shocks and offer a social safety net to the population in times of crises. Some developing countries that are directly affected by the war in Ukraine due to their geographical proximity may require additional spending to deal with refugee inflows and disrupted trade and supply chains. Even countries not directly affected by the war are very likely to suffer from negative spillovers such as increased energy and food prices, supply shortages, and a slowdown of global economic activity that may lower government revenue.

In the context of rising food and energy prices, fiscal measures should aim to protect the population and ensure affordable access to low and zero carbon options. Several developing countries – among them, India, Nigeria and South Africa – have increased or implemented fuel tax cuts or subsidies to shield the population from price increases in an attempt to alleviate poverty and ensure access to basic goods and services. Unless targeted at the most vulnerable households, these measures may

increase inequality as they disproportionately benefit the households that spend more on fuel and food. Furthermore, the sizeable increase in foregone revenue may constrain long-term planning to sustain the quantity and quality of public services offered to the population. On top of the equity concerns, the context of high fuel prices is challenging recent progress in environmental taxation, which contributes to DRM while fighting climate change and air pollution (OECD, 2021[88]). In addition, non-tax revenue exceeds tax revenue for some commodity exporters, especially oil-rich countries (Ivanhoe, 2000[145]). Without effective policies to phase out fuel and other environmentally harmful subsidies in the medium term while also generating sufficient public revenues, governments could be forced to choose between reducing inequalities and a green transition.

International tax reforms may yield additional revenues as well as encourage much-needed reform of tax incentives. In October 2021, members of the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting, or BEPS, among them more than 60 developing countries, reached a landmark agreement on the two-pillar solution to the tax challenges of the digitalising economy. This agreement on a new approach to ensure that the profits of the largest and most profitable companies are reallocated to the jurisdictions where their consumers are located (Pillar One), together with the establishment of a global minimum corporate income tax of 15% (Pillar Two), mark the biggest change in international corporate income tax in a century. Pillar One is expected to lead to the reallocation of more than USD 125 billion of profit to market jurisdictions each year. Pillar Two is expected to generate about USD 150 billion in additional annual tax revenues globally. Developing countries have been integral to the negotiations, and though developing countries did not achieve everything they had hoped for in the negotiations, the deal contains a number of features that respond to the concerns expressed by developing countries (OECD, 2021[87]). The final rules are still being determined and developing countries will need substantial assistance in the coming years to support their implementation. The global minimum tax of 15% may encourage countries to review their tax incentive regimes, as incentives that reduce taxes below the new global minimum will result in effectively gifting revenues to the countries where the multinational enterprises are headquartered. While the priority will be to reform incentives offered to these enterprises in scope for the global minimum tax, countries may take the opportunity to look at more fundamental reforms of tax incentives regimes, which have become a major challenge in many developing countries (Box 2.3).

Box 2.3. Building an Investment Tax Incentives database

Tax incentives for investment are frequently used across the world. Tax incentives are targeted tax provisions that provide favourable deviations from the standard tax treatment in a country. They have the potential to promote investment, with positive effects on output, employment and productivity and on other objectives related to the SDGs. If poorly designed, though, tax incentives may be of limited effectiveness and could result in windfall gains for projects that would have taken place in the absence of the incentive. Tax incentives can also reduce revenue-raising capacity, create economic distortions, increase administrative and compliance costs, and potentially increase tax competition. Striking the right balance between an efficient and attractive tax regime for domestic and foreign investment, on one hand, and securing the necessary revenues for public spending and development, on the other, is a particular concern in developing countries.

The wide use of tax incentives globally, along with concerns about their net impact, are also an important policy concern for national governments and the international policy community. Recent OECD work improves insights into tax incentive policies and increases the policy relevance of tax incentive analysis, with the objective of helping policy makers make smarter use of tax incentives and reform inefficient ones.

The OECD Investment Tax Incentives database systematically compiles quantitative and qualitative information on the design and targeting of corporate income tax (CIT) incentives across developing and emerging economies using a consistent data collection methodology. As illustrated in Figure 2.16, the database includes information along three dimensions for each tax incentive: instrument-specific design features, eligibility conditions and legal basis. As of July 2021, the database covered 36 developing countries in Eurasia, MENA, Southeast Asia and sub-Saharan Africa.

Figure 2.16. Key dimensions of the OECD Investment Tax Incentives database

A. Design features	B. Eligibility conditions	C. Legal basis
How does the tax incentive reduce taxation?	Which investors and projects qualify for the tax incentive?	How is the tax incentive governed?
e.g. tax incentive instrument, if temporary tax exemption then length in years, reduced CIT rate, sunset clause	e.g. sector conditions, location conditions, outcome conditions, investment size conditions	e.g. legal provision introducing the tax incentive, granting authority

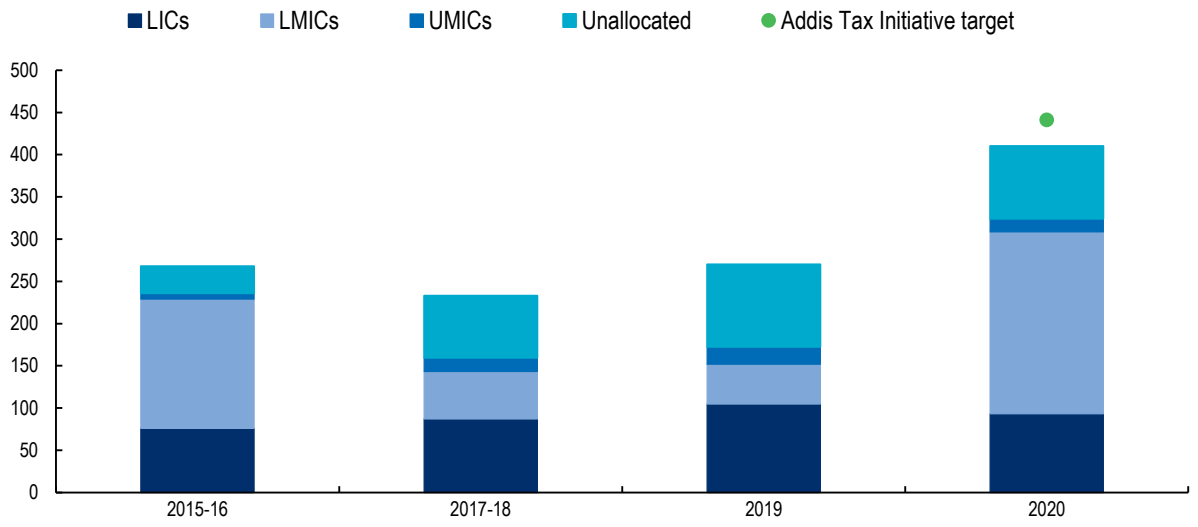
The first descriptive statistics based on information from the 36 countries show that tax incentive designs are multidimensional, complex, and often specific to a certain sector, region or investor within a country. Complex features may be a sign that countries are adjusting tax incentive designs to specific contexts. This may improve policy making, for example by improving the effectiveness of incentives or limiting foregone revenue. However, complexity also reduces transparency and can create unintended effects.

Source: Celani, Dressler and Wermelinger (2022[146]), "Building an Investment Tax Incentives database: Methodology and initial findings for 36 developing countries", https://doi.org/10.1787/62e075a9-en.

Donor support to DRM has increased, yet it falls short of commitments to assist developing countries to strengthen their tax base and increase tax compliance. Between 2015 and 2020, DAC members invested approximately USD 1.9 billion in ODA for DRM, which corresponds to an average of USD 310 million per year (Figure 2.17). In 2020, DAC members' ODA in support of DRM nearly doubled compared to 2019, reaching a record high of USD 410 million. This rise, however, was mainly driven by disbursements in a few countries. When a single large disbursement by the EU for a DRM project in Indonesia is removed from the analysis, gross disbursements in 2020 are seen to have decreased across all income groups. Despite the progress made and according to the data reported in the Creditor Reporting System, this is still far from the target set by the Addis Tax Initiative to double ODA to DRM in the period 2015-2020 to USD 441.1million (2020[64]).

Figure 2.17. Official development assistance in support of domestic resource mobilisation rose considerably in 2020

Gross ODA disbursements from DAC countries for DRM, 2020, USD million



Note: ODA for DRM is based on amounts reported under the purpose code 15114 (domestic resource mobilisation) of the OECD Creditor Reporting System. The Addis Tax Initiative set a global target (horizontal line in the graph) for 2020 of USD 441.1 million of DRM co-operation for country-owned tax reforms. The increases in 2016 and 2020 are largely driven by the disbursements to Indonesia totalling USD 123 million in 2016, or an increase of 3.61%, and USD 176 million in 2020, or up 3.43%. The values for 2015-16 and for 2017-18 are simple averages of the annual values. Considering all bilateral and multilateral official donors, total ODA for DRM reached a record high in 2020, doubling, and crossing the USD 1 billion mark, the 2019 ODA for DRM total of USD 519 million.
Source: OECD (2022[130]), *Creditor Reporting System* (database), https://stats.oecd.org/Index.aspx?DataSetCode=crs1.

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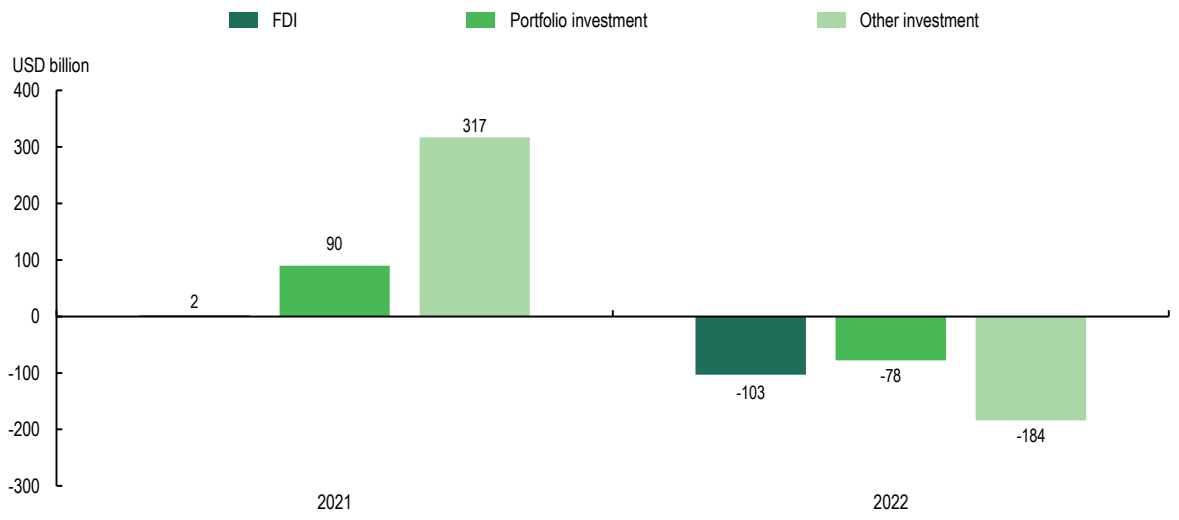
Fragile investor sentiment and deteriorated credit conditions will continue to weigh on private finance in the medium to long term

Following a rebound of cross-border capital flows to developing countries in 2021, a new drop is projected for 2022. Non-resident capital flows to developing countries excluding China rebounded to reach USD 1.011 billion in 2021, a 67% increase relative to 2020 (Institute of International Finance, 2022[31]). This increase was driven by a recovery in portfolio flows and by the issuance of IMF SDRs, which account for about half of the volume of investments other than FDI and portfolio investment in developing countries excluding China in 2021. However, estimates for 2022 suggest that the recovery of cross-border

capital flows will be short-lived. Portfolio investment and other investment are expected to decline by 50% and 45%, respectively, in 2022 while FDI is projected to drop by 23% (Figure 2.18).

Expectations of monetary tightening and emergent headwinds in the global economy contribute to the bleak outlook for capital flows in 2022. Even before the start of Russia's war against Ukraine, projections of capital flows to developing countries for 2022 pointed to a fall stemming from slower growth and incipient inflationary pressures. The recovery of FSD flows could be further constrained by recent geopolitical turmoil generated by the Russian invasion, which adds to the uncertainty and volatility in financial markets. Ultimately, these could erode investor confidence and spur another wave of capital flight from developing countries.

Figure 2.18. The threat of macroeconomic turbulence could hinder the recovery of cross-border capital flows to developing countries



Note: Values for 2022 are forecasts.
Source: Institute of International Finance (2022[31]), *Capital Flows Report May 2022: Rising Global Recession Risk*, https://www.iif.com/Research/Capital-Flows-and-Debt/Capital-Flows-to-Emerging-Markets-Report.

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Weaker credit conditions may also hamper developing countries' ability to access finance needed for their long-term recovery from the COVID-19 crisis. Due to their weak macroeconomic fundamentals, downgraded credit ratings and shallow domestic debt markets, many developing countries may struggle to borrow from capital markets in coming years (OECD, 2022[1]). Tightening of global financing conditions and the impact of the war in Ukraine resulted in downward revisions to global growth forecasts and accelerated inflationary pressures. As a result, developing countries are facing higher borrowing costs, as demonstrated by the increase in sovereign bond yields observed in the first semester of 2022. The rise in global interest rates could add to the cost of borrowing as investors are likely to ask for higher interest on government bonds.

Constrained access to credit and larger refinancing needs expose developing countries to rollover risks and could ultimately lead to sovereign defaults. As a result of issuing a large volume of short-term debt in 2021 to respond to the COVID-19 emergency, developing countries face high amounts of debt that are due to be repaid or refinanced in the short term. With 45% of their outstanding debt maturing by 2024 (against 36% for all developing countries), LICs are particularly exposed to rollover risk (OECD,

2022[1]). These risks, compounded by higher borrowing costs, increase the likelihood of new debt crises in the medium to long term. Chapter 3 examines another aspect – the barriers to access the sustainable finance market due to spiralling debt and sovereign downgrade and/or defaults and climate-related vulnerabilities.

The current limitations of the Common Framework for Debt Treatments beyond the DSSI add to the growing concerns about the sustainability of developing countries' sovereign debt. The Common Framework for Debt Treatments announced by the G20 in November 2020 to deal with countries' insolvency and protracted liquidity problems has not produced the expected results (Ahmed and Brown, 2021[30]). Only three countries – Chad, Ethiopia and Zambia – have so far requested the treatment of their debt under the Common Framework, a reflection of the fear of other countries that participation in the initiative may impact market access. The participation of non-Paris Club members in the Common Framework is a welcome development due to the shift in the creditor base of developing countries observed in recent years, with emerging creditors such as China taking on increased weight. However, the slow pace of progress observed in the debt treatment of the three participating countries raises questions about the capacity of the initiative to confront a larger wave of debt treatments in the future. In addition, the Common Framework's restrictive focus on DSSI-eligible countries means that MICs facing debt distress still face the threat of disorderly defaults, as was the case with Sri Lanka, which defaulted in May 2022 (Parkin and Cornish, 2022[147]). Looking ahead, official providers and creditors, including international financial institutions and bilateral development partners, will need to make special efforts to strengthen the debt resilience of developing countries and avoid further credit rating downgrades and sovereign defaults.

2.4.2. Financing for sustainable development leakages continue to deprive developing countries of considerable resources

The risk of increased leakages from illicit financial flows adds to the grim financing outlook

Even before the COVID-19 crisis, illicit financial flows (IFFs) were increasing the SDG financing gap. Although IFFs are difficult to measure accurately because they are illicit and because there are so many different definitions of the concept, existing estimates indicate that these flows are of sufficient magnitude to contribute substantially to the SDG financing gap in developing countries. The IMF estimates that the annual cost of bribery alone is between USD 1.5 trillion and USD 2 trillion globally (IMF, 2016[32]). However, estimates of the amounts lost to bribery, corruption, theft and tax evasion in developing countries remain challenging to determine. Current efforts to develop and test a conceptual framework to define, measure and quantify IFFs may help bring some consistency and can help encourage improved data availability, an important asset in evaluating policy action to curb IFFs.

COVID-19 may have widened pre-existing loopholes in the global financial system and reduced oversight due to emergency spending. The timely response to the pandemic led to the temporary relaxation or suspension of administrative controls and accountability mechanisms in some countries. This increased the risk of corruption via three different channels: procurement for critical healthcare resources such as personal protective equipment, income support to individuals and fiscal support to the private sector (OECD, 2020[148]). An increase in IFFs could lead to further deterioration in the capacity of the health sector, which was already estimated to lose USD 455 billion per year to fraud and corruption worldwide prior to the pandemic (Mackey, Vian and Kohler, 2018[149]). By September 2020, 19 prominent cases of already been identified globally, with the lost funds reliably estimated to total USD 1.1 billion, or the equivalent of 50 000 ventilators (Transparency International, 2020[150]).

IFFs not only deprive countries of resources for FSD but can also undermine trust in the government and public institutions. While reduced revenues for governments and reduced domestic capital for investment are their most obvious impacts, IFFs can also have spillover effects. Corruption and lack of trust in public institutions that tolerate or appear unable to stop IFFs can negatively impact tax

morale (i.e. the intrinsic willingness to pay tax), thereby further eroding a country's tax base, and undermine trust in institutions more broadly (OECD/ILO, 2019[45]). The economic, equity and stability effects of IFFs are particularly pronounced in highly vulnerable countries – that is, developing countries already grappling with chronic poverty, fragility and episodic conflict. By corroding fiscal and regulatory capabilities and empowering those operating outside the law, IFFs also undermine the rule of law, with negative security and social impacts. In the Democratic Republic of the Congo, for example, approximately 98% of the net profits from illegal exploitation of natural resources, particularly gold, charcoal and timber, flow to transnational organised crime networks operating in and outside of the country. People smuggling, which has become the dominant illicit activity across the Sahel, has enormous human and social costs yet generates IFFs amounting to more than USD 100 million for criminal networks in the region year on year (OECD, 2018[151]).

IFFs act as a reverse distribution mechanism, reinforcing economic and social inequalities and hindering progress towards the SDGs. IFFs also contribute to within-country inequality as they constrain the resources available to provide high-quality public services, which households with lower incomes tend to benefit the most from. Additionally, IFFs may increase the price that citizens pay to obtain certain public goods and services or reduce the offer of such goods and services. Over the long term, IFFs may also undermine international investors' confidence in a country by fostering uncertainty in the business environment and reducing domestic agency to shape the country's future.

While global estimates of the scale of IFFs help highlight the importance of tackling the problem, IFFs are country specific and require country-level analysis and targeted policy actions. The economic, policy and institutional environment of a country will determine both its IFF risk and the actual IFF volume, and these may vary significantly across countries; for example, there appear to be increased risks of IFFs in commodity-exporting sectors (Porter and Anderson, 2021[152]). As such, more actionable insights on the policy responses needed are more likely to emerge from country-level analysis. A recent OECD (2022[153]) study of IFFs and tax compliance in South Africa uses foreign financial account data provided to South Africa under automatic exchange of information as well as data from voluntary disclosure programmes to quantify both the scale of non-compliant assets held offshore by South Africans – determined to be between USD 3.5 and USD 5 billion a year – and taxpayers' responses to global and domestic tax transparency initiatives.

While countering IFFs requires country-specific actions, there are some common building blocks that can help countries identify and reduce their IFF risks. Analytical capacity to identify IFF risks, as noted in the aforementioned OECD study of South Africa, is a key challenge in many countries. It is also vital to put in place frameworks for both international and domestic inter-agency co-operation. At the international level, exchange of information networks for tax purposes have grown dramatically since the global financial crisis, with new multilateral instruments for exchange on request as well as automatic exchange of information. Offshore tax investigations and voluntary disclosure programmes helped identify EUR 112 billion of additional revenue (EUR 30 billion for developing jurisdictions) since 2009 (OECD, 2021[154]). While progress has been strong on expanding international information exchange, this is limited to tax purposes. The multilateral treaties enabling exchange of information contain provisions to enable the information to be used for other purposes (e.g. for other financial crimes), but few countries have opted in to doing so. An initiative is under way in Latin America through the Punta Del Este Declaration to promote a wider use of information exchanged for other purposes than tax (OECD, 2018[155]).

At the domestic inter-agency level, co-operation and exchange of information are also vital but often do not happen. The OECD's Tax Crime Investigation Maturity Model is a useful tool to help jurisdictions understand where they stand in relation to implementing the Global Principles for Fighting Tax Crime, which set out essential legal, institutional, administrative and operational mechanisms necessary for fighting tax crimes and other financial crimes (OECD, 2020[156]). The OECD International Academy for Tax and Financial Crime Investigation also provides training for investigators, while the Tax Inspectors Without Borders criminal investigation programmes offer expertise to help countries build their investigative

capacity and provide support in real time on case resolution. Stepping up these global efforts to identify and tackle IFF risks could be instrumental to help developing countries significantly reduce their SDG financing gap.

Inefficiency and poor prioritisation of public spending result in lower returns on SDG-related investments

Public spending inefficiency represents an important but often overlooked dimension of the SDG financing gap. Recently, policy makers have shifted their public spending and procurement objectives to focus more on seeking to benefit from the potential financial gains of increased public spending efficiency and to harness such gains to achieve the SDGs (The Economic Intelligence Unit, 2020[157]). Public spending efficiency is necessary to maximise the development impact of limited investments in developing countries. Inefficient public spending can contribute to widening the SDG financing gap by requiring greater levels of investment to reach development targets. While reforms to strengthen governance, public investment and public financial management can be costly, they contribute to reducing the cost of future investments and can have positive spillover effects on other sectors of the economy, for example by allowing for improved co-operation and greater trust between government institutions and the private sector.

SDG-related infrastructure investments are more costly in LICs due to low public spending efficiency (Rozenberg and Fay, 2019[16])**.** Losses due to inefficient public spending across the SDGs could amount to USD 102 billion in LICs, USD 2.7 trillion in LMICs and USD 6.5 trillion in UMICs per annum (Cristóbal et al., 2021[33]). Estimates vary widely across countries and within income groups, suggesting that public spending efficiency is closely linked to a combination of domestic institutional factors and can be the consequence of many other structural weaknesses. Inefficiencies may also arise at different points of the investment process, such as during selection and procurement or in the project planning and design stages and may also affect some investment sectors or targets more than others.

Losses due to spending inefficiencies are expected to increase as a result of the use of fast disbursement processes and the relaxation of controls during the COVID-19 pandemic. Evidence from supreme audit institutions in Liberia and Sierra Leone following the Ebola epidemic found, among other things, cases of overpayments, underpayments, and pre-delivery and duplicate emergency payments that led to significant financial losses. Similar conclusions and insights have emerged from emergency humanitarian aid and disaster management audits across developing countries (INTOSAI Development Initiative, 2020[158]), with the scale and speed of the COVID-19 pandemic posing an even greater challenge. The pressure to ensure a timely response not only increased the risk of corruption and fraud but may have undermined accountability and transparency in policy making. For instance, the COVID-19 rescue and recovery packages that governments deployed during the pandemic have failed to provide sufficient reporting on implementation and auditing and have been deployed with only limited consultation with legislatures and the general public, particularly the groups most affected by the crisis (International Trade Union Confederation, 2021[113]).

Looking ahead, careful prioritisation, accountability and transparency of public spending can increase the potential of public investment to narrow the SDG financing gap. Given the differences in efficiency across objectives, reallocating resources from sectors with high efficiency and lower investment needs to sectors with relatively high efficiency and higher investment needs may lead to further progress in achieving the SDGs, as could redirecting investment in low-efficiency sectors to improve public investment management. Clear identification of high-impact services and targeted investments may prevent countries from overspending resources in other policy areas and from developing an all-encompassing approach that results in lower quality overall of the public services delivered. Furthermore, consultation processes with stakeholders involved can guide policy action by identifying the issues and

population groups in greatest need, while confidence and trust in the government through the existence of reliable accountability mechanisms strengthen institutions and thus increase policy effectiveness.

2.4.3. Sustained efforts from official providers will be critical to enable a just and sustainable recovery in developing countries

The bleak outlook for the major sources of FSD means that ODA could come under increased pressure. The lower government revenue and the increased volatility of private finance expected in the next few years represent an added pressure on the ODA budgets of official providers. Transition finance analyses show that, in normal circumstances, the share of ODA in countries' financing mix tends to decrease as they develop over time (Piemonte et al., 2019[159]). However, the huge decline in government revenue and private investment resulting from the successive crises could hamper this tendency in the next few years. Between 2021 and 2024, the decline in government revenue from the COVID-19 crisis and the war in Ukraine could amount to USD 572 billion per year on average. This is more than three times the total amount of ODA extended in 2021 (OECD, 2022[160]).

Looking ahead, ODA resources risk being spread too thinly to effectively respond to the cascading crises facing developing countries. ODA remains the most stable and countercyclical source of FSD, particularly during crises. Preliminary 2021 ODA figures show a 4.4% increase in real terms, bringing DAC countries' total ODA to USD 178.9 billion (OECD, 2022[160]). However, global inflation is degrading the purchasing power of ODA. Compensating for this may stretch ODA resources at the same time that they are being called upon to respond to growing humanitarian and development challenges. These include the lingering effects of the COVID-19 pandemic, the consequences of the humanitarian emergency generated by the war in Ukraine, the emerging debt crises in developing countries, and the global health and climate crises. Recent analysis points to a likely spike of ODA levels in 2022 alongside a shift in spending patterns (OECD, 2022[128]). In coming years, the need for humanitarian spending could also increase to address the growing number and intensity of climate disasters, with the potential risk of diverting resources from broader investments in development (OECD, 2021[161]).

In the near term, the protracted COVID-19 recovery and the humanitarian, economic and social repercussions of Russia's war against Ukraine are creating additional financing needs. Russia's invasion cast a new shadow on global development prospects. The war has already resulted in more than 6 million people seeking refuge in neighbouring countries, with three DAC countries hosting more than two-thirds of the refugees (UNHCR, 2022[162]). In addition to its humanitarian impact, the war in Ukraine is indirectly affecting the recovery in other developing countries by fuelling a global increase in food and energy prices, supply chain disruptions, and lower economic growth. One study estimates that the combined effect of the COVID-19 pandemic and the war in Ukraine could lead to 75 to 95 million people more living in extreme poverty in 2022 than anticipated in pre-pandemic projections (Gerszon Mahler et al., 2022[163]). Huge financing needs are also likely to arise from the post-war reconstruction.

In the medium to long term, the new wave of spiralling sovereign debt in developing countries could also affect ODA trends. The end of the DSSI in December 2021 and the tightening of global financial conditions observed in the past year have compounded the challenge of their enormous debt service obligations. While only three countries have so far requested the treatment of their debt under the Common Framework, a worsening of other countries' fiscal situation will likely lead to new requests for debt relief in coming years. In accordance with DAC reporting guidelines, the rescheduled or forgiven amounts could be reported as ODA under certain parameters[1] (OECD DAC, 2020[164]). New episodes of debt distress could also limit future lending to developing countries, resulting in additional downward pressures on ODA.

Recent commitments by the DAC and other official providers in support of global public goods such as climate and health will exert upward pressure on ODA in the years leading up to 2030. These include the commitment by DAC members in October 2021 to align their development co-operation

with the goals of the Paris Agreement on climate change (OECD, 2021[165]). Their declaration recognised the key role played by ODA and other official resources to achieve the Paris Agreement objectives and committed to scaling up finance for climate adaptation. Since the start of the pandemic, official providers have also made numerous commitments in global health, such as the G20 leaders' commitment to build and fund a Financial Intermediary Fund for pandemic preparedness and response and to support vaccination of the population in LICs and MICs through the COVID-19 Vaccines Global Access, or COVAX, and other initiatives.

The decision to rechannel IMF SDRs will increase the resources available to vulnerable developing countries. In October 2021, the G20 agreed to aim to rechannel USD 100 billion of SDRs to the benefit of LICs, small states and vulnerable MICs out of the total USD 650 billion allocated to IMF members in August 2021. This is a welcome innovation. While a large share of these SDRs will be made available to LICs through the IMF's existing Poverty Reduction and Growth Trust and a new Resilience and Sustainability Trust, other options are also being considered such as channelling the SDRs through MDBs. While there were questions initially regarding the ODA eligibility and additionality of the rechannelled SDRs, it appears unlikely that SDR on-lending will be ODA eligible except in some rare circumstances.

With a heightened risk of a Great Divergence and a growing imbalance of financing needed to achieve the global goals, efforts to better align financing for sustainability and equity must be redoubled While efforts to improve the sustainability of financing have increased (e.g. build back better recovery initiatives), the implementation of standards, policies and other accountability mechanisms could lead to countries at greatest risk of divergence being left behind. Chapter 3 examines the state of SDG alignment of the hundreds of trillions of dollars held by actors, mainly in developed countries. It provides a set of targeted actions for countries at the origin of financing, financial intermediaries and countries at risk of divergence to better mobilise and align the full array of public, private, domestic and international sources of financing needed to fill the growing gap.

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Notes

The reporting directives of the Creditor Reporting System require official providers to consider countries' debt solvency in their lending decisions, for example by referring to the IMF and World Bank low -income Countries Debt Sustainability Framework (and non-concessional borrowing policies). See https://one.oecd.org/document/DCD/DAC/STAT(2020)44/ADD2/FINAL/en/pdf.

3 Sustainable Development Goal alignment for a just and sustainable recovery

To fully align with the SDGs, and build resilience to future global shocks, financing must be both sustainable and equitable. As the cross-border impacts of climate, health, geopolitical, economic and social emergencies demonstrate, there can be no sustainability without equity. In developed countries, a recent boom in investment labelled as sustainable has increased the trillions of US dollars in financial assets seeking to mitigate environmental, social and governance risk and to preserve long-term value. Yet this finance is largely bypassing the countries that need it most, and access to sustainable finance remains inequitable. Little progress has been made to redirect finance in support of SDG impact, e.g. to address the risks of growing poverty and inequalities. Much remains to design SDG-aligned regulations, frameworks and standards, to build sustainable finance markets and to redirect financing all along the SDG value chain.

3.1. Sustainable Development Goal alignment for a just and sustainable recovery

The shocks induced by COVID-19 and Russia's war in Ukraine are widening the Sustainable Development Goal (SDG) financing gap and derailing progress to achieve the 2030 Agenda. Governments' failure to contain the spread of COVID-19 in the early stages of the pandemic led to a crisis of global proportions that resulted in historic economic losses. The COVID-19 crisis is projected to have economic and health-related costs of up to 20% of 2019 GDP, or USD 18 trillion in 2020-22 (Congressional Research Service, 2021[166]). The systemic risk of the impact of a global health crisis on financing for sustainable development (FSD) was severely underestimated. While women were at the frontline of and among the hardest hit by the pandemic, few governments provided guidance to include gender equality in budget allocations (OECD/UN Women, 2021[167]). As Chapter 2 demonstrates, cascading effects across the FSD landscape have resulted in a 56% increase in the SDG financing gap in 2019-20, with USD 3.9 trillion now required annually to meet financing needs in developing countries. The pandemic lockdowns accelerated inequalities within countries, putting them at risk of a further slowdown in both economic recovery and progress towards the global goals. The war is adding to the strain of other economic, climate-related and social crises, particularly on the most vulnerable countries and marginalised population groups with the fewest resources to manage their impacts.

The need for collective action to promote the SDG alignment of financing for a greener, more inclusive and resilient future has never been more urgent. SDG alignment of finance remains a prime solution for shifting the trillions towards a better prevention and management of global risks, and the achievement of the 2030 Agenda. The heightened interdependence of nations is made visible by key issues such as climate, health, economics and social emergencies that require multilateral action. As globalisation of the flow of finance, people and goods accelerates, these flows can spread benefits as well as risks more rapidly across nations (Goldin, 2021[168]). As the United Nations (UN) Secretary-General warns, only seven years remain to achieve the 17 SDGs, and "rescuing the SDGs means rescuing developing economies around the world" (UN, 2022[169]). In other words, achieving the SDGs anywhere requires that they be achieved everywhere. However, as noted in Chapter 1, a Great Divergence between developed and developing countries is emerging for the first time in decades. Recent evidence suggests that OECD countries are not progressing towards SDG targets that focus on ensuring no one is left behind (OECD, 2022[170]).

The following subsection takes a closer look at the weaknesses in the FSD landscape that could increase the Great Divergence between developed and developing countries and threaten global resilience.

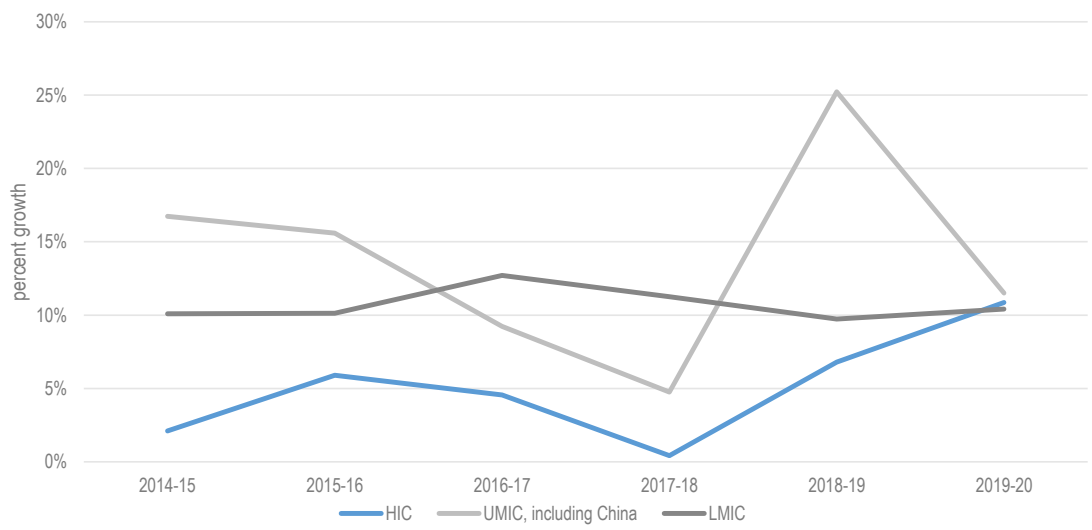
3.1.1. The pandemic amplified pre-existing imbalances in the global financial system

The commitment to mobilise "billions to trillions" has yet to bring the public and private sector closer to narrowing the SDG financing gap in developing countries (African Development Bank et al., 2015[171]). Official development assistance (ODA), totalling USD 179 billion in 2021, remains below the 0.7% ODA to gross national income commitment and represents a small share (4.6%) of the USD 3.9 trillion annual SDG financing gap. However, ODA has a special role to play as one of the only sources of external financing that has the main objective of supporting the sustainable economic development and welfare of developing countries and is provided at favourable market conditions.[1] Nearly eight years ago, the Development Committee of the World Bank Group and International Monetary Fund (IMF), seeking to better leverage scarce official development resources, called for public sector concessional financing to be used to de-risk and thereby mobilise additional trillions in private sector resources. The aim of bringing together public sector actors seeking development outcomes and private sector actors seeking profit has since faced challenges. These result from "competing and contradictory incentives, mandates and priorities", and recent studies offer further evidence that financial de-risking can create perverse incentives and impede domestic ownership (European Parliament et al., 2020[172]). As Chapter 2 notes, private finance mobilised by official development finance interventions grew by 11% in

2020, from USD 46.4 billion to USD 51.3 billion in 2019-20, following a 4% drop in 2018-19. While it is not expected that these flows can fill the entire financing gap, amounts of private finance mobilised remain roughly 70 times lower than the annual SDG financing gap post-COVID-19. The Addis Ababa Action Agenda, adopted in 2015, recognises that all resources – public, private, domestic and international – are necessary to achieve the 2030 Agenda and that no single resource is sufficient.

During the COVID-19 pandemic, the value of financial assets (stocks) held in developed countries increased. Monetary policy, including quantitative easing by major economies, contributed to an 11% increase in the value of global financial assets, from USD 423 trillion to USD 469 trillion, in 2019-20.[2] Public sector actors in developed countries, including central banks and institutional investors, responded quickly to mobilise trillions of dollars in support of the short-term emergency response to COVID-19, as elaborated in Box 3.1. The annual growth rate of assets held in high-income countries (HICs) continued to increase after the outbreak of the pandemic (Figure 3.1). Thanks in part to the actions of central banks, the growth rate of assets held in HICs increased from 7% in 2018-19 to 11% in 2019-20, while growth in upper middle-income countries (UMICs) declined from 25% in 2018-19 to 12% in 2019-20. In addition, growth in lower middle-income countries (LMICs) remained at 10% in 2018-20. Developing countries held less than 20% of global financial assets, valued at USD 93 trillion in 2020, yet these countries represent 84% of the world's population and 58% of global GDP. Only 5.7% of ODA-eligible countries (8 out of 140), none of which are low-income countries (LICs), are included in reporting on financial assets by the Financial Stability Board, evidence of a persistent barrier to deepening financial markets in these countries. A survey carried out by the OECD before the pandemic found that institutional investors were facing investment restrictions related to risk-based capital requirements that prevented resources from being allocated to developing countries or certain segments of the population. For example, the 36 pension funds that participated in the survey reported holding assets in developing countries worth USD 263.7 billion in 2017-18, representing just 8% of their total assets globally (OECD, 2021[173]).

Figure 3.1. During the COVID-19 pandemic, the growth rate of financial assets held in developing countries fell or remained stagnant while high-income countries registered significant growth



Note: The figure uses World Bank income categories.
Source: Authors based on Financial Stability Board (2021[34]), *Global Monitoring Report on Non-Bank Financial Intermediation 2021*, https://www.fsb.org/2021/12/global-monitoring-report-on-non-bank-financial-intermediation-2021/.

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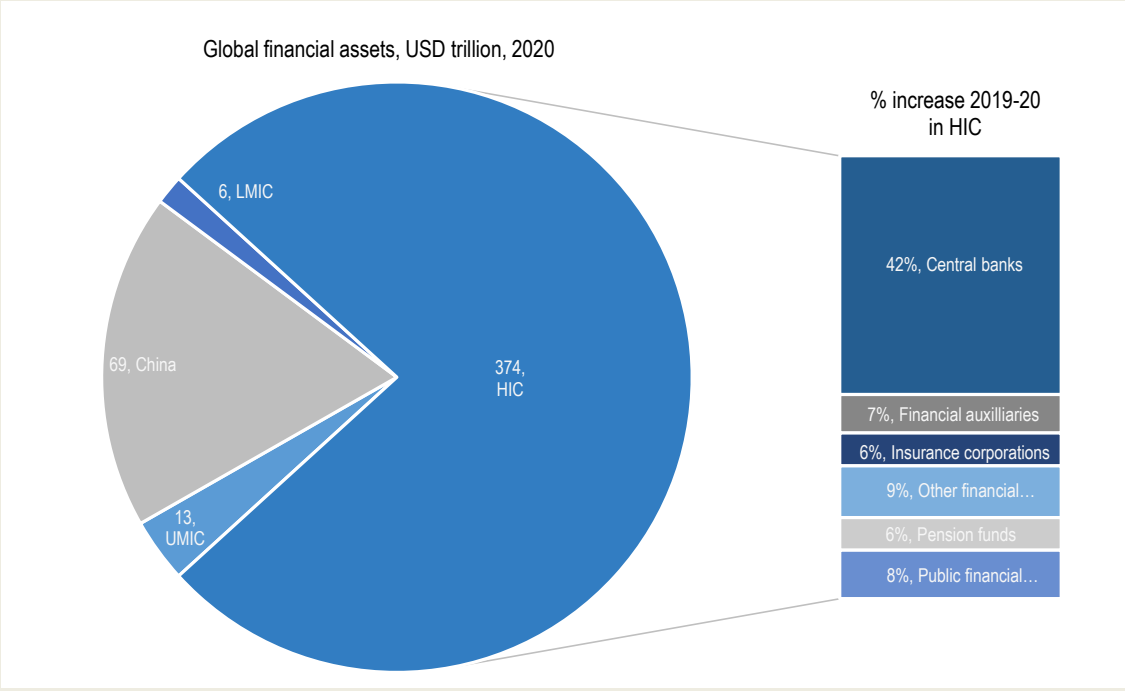
Box 3.1. In response to the pandemic, central banks in developed countries increased the trillions of dollars of financial assets

Financial assets held by central banks in HICs grew faster than assets held by other actors in the first year of the pandemic, increasing 42% from 2019 to 2020. The historic COVID-19 monetary response has demonstrated that public sector actors have tremendous influence over the allocation of global financial assets, with the value of financial assets held by central banks increasing by nearly USD 20 trillion in 2019-20 (Figure 3.2). To respond to COVID-19, central banks in major economies adopted a whatever-it-takes approach to monetary policy. For example, the euro system bought assets worth more than USD 1.85 trillion under the European Union (EU) pandemic emergency purchase programme alone through March 2022 (Schnabel, 2021[174]). The liquidity support provided by central banks kept interest rates low, reassuring markets, and buoyed the stock market rebound, benefitting nearly all other financial actors in 2019-20. Public pension funds that hold long-term patient capital were also called upon to go beyond their usual remit to disburse short-term emergency retirement funds or purchase COVID-19 bonds. Public financial institutions such as public development banks (PDBs) and development finance institutions (DFIs) also provided pandemic support. For example, in Latin America and the Caribbean alone, PDBs channelled USD 90 billion in credit support for emergency economic relief (Finance in Common Coalition, 2021[175]).

Figure 3.2. Central bank asset purchases during the COVID-19 outbreak helped buoy asset valuation across financial sector actors



Note: Coverage includes all countries included in Financial Stability Board reporting.
Source: Authors based on Financial Stability Board, (2021[34]), *Global Monitoring Report on Non-Bank Financial Intermediation 2021*, https://www.fsb.org/2021/12/global-monitoring-report-on-non-bank-financial-intermediation-2021/.

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However, the trillions in recovery spending by developed countries could have unintended collateral effects, and exacerbate pre-existing macro financial vulnerabilities in developing countries. While USD 18.2 trillion was spent on COVID-19 economic relief by March 2022, just 20% of this amount was spent on long-term build back better recovery and less than 1% was spent in support of developing countries (i.e. USD 162.2 billion of bilateral ODA in 2020) ((IEA, 2022[57]) (WBG, 2022[58])). Moreover, at least 14% of the total COVID-19 economic recovery spending in OECD, EU and key partner countries has mixed or negative impacts on the environment. The proportion could increase as fuel prices rise and governments implement consumption subsidies to protect the most vulnerable. The latest SDG Index developed by the Sustainable Development Solutions Network also shows that major economies are largely responsible for negative transboundary spillovers due to unsustainable trade and supply chains (Sachs et al., 2022[176]). While asset purchases by developed economies are being scaled back to avoid overheating and inflation, an abrupt slowdown could result in a stronger US dollar, weaken emerging market currencies and potentially drive further capital outflow from developing countries (Chapter 1). Consequently, countries furthest behind find themselves with even fewer resources than before the outbreak of the pandemic and even higher costs to achieve the global goals. The next subsection examines how to promote the SDG alignment of all sources of financing.

3.1.2. Sustainable finance can build global resilience and help to ensure no one is left behind.

The build back better agenda is an opportunity to finance global public goods more effectively and avoid costly setbacks in the future. Previous global crises have shown that political turmoil and economic deterioration in developing countries significantly affect financial stability globally. During the COVID-19 pandemic, the cost-effectiveness of investing in resilience and preparedness in developing countries became more apparent. Recognising the importance of financing to leave no one behind, Group of Seven (G7) leaders at the Carbis Bay Summit in 2021 set out a vision based on building back better to narrow the infrastructure investment gap in developing countries and address the impacts of the pandemic on climate change, health, digital connectivity, gender equality and equity. With its recent creation of the Partnership for Global Infrastructure and Investment, the G7 seeks to mobilise private finance (USD 600 billion in total over the next five years) in support of infrastructure financing in developing countries. The Partnership should avoid the mistakes of the past (e.g. a lack of domestic ownership) but focus on helping build the local enabling environment, including by supporting local financial markets and technical assistance to secure a pipeline of sustainable and investable projects in developing countries (The White House, 2022[177]). (Section 3.4 outlines further actions.)

However, current crises could either strain or accelerate collective action to align finance in support of global agendas for sustainability. On one hand, unequal access to vaccines and the impact of Russia's war against Ukraine have accelerated the fragmentation of the global economy, demonstrated by a growing number of trade and investment restrictions and diverging policy approaches that are being implemented unilaterally (OECD, 2021[178]). Developing countries are confronted with a vicious cycle of short-term emergencies (e.g. climate damage, biodiversity loss, rising food prices, debt distress, etc.) that simultaneously increase financing needs and decrease the availability of financing. For example, sovereign credit rating downgrades and higher debt service costs reduce available government revenues needed to invest in the SDGs over the long term. On the other, common interests such as energy security have moved higher on the political agenda of all countries and could accelerate action in support of net-zero commitments.

SDG alignment provides a two-pillar framework to ensure a sustainability equilibrium of finance and investment targeted across the global goals and to leave no one behind. As the 2021 FSD Global Outlook noted, SDG alignment provides a framework to assess financing across two pillars: 1) sustainability and 2) equity. Both are needed to build resilience. The two pillars complement one another and are equally important:

1. **To be sustainable, resources should avoid zero-sum trade-offs across the SDGs and ensure a financial sustainability equilibrium**. Investing in any one goal can represent an opportunity cost to invest in the other goals. Resources should aim to promote a triple bottom line within the sustainability equilibrium – that is, to leverage synergies across environmental, social and economic outcomes. Despite a 15% increase in sustainable finance in 2018-20, totalling USD 35 trillion, such financing lacks transparency and accountability for impact across the SDGs (i.e. SDG washing). Of the USD 1.8 trillion of so-called sustainable bond issuances since 2014, 56% focused on environmental goals of the SDGs while only 18% targeted social objectives in areas such as quality education, hunger, poverty and gender equality.[3]
2. **Finance must be equitable to be sustainable and if unaddressed, financing gaps in the most vulnerable countries will widen and contribute to even greater setbacks globally**. The "shift" in the trillions should reduce inequalities in access to sustainable finance across countries, allowing for more efficient management and prevention of global risks. The growing financing gap means developing countries will have insufficient resources to address future shocks, e.g. rising temperatures, value chain disruption, refugee influx, etc. Likewise, maximising positive transboundary spillovers can help all countries reach the SDGs more quickly, including by reducing the cost of progress at home. However, the sustainability boom is not yet benefitting HICs and developing countries equally. Without new efforts to help the latter tap into the opportunities, the sustainability boom could bypass the countries furthest behind, leaving significant market gaps globally, with knock-on effects on the SDG financing gap. (Section 3.3 discusses in greater detail the potential consequences if investments are not redirected in support of developing countries.)

Shifting just 1% of global financial assets would be sufficient to fill the SDG financing gap in developing countries but this would rely on engagement with all actors in the financial system. The 2021 Global Outlook on Financing for Sustainable Development called for a new way to invest in support of people and planet (OECD, 2020[63]). A shared public-private commitment to shift 1% of the USD 469 trillion in the global financial system in support of SDG alignment in developing countries would be more than sufficient to fill their SDG financing gap. Driven by the pandemic and rising geopolitical uncertainty, public and private sector actors are increasingly recognising that it is in their mutual interest to protect the long-term value of assets and mitigate global risks. Achieving the 2030 Agenda and the Paris Agreement will require collective action at home and in support of the poorest countries. But a clear framework is required to guide actions along the SDG value chain from countries of origin to financial intermediaries and on to countries at greatest risk of divergence.

The next section assesses progress in advancing the sustainability and equity pillars of SDG alignment.

3.2. The sustainability boom is underway, yet market gaps remain

The recent sustainable finance boom is a result of the increased convergence of public and private interests in the management of long-term risks. While corporate social responsibility, in its early forms, and green investing are not new, efforts to design a quantifiable framework that encompasses dimensions of environmental, social and governance (ESG) risk are at an early stage. The international community has made significant headway in mainstreaming sustainable finance. However, with a proliferation of new initiatives comes the need to ensure their transparency and accountability. The sustainable finance boom has generated new demand for financing that does no harm and contributes to positive impact for people and planet and for new supply of rating systems, financing instruments, labels, etc. The sustainable finance market can be strengthened to avoid distortions, segmentation and missed opportunities to finance sustainable development in countries with lesser market regulation capacities.

To deliver the SDG impact required to reach countries most in need, frameworks and standards, including ESG ratings, can be strengthened at the global level. Heightened interoperability of

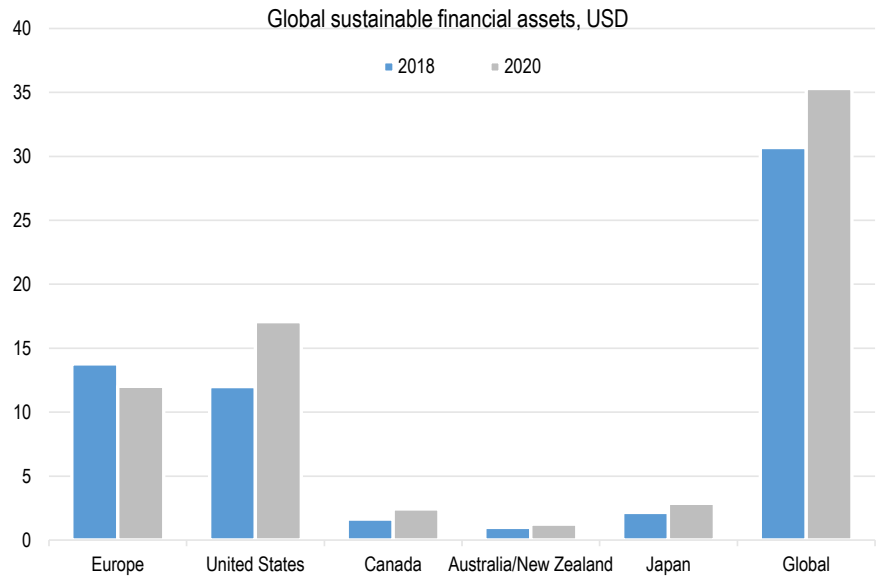
standards across capital markets is needed to mitigate cross-border risks. While ESG frameworks seek to mitigate risks to long-term financial performance, the SDG targets and indicators framework provides metrics to assess global progress across the SDGs. ESG frameworks alone will not succeed in directing finance to leave no one behind and could even create significant barriers to access for countries with shallow financial markets. The 2030 Agenda and the SDGs are necessary to guide financing where needs are greatest and manage global, cross-border and long-term risks and spillover effects.

The next subsection provides orders of magnitude of the volume of sustainable finance, the drivers of recent growth, and remaining barriers to promote transparency, accountability and SDG impact of financing to leave no one behind.

3.2.1. Public and private interests are converging towards a fast-growing market for sustainable finance in developed countries

The supply of investment labelled "sustainable" has registered unprecedented growth since 2018. Total sustainable investment grew by 15% in just two years, increasing from USD 30.7 trillion in 2018 to USD 35.3 trillion in 2020 (Figure 3.3).[4] Of the nearly USD 100 trillion total assets under management in 2020 from institutional investors, asset managers and asset owners, sustainable assets make up 35.9% (Global Sustainable Investment Alliance, 2021[39]). Canada has the highest share of sustainable investment within its market, representing up to 60% of total assets under management. The EU and the United States hold 80% of total sustainable investments. Anti-greenwashing and rules for labelling finance are becoming priorities, driven by the EU's preparation of a new anti-greenwashing rulebook and the European Securities and Markets Authority roadmap, released in early 2022. These initiatives have resulted in fund managers pre-emptively removing the ESG label from USD 2 trillion of assets under management in the EU, which explains the decline in sustainable investment in the EU between 2018 and 2020.

Figure 3.3. Global sustainable investment in developed countries reached a new high in 2020 despite the global recession (USD trillion)



Note: The figure is based on currency exchange using 2019 prices. A regional comparison of growth rates is challenging due to a significant change in the definition of sustainable investment such as the new EU anti-greenwashing rulebook. Global Sustainable Investment Alliance reporting on financial assets includes sustainable investments such as impact investing and positive, sustainability-themed, norms-based and negative screening, ESG integration, and corporate engagement and shareholder action.
Source: Global Sustainable Investment Alliance (Global Sustainable Investment Alliance, 2021[39]), *Global Sustainable Investment Review 2020*, http://www.gsi-alliance.org/wp-content/uploads/2021/08/GSIR-20201.pdf.

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The COVID-19 pandemic accelerated the transition to a new era of global sustainable finance regulation that seeks to manage a broader set of cross-border risks over the long term. Sustainability of business and finance has shifted from a niche concern (e.g. fair trade, impact investment, corporate social responsibility projects) to the mainstream. By recent estimates, ESG assets could exceed USD 53 trillion globally by 2025, more than double the 2020 level (Platform on Sustainable Finance, 2022[38]). Just over half of stock exchanges, or 67 of the 120 stock exchanges tracked by the Sustainable Stock Exchanges Initiative, had published ESG reporting guidance for their listed companies in 2021 (Sustainable Stock Exchanges Initiative, 2022[179]). COVID-19 served as a wake-up call to public and private actors about the important impact of non-financial risk (i.e. global health) on financial performance. The line between sustainability risks and financial risks is blurred. Investors recognise the need to avoid future sources of market volatility (e.g. climate change, social unrest, geopolitical instability, etc.) and to seize investment opportunities. The cost of failing to align investment to the SDGs is also significant: 10% of global GDP could be lost without investment in gender equality, with the same estimated cost to GDP of not investing in biodiversity loss or not investing in addressing violence and armed conflict (BlackRock, 2021[36]).

Governments are doing more to establish common rules for more efficient, impactful and, for example, SDG-aligned sustainable finance markets. Taxonomies developed by the public sector are crucial to classifying environmentally sustainable economic activities and establishing common definitions for public and private actors. The EU has taken the lead in establishing the Sustainable Finance Taxonomy Framework and regulation on sustainability-related disclosures in the financial sector to improve sustainability measurement and reporting. The EU taxonomy, which includes mandatory reporting by

investors, aims to strengthen the sustainable finance market and shift investments where they can have greatest impact in support of a low-carbon transition, social objectives and economic prosperity (Platform on Sustainable Finance, 2022[38]). Fiscal policies, including tax and subsidy reform and carbon pricing, present an emerging opportunity to mobilise domestic resources while promoting a green transition. To succeed, carbon pricing must be implemented on a global scale to avoid shifting to third countries. Subsection 3.4.2 outlines discusses recent efforts to advance carbon pricing globally in greater detail.

ESG integration serves as a key barometer for firms, issuers and investors to assess and quantify the extent to which investments generate financial returns over the long term, while doing no harm and promoting positive returns. The OECD defines ESG investing as an approach that "seeks to incorporate environmental, social and governance factors into asset allocation and risk decisions, so as to generate sustainable, long-term financial returns" (Boffo, 2020[180]). According to recent estimates, ESG integration (USD 25.2 trillion) and negative/exclusionary screening (USD 15.9 trillion) represent the largest categories of sustainable investment by volume in 2020 globally. Sustainability-themed investment had the highest compound annual growth rate (63%) over 2016-20 (Global Sustainable Investment Alliance, 2021[39]). Further, ESG integration provides a risk mitigation framework to assess the positive and negative risks that a firm's financing and actions have across ESG criteria. However, ESG integration is currently carried out at firm or country level, which raises concerns of cross-border risks (Box 3.2).

Box 3.2. Deeper integration of environmental, social and governance criteria in financing can lessen cross-border risks

Financing that integrates ESG criteria can help mitigate financing risks and strengthen long-term financial performance. However, recent evidence of a correlation between stronger financial performance and higher ESG ratings remains uncertain. Factors such as lack of data and comparability of metrics (e.g. indicators beyond gender equality or CO_2 emissions) currently hinder the establishment of a direct link between ESG scores and real-world SDG impacts such as job creation and investment in human capital in developing countries, etc.

Moreover, ESG frameworks could benefit from integration of the SDGs, including the global dimensions of cross-border and long-term risks and spillover effects. Current ESG frameworks tend to focus on evaluating firm or country-level activities. However, the assessment, particularly of the social pillar of ESG, does not adequately account for potential risks of leaving the poorest and most vulnerable behind. Rating agencies also lack consistent indicators that reflect impact on social considerations (Platform on Sustainable Finance, 2022[38]). One survey of 64 asset owners found that 39% lack best practices for assessing impact and 78% consider a lack of capacity to collect impact data as the main challenge (Global Impact Investment Network, 2022[181]). The following target areas illustrate common measures of a firm's ESG performance:

- **Environmental.** Evaluating a company's environmental policies, practices and performance including:
  - positive – efforts to protect the environment, improvement of waste disposal and recycling
  - negative – use of resources and negative environmental impact such as excessive carbon emissions, pollution and water usage.
- **Social.** Evaluating a company's policies and practices towards employees, suppliers, customers and communities including:
  - positive – supporting diversity, employment, community development and gender pay equality
  - negative – signalling human rights violations and poor labour conditions due to insufficient health, safety and quality standards.
- **Governance.** Evaluating a company's corporate policies and procedures including:
  - positive – promotion of diversity, board composition, business ethics and reputational issues
  - negative – low business ethics, including bribery or corruption, and evaluation of executive compensation.

Source: Author adapted from J. P. Morgan (2022[182]), *Sustainable investing: Environmental, social and governance* (webpage), https://privatebank.jpmorgan.com/gl/en/services/investing/sustainable-investing/esg-integration.

Several factors are motivating governments to create incentives to move from assessing ESG risks to assessing broader SDG impacts across borders for people and planet. As governments recognise the importance of establishing the right incentives for the private sector to contribute to the achievement of the SDGs and the Paris Agreement, fund managers in turn are anticipating upcoming sustainability regulations and mandatory disclosure laws. For example, the United States recently recommitted to the Paris Agreement and if legislation to fulfil commitments is implemented, this could result in the removal of US direct subsidies for oil and gas companies. In addition, the EU has adopted a climate law aiming to reduce CO_2 emissions by 55% of 1990 levels by 2030, signalling forthcoming incentives for sustainable

and low-carbon investments. Several additional trends reflect the convergence of public and private sector actors' interests in support of common, mission-driven, rather than risk-averse, sustainability objectives.

Drivers from the perspective of policy makers:

1. **One driver is the desire to avoid costly setbacks due to global crises by promoting a paradigm shift to increase the positive impact of cross-border spillovers.** The pandemic turned future risk into present-day reality. All governments were struck by the urgency to respond to a global crisis. The potential costly impacts of future risks (e.g. cost of forced population displacements, climate-related natural disasters, health crises, etc.) were brought into focus and have since reinforced the need for investments that seek to both mitigate the risk of future crises and deliver positive impact in support of the global goals.
2. **A second driver is recognition of the economic advantages of net-zero economies and the need to manage the risk of stranded assets.** Climate-compatible policy packages can increase GDP in the long term by up to 4.7% on average across the Group of Twenty (G20) by 2050, including through savings from climate-related costs that are averted (OECD, 2017[183]). Renewable energy projects represent the largest share of energy investment and are less costly than developing fossil fuels. In recognition of the potential economic benefits, net-zero commitments to date cover roughly 70% of global GDP and carbon emissions, with nearly a quarter of such commitments taking the form of legally binding pledges (IEA, 2021[184]). However, as discussed in section 3.3, fossil fuel dependency in many developing countries presents the risk of stranding financial assets and contributing to further fiscal and monetary constraints.

Drivers from the perspective of investors:

1. **Interest in investing to address and protect against systemic risks, including protecting against value chain and/or resource disruption such as food price hikes, water scarcity, travel restrictions, etc.** Governments are developing new mandatory and legally binding frameworks to promote a common understanding of the activities and types of financing that are considered sustainable and the impacts these may have on society. For example, the US Securities and Exchange Commission set out draft rules for mandatory harmonised climate-related disclosure in 2022. The pandemic has further accelerated the use of social and sustainable bonds linking use of proceeds to addressing social and environmental issues. Subsection 3.3.1. examines the emergence of green, social, sustainability and sustainability-linked (GSSS) bonds.
2. **New growth and investment opportunities from the net-zero transition. However, the recent spike in oil prices is testing markets.** Investors seek to secure the long-term value of assets by mitigating non-financial risk, including through decarbonisation of portfolios to support the green transition. According to the UN Environment Programme (2021[185]), 20% of all major companies have made a net-zero pledge of some kind. Asset owners, who can play a particularly important role to direct capital in support of a low-carbon transition, are stepping up commitments to address the systemic risks from climate change. For example, the UN-convened Net-Zero Asset Owner Alliance, which includes 73 investors with USD 10.7 trillion in investments, released a protocol for investors establishing short-term, net-zero targets.[5] However, following Russia's full-scale invasion of Ukraine and subsequent spike in oil prices,[6] major asset managers have rolled back commitments to decarbonise. For example, the world's largest asset owner, BlackRock, with assets valued at USD 9.57 trillion in 2022, took action following the outbreak of the COVID-19 pandemic to integrate the SDGs into its fiduciary duty as a means to strengthen the long-term economic interests of its clients. With the increased price of oil, BlackRock indicated that it would scale back commitments to invest in companies that end fossil fuel production, challenging the integrity of the SDG alignment of its allocation strategy (Fink, 2022[186]).

Despite the increasing convergence between public and private interests in sustainable finance, the transparency, accountability and impact of the global sustainable finance market continue to

face challenges. The global dimension of recent shocks requires a multilateral approach to co-ordinate and implement new cross-border solutions. While business has long operated across borders, governments are reaching a turning point for global harmonisation of regulations and rules governing the sustainability of finance. As noted in *Global Outlook on Financing for Sustainable Development 2021*, without alignment of all actors along the value chain, the effect of any single action or actor will be limited. Better policies, taxonomies and standards are needed to align activities of all stakeholders in support of the SDGs. The next subsection identifies improvements needed to measurement frameworks and improve disclosure by the private sector.

3.2.2. Barriers including incompatible standards and definitions continue to impede sustainable finance on a global scale and the move from an ESG to an SDG paradigm

Moving from ESG to SDGs is more than semantics: Promoting financial sector alignment to SDG targets will be crucial to strengthen interoperability and global resilience to future shocks. A key difference between ESG and SDG sustainability ambitions is to expand risk assessment from firm level to global level. While the increase in the number of sustainability initiatives demonstrates growing demand for sustainable finance, the next challenge is to ensure that these initiatives are contributing to impact. If sustainable investment does not lead to impact, markets will lose credibility. Investors require confidence that labels are genuinely reflecting a portfolio's relation to sustainability.

The proliferation of sustainability definitions coupled with a lack of data impede transparency and accountability of the impact of resources. There is currently no universally agreed definition of sustainability in financial or capital markets. The Global Sustainable Investment Alliance estimates sustainable investments total as much as USD 35.3 trillion. However, the UN Conference on Trade and Development and others, using a much narrower definition of sustainability, identify only USD 5.2 trillion assets under management as sustainable investment in 2021, an increase of 63% from 2020 (UNCTAD, 2022[187]). The International Organization of Securities Commissions, the global standard setter for securities market regulation, warns there is a lack of clarity about what ratings or data products intend to measure and lack of transparency about the methods used to produce the ratings (Jackson, 2022[188]). The lack of clarity was demonstrated when Morningstar removed the ESG label from over USD 1 trillion in managed funds that it alleged was misleading investors (Schwartzkopff and Kishan, 2022[189]). Recent studies by the OECD also show that climate-related metrics are not as strongly correlated with the environment pillar of ESG as are factors not directly related to a climate-friendly transition, such as market capitalisation or financing for disclosure reporting (OECD, 2022[190]). In fact, a high score on environmental criteria from certain providers can be positively correlated with higher CO_2 emissions (OECD, 2022[190]). About 25% of self-declared green funds have an exposure to fossil fuels of more than 5%, and in some cases nearly 20%, which calls into question the greenness of these funds (UNCTAD, 2022[187]).

In addition, reporting standards are not interoperable across borders, which creates confusion among international investors and regulators. Recent sustainability standards published by the G20 International Sustainability Standards Board and existing voluntary standards across countries and regions (such as China's Green Industry Guiding Catalogue) create a patchwork of guidance for reporting globally. Some of these standards do not assess a company's direct impact on the environment or society. For example, a study of five regions found that not all sustainability taxonomies include social criteria within the definition (OECD, 2020[138]). The risk of global market failure increases when assessment and costs of negative externalities, including social dimensions, are not integrated and harmonised into sustainable finance taxonomies in a comparable manner. For example, while a country's industrial classification system may be consistent with national statistical data, it often is not compatible with classifications systems used in other countries (Ehlers, Gao and Packer, 2021[191]). Without interoperability, activities deemed sustainable in one country may not be considered as such in another country. This increases transaction costs for investors.

The lack of sustainable finance markets in developing countries is a missed opportunity to move from an ESG to an SDG paradigm. The SDGs, by definition, are universal in that they encompass all countries, developed and developing. Moving to a universal SDG paradigm can help ESG risk mitigation strategies integrate potential transboundary impacts from countries where the needs are greatest. There is a heightened likelihood that sustainable finance will bypass countries most in need in the absence of significant efforts to improve reporting capacities in countries with shallow financial markets. China and South Africa are among the only developing countries to have developed an ESG taxonomy, and South Africa's taxonomy was only adopted in April 2022. Just 25 of 60 developing countries' stock exchanges require ESG reporting (IEA, 2021[74]). Subsection 3.3.2 explores in greater detail the roadblocks facing developing countries to access and participate in sustainable finance markets.

Most ESG reporting frameworks seek to assess and quantify a company's sustainability performance – that is, the risks that are material to financial performance for investors – rather than assessing how a company risks impacting external considerations (double materiality or SDG impact). The draft European Commission Corporate Sustainability Reporting Directive proposed a social taxonomy, or subset of the EU Environmental Taxonomy, that would reinforce the social and governance dimensions of ESG criteria by setting minimum mandatory social safeguards to mitigate risks to social and human rights violations (Platform on Sustainable Finance, 2022[38]). The EU social taxonomy would link a country's SDG achievement or lack thereof to its private sector's contribution to the SDGs. Subsection 3.3.2 examines the trade-offs of sovereign ESG ratings that present challenges to ranking a country's ESG dimensions.

SDG labelling requires a broad range of data, meaning it poses potentially greater risks of green or impact washing than ESG labels. Gathering the data needed to avoid SDG-washing across the goals, and particularly social objectives, remains a significant obstacle. The SDG targets and indicators were first designed for implementation by governments, not firms and asset managers. This is evidenced by the distribution of sustainable bond issuances since 2014. For instance, environmental goals related to CO_2 emission reduction have more accessible data for reporting. In another study, 46% of the 347 institutional investors surveyed indicated that social dimensions of ESG criteria are the most challenging to integrate into investment strategies (BNP Paribas, 2019[192]). A recent OECD survey of blended finance indicates that only 1% of surveyed financial assets under management were dedicated to gender equality as the main objective (OECD, 2022[22]). The use of artificial intelligence (AI) algorithms provides a new tool for investors to harness big data to align investment standards. For example, BNP Paribas introduced the use of a new AI tool to assess both ESG risks and SDG impact (BNP Paribas, 2021[193]). However, automatised portfolio allocations, which use AI, could exclude developing countries on the basis of a lack of quality data needed for sustainability reporting. Self-reporting schemas must be fine-tuned to avoid increasing existing inequalities or misleading investors.

The next section examines the equity pillar of SDG alignment. A sustainable recovery cannot be achieved without an equitable and just transition that leaves no one behind.

3.3. The equity pillar: No sustainability without equity

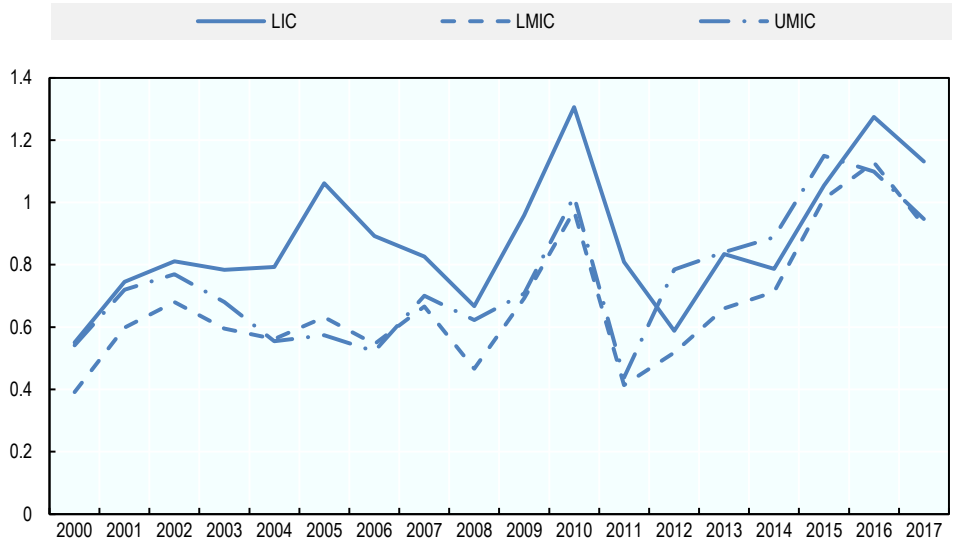
The recovery will be neither sustainable nor resilient if the poorest are left behind. No single country can achieve SDG alignment as long as the risk of negative spillovers (in terms of securing global value chains, limiting temperature increase, etc.) exists in other countries. Despite great strides to secure a more efficient and impactful sustainable finance market, advances are limited mainly to major economies. If finance is to be sustainable on a global scale, it must be equitable. And if equity is unaddressed, financing gaps in the most vulnerable countries will be amplified and ultimately contribute to even greater setbacks over the long term. The COVID-19 pandemic and looming climate and environmental emergencies make clear the interdependence of countries and the high price of failure to co-ordinate globally.

Failure to progress towards achieving the equity pillar will make the sustainable finance market a missed opportunity to address growing inequalities and could lead to additional diversion of financing away from those most in need. The sustainable finance boom in HICs could have unintended consequences in lower-income countries if the barriers to sustainable investment are not addressed (UNCTAD, 2021[194]) (Cattaneo, 2022[195]). Subsection 3.3.2 highlights factors that impede access to sustainable finance in the poorest countries, which confront a vicious cycle of short-term emergencies such as climate, food, health and migration among others. Such crises simultaneously increase financing needs and decrease the availability of financing in these countries to invest in the SDGs – for example, by lowering sovereign credit ratings and prompting tighter terms and conditions of financing. As a result, those countries furthest behind could find themselves with even fewer resources and even greater financing setbacks to achieve the global goals.

In an interdependent system, it is imperative to mobilise investment in developing countries to achieve sustainability at home. As the COVID-19 and climate crises have shown, the SDGs are interconnected, and performance of every individual country is dependent on the performance of others. Growing global inequalities thus will also lead to other crises by weakening economic and societal resilience to shocks. For example, global forced displacement (driven by the war in Ukraine, persecution and human rights abuses) reached a new historic high in 2022, with more than 100 million people displaced – more than double the number in 2012 (UNHCR, 2021[54]). As public development finance is shifted to address the growing refugee crises within donor countries' borders, there is a risk that less financing will be available to advance the SDGs across borders, in the poorest countries, contributing to a widening of the sustainable finance divide and heightening inequalities between countries.

Avoiding future shocks, including the climate emergency, is not possible if major economies do not remove the barriers to access sustainable finance for those with the greatest climate and financial vulnerabilities. As many as 132 million people could be pushed into extreme poverty due to climate change by 2030 (Jafino et al., 2020[56]). Developing countries have contributed the least to climate change, yet they have lost 20-25% of cumulative GDP per capita since the turn of the 21st century due to temperature increase (de Brandt, Jacolin and Lemaire, 2021[55]). As shown in Figure 3.4, GDP per capita losses in LICs were on average 20% higher than in all middle-income countries. LICs have experienced the highest GDP per capita losses due to their geographical concentration in hotter climates, yet are the least prepared to carry out climate change adaptation and are the most vulnerable to climate-related shocks. Looking ahead, Russia's war against Ukraine will magnify hunger and food insecurity in developing countries. This is particularly the case for LICs that are highly dependent on the agriculture sector, which is vulnerable to the impacts of temperature increase and biodiversity loss. Climate change adaptation financing will be increasingly needed in the poorest countries and population segments to avoid increasing pre-existing inequalities and poverty levels.

Figure 3.4. Low-income countries suffered the greatest economic losses due to temperature increase (percentage loss of GDP per capita annual growth)



Note: A sustained one-degree Celsius temperature increase lowers real GDP per capita annual growth by 0.74 to 1.52 percentage points, irrespective of levels of development. Country income groups are presented as an unweighted average of country-level data. Income categories correspond to 2019 World Bank classifications.
Source: Authors adapted from de Brandt, Jacolin and Lemaire (2021[55]), "Climate change in developing countries: Global warming effects, transmission channels and adaptation policies", https://publications.banque-france.fr/sites/default/files/medias/documents/wp822_0.pdf.

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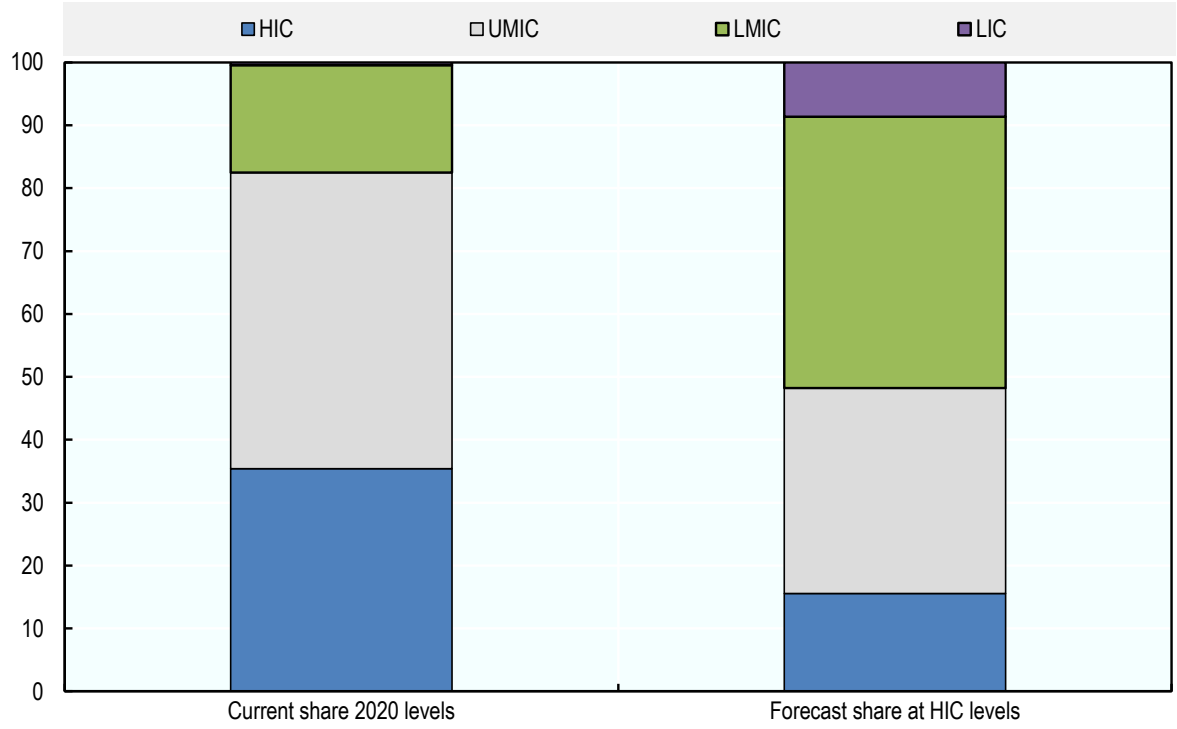
Achieving the 1.5°C limitation will not be possible if the world returns to pre-COVID-19 growth levels (Intergovernmental Panel on Climate Change, 2022[4]). The Intergovernmental Panel on Climate Change predicts that, on its current trajectory, the world will exceed its carbon budget and warming could surpass 1.5°C by 2030. A country's income per capita is an indicator of its greenhouse gas emissions per capita (Figure 3.5). Without decoupling CO_2 emissions from economic growth and productive capacities and as developing countries grow, their CO_2 emissions per capita could reach HIC levels in the next 70 years or by 2094.[7] In 2094, developing countries could represent at least 84% of CO_2 emissions, a doubling of current CO_2 emissions per capita from 33 tonnes to 75 tonnes. To address the global CO_2 imbalance and respective capacities to mitigate CO_2 and adapt to climate change, a just transition should, according to recent estimates, allow the poorest nations an additional 20 years to reach net zero (Calverley and Anderson, 2022[196]). Developed countries must meet their CO_2 reduction commitments in the short term and also deliver massive support to help promote sustainable growth paths in developing countries over the long term.

Figure 3.5. Based on current trajectories, the distribution of annual CO_2 emissions per capita will shift significantly (percent share of global emissions)



Note: The figure shows annual CO_2 emissions per person in HICs using the population in World Bank income categories in 2020. The scenario of no climate action estimates CO_2 emissions per capita if all countries reach emission levels equivalent to those of HICs in 2020, but it does not account for other factors such as the current rate of emissions growth, population growth, new climate policies, technologies or mitigation strategies.

Source: Author adapted from Ritchie (2018[51]), *Global Inequalities in CO_2 Emissions*, https://ourworldindata.org/co2-by-income-region; Global Carbon Project (2022[52]), *The Global Carbon Project* (webpage), https://www.globalcarbonproject.org/; World Bank (2022[53]), *World Development Indicators* (database), https://databank.worldbank.org/source/world-development-indicators.

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However, at current levels of external public financing, the low-carbon transition in developing countries will not be achieved. In 2020, total climate finance mobilised and provided by developed countries to developing countries amounted to USD 83.3 billion, an increase of 4% from 2019 (OECD, 2022[197]). This amount is less than the annual total of USD 150 billion required in 2020 to fill the gap left by potentially stranded assets in developing countries. Sub-Saharan Africa alone needs to mobilise USD 50 billion annually, or 30% of regional GDP in 2020, to address climate adaptation in agriculture, power and urban infrastructure (Tyson, 2021[198]). Access to climate or green funds by countries that need them most, such as small island developing states (SIDS) and least developed countries (LDCs), remains low at 2% and 17%, respectively between 2016 and 2020 (OECD, 2022[197]). Most climate development finance (80%) is spent on mitigation in middle-income countries in energy and transport infrastructure. Since the COVID-19 crisis, external financing by donors has been reallocated away from climate change adaptation in favour of domestic emergency response (Richmond et al., 2021[60]). African nations recently called for a tenfold increase in climate finance commitments, from USD 100 billion in public climate finance to USD 1.3 trillion in public and private finance annually, by 2030 (Rumney, 2021[59]). To achieve the equity pillar of SDG alignment, external public and private financing will be needed to narrow the growing climate financing gap for mitigation and adaptation, particularly in the poorest countries.

Short-term costs, if unbearable due to limited fiscal space or debt levels, could hinder spending in support of long-term benefits such as the guarantee of basic social protection. A paradox emerges as financing needs increase in developing countries. If developing countries were to raise the additional finance needed to achieve a low-carbon transition by 2060 exclusively through higher taxes and borrowing, household consumption in these countries could decline on average 5% per year, rendering developing country households around USD 2 trillion poorer each year between 2021 and 2060 (World Economic Forum, 2022[95]). In comparison, guaranteeing basic social protection across LICs, LMICs and UMICs is estimated to cost USD 1.1 trillion annually (Bierbaum and Schmitt, 2022[199]). While it is necessary for these countries to mobilise more resources to build back better and invest in long-term climate resilience, financing should not result in debt distress or reduced government expenditure in a "human-centred" and just recovery (such as investment in human capital) (International Labour Organization, 2021[62]). External financing solutions and instruments must be tailored to integrated national financing strategies – for example grants, debt swaps, domestic savings and investment among others – to ensure debt sustainability and long-term achievement of the SDGs. Options to provide technical assistance and ensure capacity building to access sustainable external financing solutions are further explored in section 3.4.

3.3.1. Opportunities for investment aligned to the Sustainable Development Goals in developing countries

The demand for sustainable investment in developing countries is on the rise. The COVID-19 crisis is driving progress in developing countries towards integration of sustainability initiatives and digitalisation to guide private investment (OECD, 2021[200]). The Indonesian G20 presidency identified GSSS bonds as crucial to mobilising resources for sustainability in developing countries (G20 Indonesia, 2022[201]). ESG investments in developing countries excluding China have tripled from 2020, amounting to USD 190 billion in 2021 (Gautam, Goel and Natalucci, 2022[202]). This growth underscores the need for increased transparency and accountability in the taxonomies and definitions underpinning the assessment and quantification of investments that qualify as sustainable. Ensuring operational guidance on sustainable finance classifications as a global public good and ensuring these are freely accessible is a first step to meeting the demand in developing countries while maintaining the integrity of sustainable finance markets globally (Imperial College Business School, 2021[203]).

Investment in renewable energy infrastructure represents a growing opportunity in emerging market economies. Investment in clean and renewable energy infrastructure is needed in developing countries. An estimated USD 4 trillion is required annually by 2030, with developing countries needing 40% of that amount and 70% invested by the private sector (IEA and Imperial College London, 2022[204]). Foreign direct investment (FDI) is an important source of renewable energy investments. It already accounts for 30% of new investments in renewable energy globally and will be especially important in developing countries where demand for energy is expected to grow most rapidly and where financing constraints are greatest (OECD, 2022[205]). In Africa, three countries – South Africa, Egypt and Nigeria – have reached levels of FDI in clean energy comparable to European peers and are likely to supersede them in the near future in terms of their market share. In terms of their share in global greenfield FDI stock in renewable energy, South Africa (1.8%), Egypt (1.9%) and Nigeria (1%) are comparable to France (1.7%), Canada (1.4%) and Italy (1%).

The cost efficiency gains of decarbonisation in developing countries provide further incentives for investors seeking to minimise environmental impacts. As portfolios shift in favour of low-carbon investments, the incentives for investors to allocate financing to markets where CO_2 mitigation is least costly will increase in tandem. For example, the average cost of eliminating one tonne of carbon in developing countries is estimated to be about half that in advanced economies, thanks to new low-carbon projects and technologies that are less costly than retrofitting and adapting existing projects (IEA, 2021[74]). Investors seeking to reduce CO_2 emissions at minimal cost can invest in developing countries where they benefit from such efficiency gains.

In addition to climate mitigation, private sector market creation for climate adaptation and resilience in the poorest and most vulnerable developing countries can generate tremendous savings. Financing for climate change adaptation and resilience can generate large returns in terms of avoided costs and social and environmental benefits: for instance, investments of USD 1.8 trillion for these purposes result in USD 7 trillion in savings (Tall et al., 2021[61]). However, mobilising such financing remains challenging in developing countries due to these projects' small size and lower profitability (OECD, 2021[206]). Adaptation projects often require financing of public goods that generate low revenues and the use of loan-based instruments that require repayment (and thus create further debt risks). While investment in climate adaptation is trending upward, private sources currently provide less than 2% of adaptation finance, or about USD 500 million (Tall et al., 2021[61]). Better estimates of the quantitative value of climate risks and losses averted – that is, how to monetise the benefits generated by adaptation and resilience finance – are needed to incentivise private sector engagement.

More investment in a human-centred recovery, or social protection, could generate economic gains in the poorest countries. Less than half of the world's population has access to social protection, meaning access to a guaranteed level of healthcare systems and income security needed to eradicate poverty and shield the poorest during economic downturns (Durán-Valverde et al., 2019[207]). The poorest countries have the lowest access to social protection. For example, old age pension funds have only 15% coverage rates in LICs but 90% coverage in UMICs (Durán-Valverde et al., 2020[208]). However, eight case studies in developing countries show that countries with lower GDP per capita generate higher rates of economic growth from the same investment in social protection. Investing 1% of GDP in social protection generates a multiplier effect on GDP of between 0.7 and 1.9 (International Trade Union Confederation, 2021[113]). Domestic resources in developing countries remain insufficient to generate the financing needed for such investments, despite the potential economic gains. Recent estimates show that the financing gap in 2020 to achieve universal coverage of social protection (including healthcare) was estimated at USD 1.9 trillion, or roughly 4% of GDP in the 134 developing countries and territories studied (Durán-Valverde et al., 2020[208]). Subsection 3.4.2 identifies options to raise external financing, including innovative financing instruments that increase fiscal space needed for social protection investments.

The following subsection identifies the roadblocks to tapping into growing investment opportunities in the sustainable finance market in developing countries.

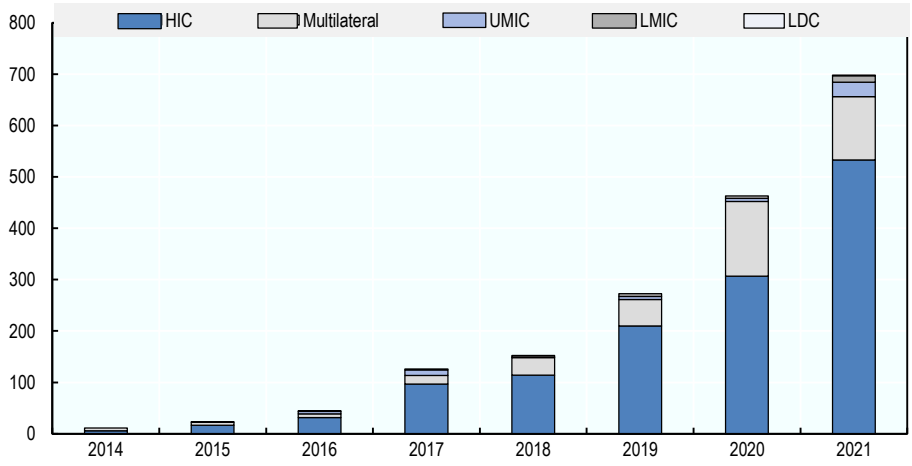
3.3.2. Barriers to access sustainable finance in the poorest and most vulnerable countries could lock in the Great Divergence

A paradox has emerged with the profusion of sustainable finance, which ultimately is not needs based. While an increase in the number of actors and financing instruments aiming to support the SDGs provides opportunities to mobilise more financing, it also adds a layer of complexity and risk that add to difficulties of access to countries most in need of financing. Research by the OECD found that developing countries have more than 1 000 instruments to choose from to finance their development. These instruments imply varying terms, conditions and technical expertise, which can create barriers to access. For example, SIDS face many challenges to access vertical climate funds due to low return on investment for CO_2 reduction and a lack of administrative and human resource capacities to apply for and carry out large projects (Morris, Cattaneo and Poensgen, 2018[209]). With small populations and limited skills and technical capacities to manage the projects adequately, SIDS' access to green funds is slowed. For example, the Green Climate Fund disbursed commitments with a two- to four-year lag in SIDS. The Climate Investment Funds and the Global Environmental Facility had longer commitment delays of up to eight years (OECD, 2022[134]).

Many developing countries struggle to build a pipeline of bankable sustainable projects for environmental and social impact. Despite the growth in investments, 97% of the estimated USD 1.7 trillion in total sustainable investment funds are held in HICs (UNCTAD, 2021[210]). As shown in

Figure 3.6, all ODA-eligible countries account for less than 7% and LDCs for less than 1% of cumulative total GSSS bonds issued since 2014. To date, there have been 16 green bond issuances in sub-Saharan Africa, representing 1.5% of total global bonds by number and less than 0.3% by value (Tyson, 2021[198]). Shallow financial sector development in the poorest countries, as noted previously, is one of the key factors hindering sustainable finance market creation. Additional factors related to the risk-return profile of developing countries, including financial and climate risk, create further impediments to access financing.

Figure 3.6. Green social, sustainability and sustainability-linked bond issuances by HIC and multilateral agencies have increased significantly (EUR billion)



Note: Country classifications are based on the OECD Development Assistance Committee (DAC) ODA-eligibility list (2021).
Source: Authors' calculations based on Luxembourg Stock Exchange (2021[47]), DataHub, https://lgxhub-premium.bourse.lu. (OECD, 2022[48]).

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A long-standing lack of data to report on the most basic sustainability criteria in developing countries – economic growth – increases the exclusionary risk. Relevant data to assess ESG criteria can be costly to compile and can require technical competencies to produce accurately. Without complete and timely data, developing countries face further exclusion and lower scores. For example, the World Bank found that about 90% of a country's sovereign ESG score can be explained by a country's national income. However, the base year for which GDP is calculated in many developing countries is not updated in a timely manner (at least every five years), which contributes to a lag in income level in the poorest countries. One example is Ghana: its GDP was under-reported by 60% until 2010, when the country changed its base year and transitioned from the low-income to lower middle-income category (Moss and Majerowicz, 2012[211]). Presently, it is estimated that 7% of the global economy is missing from GDP data, mainly for developing countries with low national statistical office capacities and large informal economies,[8] such as those in sub-Saharan Africa (Ritchie, 2021[44]; OECD/ILO, 2019[45]).

Recent crises demonstrate that sovereign credit ratings favour short-term financial risk assessment to the detriment of a country's long-term efforts to mitigate ESG risks or achieve the SDGs. The incentives imposed by credit rating agencies (CRAs) can force developing countries to choose between investment grade credit scores and investment in sustainable development over the long term. While ESG ratings issuers often consider long-term risk mitigation strategies and growth potential, CRAs focus their evaluation mainly on short-term factors such as GDP, climate vulnerability, debt distress, inflation, etc. During the pandemic, several developing countries were penalised for heightened spending on public services, including for emergency health support, while other countries chose not to borrow for

emergency relief to avoid credit downgrades. Sovereign credit rating downgrades increase borrowing costs and can contribute to economic recession. During COVID-19, developing countries, many of which were already rated non-investor grade (BB+ or lower), may have faced a perception premium or downgrades, despite having an improved economic outlook in the country prior to the COVID-19 crisis (Fofack, 2021[46]). While developed countries' sovereign credit ratings remained stable throughout the crisis, more than 56% of rated African countries were downgraded in 2020, significantly above the global average of 31.8% (Fofack, 2021[46]). Of the seven sovereign defaults that occurred in 2020, three (Argentina, Lebanon and Zambia) were already rated in the lowest rating category of CCC/CC. Sri Lanka recently defaulted on debt owed to external creditors valued at roughly USD 50 billion due to rising inflation and energy prices. In addition, since Russia's full-scale invasion of Ukraine, the credit scores of oil commodity-dependent countries improved as oil prices increased, creating further barriers to transition to low-carbon pathways.

Soaring energy prices raise the value of stranded assets and threaten setbacks to clean energy finance in developing countries. Commitments to divest from carbon-intensive sectors were accelerating before the war, including commitments to end public export guarantees for fossil fuel projects and DAC members' commitment to end new ODA for unabated international thermal coal power generation by the end of 2021 (OECD, 2021[49]). Divestment decreases the value of assets by signalling a decrease in demand. As a result, clean energy financing needs in developing countries by the end of the 2020s could increase from USD 150 billion to USD 1 trillion, particularly for coal-fired power plants.[9] Developing countries hold 89% of the total capital globally at risk of being stranded.[10] Nearly 50% of sub-Saharan Africa's export value is composed of fossil fuels, or roughly USD 120 billion in 2019 (World Bank Group, 2020[50]). However, as energy prices increase due to the effects of the war, the value of energy assets also increases to the benefit of energy export-dependent countries. Promoting continued commitment to the clean energy transition will be challenging in countries that are currently benefitting from the increase in export value.

As developing countries' access to international financial markets narrows, there is a greater risk of locking in pre-existing political and social instability. The drive to build markets for sustainable finance cannot succeed without sound governance and public institutions. Sound governance is needed to ensure quality regulatory policy, protect against corruption and to ensure rule of law. Financial intermediaries, such as CRAs, assesses sovereign credit ratings according to the World Bank Governance Indicators for political risk assessment, (Fitch Ratings, 2021[212]). However, LICs, since 2015, rank lowest across all indicators of sound governance. In the area of political stability, LICs even regressed (World Bank, 2022[53]). The mounting wave of global inequity, if left unaddressed, will lock in a Great Divergence that eliminates the possibility of achieving the 2030 Agenda and the SDGs.

A new paradigm is needed that ensures incentives to allocate and commit a greater share of sustainable financing in support of countries at greatest risk of SDG setbacks. Current capital market incentives are not optimal to addressing capital shortages in developing countries. Capital markets are weighted to direct flows towards countries with the least shortages: For example, 65% of the MSCI emerging market index is held by only 3 of 26 countries covered) (Principles for Responsible Investment, 2022[213]). The cost of borrowing in the poorest countries has increased significantly, while spending towards the SDGs remains constrained. Increased vulnerability due to recent shocks brought on by COVID-19 and the war in Ukraine has compounded pre-existing financial and climate risks. Delivering the equity pillar of SDG alignment will ultimately require that financing reaches the countries where it is most needed. A paradigm shift is required to create global incentives for investment to be directed to countries that seek to align financing to the SDGs, despite the risk-return profile.

3.4. Actions to avoid the Great Divergence

Collective action by actors in all countries is urgently needed to avoid the great SDG divergence and enforce the equity pillar of SDG alignment. The supply of and demand for sustainable finance and recovery spending have reached a record high in OECD countries. However, developing countries hardest hit by successive crises and where demand for sustainable finance is greatest are struggling to access the sustainable finance market and to mobilise domestic resources. Strengthening the market for sustainable finance requires a sustainable finance equilibrium that balances both pillars of SDG alignment – sustainability and equity. As the SDG financing gap increases in the poorest countries and short-term financing needs arise, the risks of beggar-thy-neighbour policies also rise, meaning policies in one country that rely on short-term solutions to resolve a domestic economic problem – deceleration of the low-carbon transition, for instance, or protectionism – could harm other countries' economic welfare. Without swift action to finance the poorest and most vulnerable, the next waves of crises will be all the more harmful for people, planet and prosperity.

The war in Ukraine and the COVID-19 pandemic open a window of opportunity to "reset" market incentives in favour of the SDG paradigm (World Economic Forum, 2020[214]). The geopolitical shifts in the wake of the pandemic and Russia's full-scale invasion of Ukraine shook the global economic system. These shocks could be an impetus to set new rules in favour of a fairer economic system. Following the 2008-09 global financial crisis, multilateral groups such as the G20 took the lead to carry out major reforms to strengthen the stability of the international financial system and reduce future risks within it. One potential outcome of the pandemic and the war could be that common geopolitical and values-based interests align and result in a "great reset" of capitalism, led by governments to reduce strategic vulnerabilities and promote the social and environmental benefits of investment (e.g. moving from an ESG to SDG paradigm). For example, a new value system is emerging that could reroute trade and commerce to embed environmental and social concerns into global value chains that contribute to strengthening resilience to the benefit of a low-carbon transition and achievement of the SDGs in the poorest countries (OECD, 2021[178]; Lagarde, 2022[215]). Diversification of supply chains, including at the frontier in developing countries, provides a means to strengthen resilience to future shocks.

To save the SDGs, simultaneous actions are needed all along the SDG investment value chain from country of origin to financial intermediaries to countries at risk of divergence. The 2021 Global Outlook on Financing for Sustainable Development and OECD-UNDP Framework for SDG Aligned Finance call for mutually reinforcing actions in support of alignment of all actors along the investment value chain (OECD/UNDP, 2020[2]). But, as noted here, new taxonomies and standards to define and assess sustainability are only effective and impactful if they are interoperable and enforceable across borders. For reforms by any one country or region to succeed, a global agenda is required to identify where the international community can take collective action to correct misalignment and avoid shifting of activities beyond borders (for instance, to avoid a race to the bottom). Action is needed along the value chain to guide all actors in countries at risk of divergence (e.g. strengthening domestic sustainable finance markets and strategies) and financial intermediaries (e.g. risk management and innovative instruments) as well as actors in countries of origin (e.g. coherence of policies and combatting SDG-washing).

The next subsection discusses measures to narrow the SDG financing divide and deliver the sustainability equilibrium for SDG alignment, focussing first on recommended actions in support of countries at risk of divergence (including how the international community can provide support) and then on support by countries of origin (e.g. promoting policy coherence) and by financial intermediaries.

3.4.1. Actions in support of countries at risk of divergence

Without external support from developed countries, developing countries will not benefit from the sustainable finance boom and the Great Divergence will accelerate. Faced with mounting, immediate

financial and fiscal pressures due to the war in Ukraine and COVID-19, developing countries are unable to mobilise the resources needed to finance short-term emergency responses without sacrificing spending for long-term resilience. As a result, developing countries require external support to reinforce domestic sustainable finance markets, strengthen domestic revenue mobilisation and attract sustainable external finance. Burgeoning sustainable finance markets are largely concentrated in developed countries. For these markets to be sustainable, they must be equitable – that is, they must deliver sustainable financing in countries at greatest risk of falling behind. The following are recommendations for action in support of countries at risk of divergence.

Support domestic resource mobilisation to increase fiscal space in developing countries

Developed countries can invest in domestic resource mobilisation (DRM) to alleviate the fiscal and credit crunch in developing countries. In recent years, there has been growing concern about fiscal vulnerabilities as debt levels become unsustainable. As noted in Chapter 2, donors have made important strides towards the target of USD 441.1 million in ODA to support DRM that was set by the Addis Tax Initiative in 2015, and maintained in its 2025 Declaration. Bilateral and multilateral actors could deliver more and better technical assistance and capacity building for stronger global sustainable finance markets and tax systems in the poorest countries. One initiative that helps bring technical tax expertise to support DRM in developing countries is the joint OECD-UNDP initiative, Tax Inspectors Without Borders, which provides a mechanism to bring experienced serving tax officials from one country to work alongside officials in a developing country administration on live cases. To date, the initiative has resulted in over USD 1.7 billion in increased revenues in developing countries, with a return on investment of 127:1.

Donors can also align support to national strategies such as Medium-Term Revenue Strategies to ensure that DRM targets SDG alignment. Demand is growing for support in specific areas to collect more and better revenues, such as digitalisation of tax administrations and tax system reform to both address inequality, and for support related to specific SDGs (e.g. on health and social protection). DRM strategies, such as MTRS, enable donors to align support to country-owned plans, with clear priorities and sequencing for reforms. Ideally, DRM strategies will be a part of broader integrated national financing frameworks (see below) to ensure the DRM strategy is targeting SDG alignment. Major economies can help by providing peer learning and technical assistance to reap the benefits of DRM reform. A US Agency for International Development (2016[65]) case study found that by rebuilding basic infrastructure, restoring public service and introducing modern digital tax systems, development partners could support developing countries, including fragile contexts, to improve revenue-to-GDP ratios. An example cited in the study was Rwanda, which succeeded in increasing its revenue-to-GDP ratio from under 10 percentage points in 2000 to about 16% in 2016 with the support of the United Kingdom.

Developed countries can help developing countries implement country-led carbon pricing policies to generate additional domestic revenue aligned to a just and sustainable transition. While revenue potential varies across countries, developing countries on average could generate revenue equivalent to about 1% of GDP if they set carbon rates on fossil fuels equivalent to EUR 30 per tonne of CO_2 (OECD, 2021[66]). In developing countries, where 70% of all employment is informal, carbon pricing is an important policy lever as direct taxes on personal or corporate income are more challenging to collect (OECD/ILO, 2019[45]). Peer-to-peer learning can help developing countries implement best practices to ensure that carbon pricing is part of a suite of climate actions and policies for equitable and long-term sustainable economic development. For example, Egypt has demonstrated successful fossil fuel subsidy reform that protects vulnerable households and encourages private sector development. Subsection 3.4.2 further explores the importance of policy coherence of actions by countries of origin and highlights the potential of a global framework for carbon pricing.

Developed countries can strengthen support for debt-to-SDG swaps. A long-standing sustainable finance option, debt-to-climate swaps allow bilateral and multilateral actors to carry out debt forgiveness

or restructuring with developing countries, thus freeing up financing that can then be used for SDG action (Thomas and Theokritoff, 2021[216]). For example, a debt swap worth USD 2.9 million in 2012 was carried out between Italy and the Philippines, and the targets of the liberated financing included poverty reduction. However, this option is most effective in countries that are not in debt distress and are able to service their debt. A country that is unable to service its debt will also be unable to redirect such service costs to finance SDG action. Traditionally, such swap arrangements are carried out between official creditors and debtors. However, more recently, private sector actors have engaged in purchasing climate swaps. For example, Belize issued a debt-for-nature swap equivalent to its entire external commercial debt stock of USD 553 million, or 30% of its GDP, with the support of the Nature Conservancy; the US Development Finance Corporation, which provided insurance; and Credit Suisse, which secured an investment grade rating from Moody's (Owen, 2022[217]). Future efforts could seek to engage the private sector in investing in climate change adaptation and mitigation debt swaps in exchange for carbon emission offsets.

Developing countries can more actively implement frameworks and policy reforms needed for external investment, such as FDI, to align to the SDGs. Developing countries with clean energy policies are, on average, seven times more likely to attract clean energy investment than countries without such policies. However, as shown by the International Energy Agency's Policies and Measures Database, there are a great many policies and instruments available to promote climate-friendly growth, with over 5 500 climate policies and instruments currently in use (Glemarec, 2021[71]). In addition, the OECD Policy Framework for Investment serves to guide governments in undertaking reforms to improve the investment climate and choose the right policy mix and covers a wide range of areas including investment policy, competition, trade, taxation, corporate governance and green growth (OECD, 2015[218]). Building on the Policy Framework for Investment, the FDI Qualities Policy Toolkit, launched in June 2022, provides a framework for designing and implementing policy interventions to maximise the contribution of FDI to sustainable development (OECD, 2022[72]). The toolkit focuses on innovation, jobs and human capital development, gender equality, and decarbonisation. The recently launched OECD FDI Qualities Indicators guide also provides tools to inform and direct policy reform on designing and implementing policy and institutional reforms to enhance the positive impacts of investment on sustainable development (OECD, 2022[205]). Country-level implementations of these frameworks and indicators, such as investment policy reviews and FDI Qualities reviews, seek to assist governments in designing and implementing policy interventions to improve the investment climate and attract sustainable investment. The 2020 investment policy review carried out with Indonesia, for example, found that reducing regulatory restrictions on FDI could significantly increase the stock of FDI by up to 85% (OECD, 2020[73]). The 2022 FDI Qualities review of Jordan found that lifting regulatory restrictions on FDI in selected services sectors could help increase labour force participation of women and improve gender equality in the labour market.

Deepen domestic sustainable finance markets and strategies in countries most in need

Developed countries can assist in building absorptive capacities in developing countries to create a pipeline of sustainable finance projects. Ensuring the right SDG-aligned incentives for a broad range of actors – banks, pension funds, insurance companies, asset managers, multilateral development banks, PDBs and more – is complex. At least 527 PDBs and DFIs were identified as holding a combined total of more than USD 13 trillion in financial assets (Xu, Marodon and Ru, 2021[69]). These multinational, national and subnational actors play a key role to align finance in support of the SDGs, including for climate change adaptation and resilience, gender equality, biodiversity, and agriculture among other areas. However, good practices are needed to work with these actors to help unlock access to climate-related financing and to access climate finance and services, notably in LDCs and SIDS (Casado Asensio, Blaquier and Sedemund, 2022[70]). One example is the support provided by the Green Climate Fund in its work with PDBs and DFIs in LDCs, SIDS and other developing countries to strengthen investees' operational efficiency and ESG compliance (Glemarec, 2021[71]). Accelerating access to the Fund's climate finance

requires an institutional architecture that can build strong, effective climate finance-related pipelines and enable stronger ownership and leadership in climate finance (OECD, 2022[134]).

Developed countries can deepen financial markets in developing countries to create a buffer against future shocks. Strengthening financial markets helps improve individual access to financial services, increase financial reserves in times of crisis and lower financial services costs. Financial markets in the poorest countries are subject to pro-cyclical swings of external private finance, particularly portfolio flows. Without stable domestic long-term capital and reserve assets, such as those held by central banks, developing countries are left without financial buffers in times of crisis. Multilateral organisations are playing a key role to promote deepening of financial markets in developing countries. One example is the IMF-administered Resilience and Sustainability Trust created in April 2022, which aims to channel special drawing rights (SDRs) (i.e. reserve assets housed in developed country central banks) to support the poorest countries and most vulnerable middle-income countries. The Trust seeks to promote structural reforms (e.g. climate change and pandemic preparedness) while also reducing risks to prospective balance of payments stability. Continued support is crucial to ensure equitable channelling of SDRs alongside support to build macro prudential stability, including in co-operation with multilateral development banks.

Donors can promote peer-to-peer exchange and technical support to strengthen standards and regulations to build sustainable finance markets in developing countries at risk of missing out. Many financial actors are seizing opportunities to deliver in response to global demand for sustainable finance in frontier markets. For example, the Luxembourg Green Exchange is dedicated to the promotion of sustainable finance on a global scale and provides capacity building to address market gaps for SDG financing in developing countries. Other multilateral initiatives can help pool expertise in support of better standards and regulations to improve the transparency and accountability of sustainable finance markets. For example, as of 2022, the Sustainable Stock Exchanges Initiative (2021[219]) has brought together over 120 stock exchanges and 13 derivative exchanges, representing over 70% of listed equity markets and with a market capitalisation of USD 126 trillion. Members of the Initiative provide technical assistance and knowledge exchange to developing countries on matters such as ESG disclosure and bond development, Task Force on Climate-related Financial Disclosures reporting, etc.

Attract and monitor financing for development aligned to country-led financing strategies

Developed countries can strengthen country-led integrated national financing strategies to better align donor support and effectiveness of all types of development finance towards achieving development priorities, including climate-related objectives and gender equality. National financing strategies cover the full range of financing resources, support the bridging of short- to longer-term planning, and provide measures for added transparency and collective accountability. National financing strategies help steer partnerships in support of the development of viable pipelines of scaleable, bankable and replicable SDG-compatible projects. For example, Nigeria is carrying out an Integrated National Financing Framework (INFF) process[11] that integrates a gender lens for all sources of financing. Such gender-lens investing helps increase the return on investment and contributes to the development of women-owned and led enterprises, workplace equality, and products and jobs that improve the lives of women and girls (OECD, 2022[75]). National climate finance strategies such as nationally determined contributions are a core component of INFFs and are also crucial for co-ordinating support. Maldives, for instance, is costing its nationally determined contribution through the INFF process (UNDP, 2022[92]).

Developed countries can help developing countries access affordable, neutral and quality advice on FSD that is aligned to integrated national financing strategies. The OECD, the UN Department of Economic and Social Affairs, and the UN Development Programme launched the INFF Facility at the Financing for Development Forum in 2022 to help developing countries navigate the increasingly complex landscape of financing instruments tailored to country contexts. As noted, countries most in need such as SIDS and LDCs face significant challenges, for example due to lack of institutional capacities, to access

green or other forms of innovative finance. With the support of consulting and expert guidance, developing countries can access FSD that meets country-led financing needs. Pooled advisory services could also help developing countries gain access to global funds and innovative instruments that limit the risk of debt distress. The donor community can also scale up financial tools to incentivise SDG alignment of finance such as SDG, green or other innovative bonds and instruments in support of sustainable growth. Support for technical assistance and capacity within aid programmes could help to navigate compliance and accelerate access.

Donors can explore the use of innovative instruments, including investment based on results, to mitigate risk and to attract external resources aligned to the SDGs. Several sovereign developing country issuers have recently developed sustainability bonds, a form of results-based financial instrument. An example is Benin, which launched a USD 500 million SDG bond programme in 2021, the first SDG bond issuance in Africa, with investment grade ratings by Moody's and Standard & Poor's (Ministry of Economy and Finance of Benin, 2022[76]). The UN Sustainable Development Solutions Network will monitor the SDG impact of the bond proceeds, and Moody's will assess the ESG ratings of the proceeds. Nearly 75% of funds are allocated in support of social goods such as education, housing and health-related SDGs. Other forms of financing rely on multilateral organisations. For example, Rwanda established the National Fund for Environment, or the Rwanda Green Fund, with the help of the United Kingdom. The fund provides access to investment based on performance of up to 25% match funding at below market rates for private sector investment requests for up to USD 300 000 (National Fund for Environment, 2021[220]). To date, the Green Fund has generated over 137 500 green jobs and provided nearly 60 000 households with access to off-grid clean electricity. There is scope to further develop other results-based reward mechanisms, such as those for reducing carbon emissions or forest degradation. Gabon, for instance, received a EUR 14 million reward in 2021 based on an independent assessment of its efforts to reduce CO_2 emissions in 2016 and 2017 – the first country to receive this reward. The results-based payments are part of an agreement between Gabon and the Central African Forest Initiative that aims to protect forests in return for additional tonnes of CO_2 sequestered thanks to the measures implemented to combat deforestation.[12]

All countries can work together to deliver on a global framework that strengthens the transparency and accountability of external debt financing. A global response to debt sustainability is required to avoid situations in which debt forgiveness or restructuring from one creditor serves to finance debt on harsher terms and conditions from another creditor and jeopardises the debt sustainability of the borrower. International efforts to strengthen debt transparency of all stakeholders, public and private, can help ensure debt sustainability in the poorest countries. Global frameworks should seek to achieve co-ordination among public and private lenders. For example, the OECD debt transparency initiative in LICs, with the support of the United Kingdom government and the Institute of International Finance, aims to provide greater transparency of creditors and borrowers in LICs to ensure debt sustainability and reduce financing costs, particularly in the context of monetary policy tightening that will result in a higher interest rate environment (OECD, 2022[68]).

For innovative and blended finance to be effective, the SDG impact of such instruments and structures must be better measured and managed. In addition to labelling, standards and frameworks are needed to track development performance. For example, in 2020, the OECD Blended Finance Funds and Facilities Survey found that the vast majority of funds and facilities, or 92%, align results-based measures with the International Financial Corporation performance standards. The OECD-UNDP Impact Standards for Financing Sustainable Development (IS-FSD), adopted by the DAC in March 2021, encourage a mindset shift away from focussing on metrics and reporting and to embedding positive and negative impact considerations in the strategy, management approach and governance of an organisation. The IS-FSD provide guidance to donors to better select private sector partners for blending operations that can deliver sustainable development impact (OECD/UNDP, 2021[77]).

Donors should ensure the effectiveness of external development finance through a broadly owned development process that enables participatory policy making and action with local partners

around a shared agenda and with a clear focus on results and accountability. The Global Partnership for Effective Development Co-operation provides a unique multi-stakeholder platform to invest in inclusive, evidence-based dialogue and capacity support that builds trust and responds to the practical challenges and inherent tensions complicating more effective development co-operation partnerships. The Global Partnership's Effective Development Co-operation Summit in December 2022 offers a critical opportunity to collectively reaffirm the centrality of the effectiveness principles and apply them to all efforts to implement the 2030 Agenda.

All countries should utilise the SDGs as a universal road map for collaborative and comprehensive approaches in development co-operation. An OECD study carried out in seven partner countries confirms that using the SDG framework in development co-operation offers many co-benefits, including the ability to navigate complex multidimensional challenges using the same language and data; building partnerships around a consensus agenda; co-ordinating more effectively and efficiently across institutions, borders and sectors; and maximising the impact and value for money of every investment. However, as of 2021, these benefits remain unrealised. Most partners have yet to reorient development co-operation towards SDG results, as political, technical and organisational challenges have delayed these processes. Only one-third of development partners are systematically or frequently using SDG indicators in their results frameworks at country level (OECD, 2021[221]). And only half of the development partners in Uganda and Samoa, for instance, are explicitly using SDG targets and indicators to measure outcomes, and the proportion drops to one-quarter in Peru (Guerrero-Ruiz, Kirby and Sachin, 2021[222]).

Successful alignment of development co-operation to SDG results rests on three broad foundations:

1. **Promote the SDGs from the top**, including by investing in SDG alignment of development co-operation systems and management practices.
2. **Support partner country ownership** and synchronise and adapt development co-operation processes with partner countries.
3. **Recognise that no country, ministry or agency can deliver on the SDGs alone**. Donors can adopt a variety of approaches to leverage funding for gender equality, for example, including by partnering financially with private sector actors, providing guidance and financial incentives for financial actors to work on gender equality, and providing technical support on gender equality for actors in partner countries (OECD, 2022[75]).

3.4.2. Actions by countries of origin and their financial intermediaries

SDG alignment of financing will largely depend on domestic policies in developed countries. Shifting just 1% of the hundreds of trillions of dollars of sustainable finance held primarily in developed countries offers the potential to achieve the SDGs and leave no one behind. Given that financial assets are concentrated in developed countries, it falls to these countries to strengthen standards, regulations, policies and other incentives to improve risk management, avoid SDG-washing and ensure that domestic policies avoid negative spillovers on FSD across borders. This subsection recommends key actions and identifies best practices to ensure an integrated approach across developed country governments and financial intermediaries.

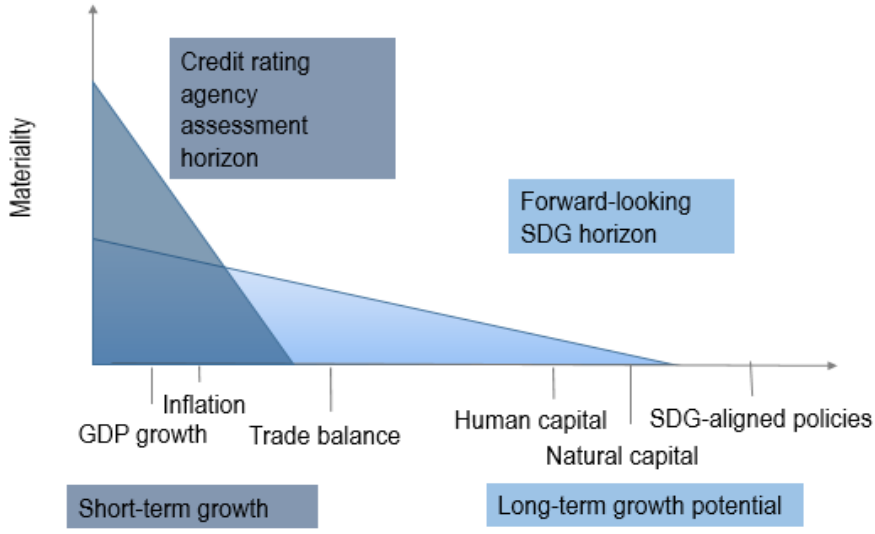
Strengthen financial risk management standards and incentives including risk perception criteria and ratings aligned to the SDGs

Working with asset managers, DFIs and other institutional investors, donors can help reduce real and perceived financial risk in developing countries and better target blended finance risk mitigation instruments. New types of collaborative and private sector-led public-private models, such as BlackRock's Climate Finance Partnership (with the Agence Française de Développement, KfW and the

Japan Bank for International Cooperation), seek to remove the bottlenecks between two categories of long-term investors – institutional investors and DFIs – to mobilise financing for climate infrastructure in developing countries (BlackRock, 2021[78]). The BlackRock partnership has mobilised USD 400 million of financing (a 4:1 ratio) from institutional investors – financing that would not have been disbursed otherwise – by deploying a 20% first-loss tranche vehicle (that is, the amount of loss that public sector investors are willing to absorb). Credit enhancement tools such as letters of credit, which involve a guarantee from an investment grade public or private actor, can also be effective in attracting investment and reducing the cost of financing in developing countries. For example, a credit enhancement model in Nigeria to reduce credit risk was found to reduce loan interest rates by at least 50% (Global Green Growth Institute, 2019[223]). Other means of credit enhancement include integration of ESG criteria into sovereign credit ratings, which can provide a more accurate assessment of a country's risk-return profile as an alternative to reliance on limited and often unreliable GDP data.

Developed countries can work with credit reporting agencies (CRAs) to enhance the transparency of sovereign credit ratings and create incentives for ratings to integrate long-term SDG rating criteria. CRAs and fixed income investors can incorporate ESG into credit ratings and analysis in a systematic and transparent way. Developed countries can promote a revamped approach to current sovereign ratings and investment models by seeking to integrate SDG progress as a key indicator. A higher sovereign credit rating score should be provided to incentivise investment in countries that are making a demonstrable effort to advance towards the SDGs. To date, over 170 investors (with nearly USD 40 trillion in collective assets under management) and 27 CRAs support the UN Principles for Responsible Investment initiative to integrate ESG into credit ratings (UN, 2022[80]). Further work will be required to ensure more granular reporting and disclosure of ESG ratings. As shown in Figure 3.7, criteria related to a country's long-term sustainability and SDG progress, such as indicators related to human and environmental capital, are material to a country's credit rating. However, to date, only one CRA, Scope GmbH, includes ESG criteria as a standalone category (weighted at 20% of the total score) in its assessments (Gratcheva et al., 2022[79]).

Figure 3.7. Towards credit rating criteria with a forward-looking Sustainable Development Goal horizon



Source: Authors' adapted from Gratcheva et al. (2022[79]), *Credit Worthy: ESG Factors and Sovereign Credit Ratings*, https://openknowledge.worldbank.org/handle/10986/36866.

Implement regulations to avoid washing and diversion

Developed countries can help link ESG and SDG key performance indicators to direct financing to achieve SDG-aligned impact. Comparable data and standards that make sense to the private sector are needed to avoid green washing and SDG-washing. The public sector can work more closely with private sector actors to raise their awareness of the SDGs and to translate the goals and targets into key performance indicator standards. For example, the European Commission's draft Corporate Sustainability Reporting Directive draws from both the SDGs and the Paris Agreement to establish a set of targets and indicators to achieve impact in support of sustainable development. With its adoption, EU sustainability reporting standards will become mandatory for a broader set of companies requiring double materiality assessment and ESG reporting (European Commission, 2021[81]). Assessment of key performance indicators also can help identify areas where the private sector can have the most SDG impact and can be aligned with SDG targets to improve monitoring of outcomes. Another example is IRIS+, a resource managed by the Global Impact Investment Network that has developed a catalogue of output and outcome metrics aligned to the SDGs including sectoral areas such as agriculture, climate and education (Global Impact Investment Network, 2022[181]). The Bank for International Settlements (2021[191]) also has provided suggestions to link ESG assessments to the SDGs based on four areas: objective (which sustainability goals are supported?); scope (which activities, industries and/or entities are included?); target (how is the purpose translated into a measurable target?); and output (what types of information are provided?).

Developed countries, including the donor community, can step up support for responsible business conduct. Promotion of voluntary and mandatory compliance and disclosure of private sector activities, including financial sector activities, can help achieve meaningful impact for people and planet along the value chain. An example is the OECD Guidelines for Multinational Enterprises, which provide an international toolkit to help businesses and institutional investors such as pension funds and insurance companies assess the environmental and social risks associated with their activities. The OECD Due Diligence Guidance for Responsible Business Conduct, adopted in 2018, provides support to companies to implement due diligence for the responsible business conduct outlined in these guidelines. The guidance also seeks to promote a common understanding among governments and stakeholders, including in relation to the UN Guiding Principles on Business and Human Rights and the International Labour Organization's Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy, which also contain due diligence recommendations (OECD, 2018[155]). The OECD FDI Qualities Guide for Development Co-operation will be launched in 2022, seeks to provide specific guidance to donors and other development co-operation actors on strengthening the role of development co-operation in mobilising FDI and enhancing its positive impact in developing countries (OECD, forthcoming[82]). More work is also needed to enable accountability for adherence to such standards, including those pertaining to taxation. Recent OECD research found wide variation in tax officials' perceptions of large business adherence to voluntary best practices in taxation, with noticeably lower perceptions of adherence in Africa and the Latin America and Caribbean regions (OECD, 2022[224]).

Working with the multilateral system, developed countries can help improve interoperability of sustainability standards. Interoperability of standards and co-ordination of regulatory policy tools are needed to ensure a fair global playing field and comparability across financial and capital markets. Efforts to promote co-ordination provide a way forward to clarify taxonomies, guidelines and market-based frameworks and to ensure comparability. For example, the EU-led International Platform on Sustainable Finance facilitates the exchange of best practices and brings together different initiatives on environmentally sustainable finance and investment, including green taxonomies, disclosures, standards (e.g. green bonds), labels and benchmarks.[13] The Global Reporting Initiative and the International Financial Reporting Standards Foundation have also announced plans to co-ordinate and align their capital market and multi-stakeholder standards for sustainability disclosures. To advance co-ordination with the private sector, the OECD ESG Risk Policy Framework in 2023 will identify inefficient market practices and policies with the goal of better aligning capital flows with sustainable and climate-resilient growth.

Developed countries and their financial intermediaries should advocate for the 1% SDG Investment Club for a joined-up public-private commitment to leave no one behind. A stronger joint public-private commitment to SDG targets could allow private sector actors to achieve greater positive impact in countries most in need. Progress has accelerated on rethinking SDG investment as a global financial risk mitigation strategy. Joint public-private initiatives such as the 1% SDG Investment Club advocate for 1% of global private sector capital to be put towards investments that will directly promote the SDGs in developing countries (Alam, 2021[83]). For example, J.P. Morgan's development finance institution, launched in 2020 in collaboration with the International Finance Corporation, has introduced portfolio allocation criteria that require client countries to meet geographical targets based on the World Bank-eligible borrowing country lists (i.e. International Development Association, International Bank for Reconstruction and Development, or blend countries) to spur capital in favour of financing in frontier and emerging markets (J.P. Morgan Development Finance Institution, 2022[84]). This DFI mobilised USD 124 billion with sustainable development impact in 2021 (J.P. Morgan, 2021[85]).

Promote coherence of domestic and external financing for sustainable development policies

Developed countries must address transboundary effects of domestic policies that can undermine sustainable development globally. The multidimensional nature of the SDGs implies that progress made in a particular social, economic or environmental area or towards an individual goal could generate synergies and trade-offs across dimensions. These spillover effects may lead to positive or negative impacts beyond national borders. Failure to address such impacts could significantly undermine countries' efforts to implement the 2030 Agenda (OECD/EC-JRC, 2021[225]). Policy coherence challenges should move up the agenda of dialogue with parliaments and key stakeholders at home. Efforts to shift domestic policies should be based on insights from quality reporting and assessments and ensure the readiness of line ministries by providing them clear responsibility, resources and capabilities to assess the direct and indirect effects of their policies on developing countries. In development co-operation, using multilateral frameworks (including the SDGs and voluntary national review processes) as a driver for whole-of-government engagement for the SDGs can help build mutual commitments. This can also help strengthen connections between development co-operation and domestic policies to promote integrated approaches at country level.

Donors should redouble international co-operation to achieve a framework for a low-carbon transition globally. Carbon pricing can support a green recovery by shifting investment incentives and boosting public revenue, provided it is designed in a progressive manner. However, currently around 60% of energy-related CO_2 emissions remain unpriced and some of the most polluting fuels remain among the lowest priced. International co-operation on carbon pricing is essential to strengthen the market and ensure a just redistribution of resources for a low-carbon transition in developing countries. For example, the EU Carbon Border Adjustment Mechanism seeks to reduce the incentives to outsource carbon emissions beyond the EU. However, the mechanism also could reduce up to 2% of exports from developing countries (Magacho, Espagne and Godin, 2022[226]). Resources generated by the Mechanism in support of a low-carbon transition could benefit developing countries that depend on EU exports and where the carbon intensity of production remains high (Berahab, 2022[227]). The OECD's recently launched Inclusive Forum on Carbon Mitigation Approaches seeks to support the international community to lift the level of ambition by improving mutual understanding of the expected impact of a full range of policy approaches beyond carbon pricing. Donors' commitment to a low-carbon transition must also be accompanied by scaled-up resources. An example is the OECD Clean Energy Finance and Investment Mobilisation programme, which aims to strengthen domestic enabling conditions to attract finance and investment in renewable energy, energy efficiency, and decarbonisation of industry (or clean energy) in emerging economies.

Developed countries can ensure sufficient support to implement international co-operation on tax matters to the benefit of the poorest countries. While international taxation is only one part of the DRM challenge in developing countries and assistance is needed across the board, international taxation is a

high priority for many developing countries, not least due to the relatively higher reliance on revenues from MNEs in developing countries. The two-pillar solution to address the tax challenges of the digitalising economy is a major breakthrough that will enable more effective taxation of large enterprises. The global minimum tax provides a floor for international tax competition as well as new impetus for countries to review their tax incentives and eliminate those that are wasteful. Significant technical assistance will be needed to support these reviews and ensure the new rules are effectively implemented. The two-pillar solution is one of a range of standards established in recent years that provide countries with options to more effectively tax cross-border activity. The standards on base erosion and profit shifting (BEPS), exchange of information, and value-added tax on e-commerce all have potential benefits for developing countries Technical assistance is required for both legislative and administrative implementation of such international standards. These often require current expertise, which is in short supply globally.

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Notes

[1] Private philanthropy for development also continued to increase despite the pandemic, from USD 9.6 billion in 2020 to USD 10.4 billion in 2021, based on preliminary OECD estimates (OECD, 2022[228]).

[2] Stock-based measures capture fluctuations in the value of financial assets held by actors such as banks, central banks, financial auxiliaries, insurance corporations, other financial intermediaries, pension funds and public financial institutions. Asset valuations are counted in the measure of stocks or asset purchases rather than as a flow-based measure.

[3] These are author's calculations based on the Luxembourg Stock Exchange DataHub at https://lgxhub-premium.bourse.lu.

[4] It should be noted that the Global Sustainable Investment Alliance figures include an aggregation of amounts of sustainable investment reported by regions and that regions use a variety of different methodologies.

[5] This international collaboration of asset owners was convened by the UN Environment Programme Finance Initiative and the Principles for Responsible Investment to respond to Article 2.1c of the Paris Agreement and enable financial flows to support the transition to net-zero CO_2 emissions economies by 2050.

[6] The price of Brent crude oil tripled in 2020-22, reaching USD 121 per barrel, the highest price since 2008. See https://www.nasdaq.com/market-activity/commodities/bz:nmx.

[7] The median time lag for GDP per capita in developing countries to reach high-income country levels of GDP per capita was estimated in 2020 to be 74 years. For more information, see https://doi.org/10.1007/s11205-020-02488-4.

[8] In 2019, informal employment represented on average 63% of employment in African countries. In 15 African countries, more than 80% of employment was informal employment.

[9] The International Energy Agency defines stranded assets as "those investments which have already been made, though at a point in time prior to the end of their economic life (as assumed at the investment decision point), are seen to no longer earn economic returns as a result of changes in the market and regulatory environment brought about by climate policy".

[10] The figure reflects World Bank estimates. Costs would include the remaining financial value of the asset (although the economic value would be lower), the costs of decommissioning coal-fired power plants, and the costs of social and job dislocation. These will be country specific and require further analysis and specification; estimates vary widely.

[11] The INFF concept was first introduced with the adoption of the Addis Ababa Action Agenda in 2015.

[12] The Central African Forest Initiative was established in 2015 following the adoption of the Paris Agreement by a coalition of donors (Belgium, the EU, France, Germany, the current chair, Korea, the Netherlands, Norway, and the United Kingdom); six partner countries (Cameroon, Central African

Republic, Republic of the Congo, Democratic Republic of the Congo, Equatorial Guinea and Gabon; and implementing organisations and South-South partners.

[13] The International Platform on Sustainable Finance to date comprises EU member states as well as Argentina, Canada, Chile, China, India, Indonesia, Kenya, Morocco, New Zealand, Norway, Senegal, Singapore and Switzerland. The Coalition of Ministers for Climate Action also supports the platform.

Global Outlook on Financing for Sustainable Development 2023

NO SUSTAINABILITY WITHOUT EQUITY

Successive crises including COVID-19, Russia's war of aggression against Ukraine and the climate emergency are exacerbating inequalities between and within countries and stifling progress to achieve the Sustainable Development Goals (SDGs) and the Paris Agreement. While developed countries deployed historic stimulus packages to build back better, developing countries lacked fiscal and monetary buffers to respond. Countries with the fewest resources face challenging trade-offs between short-term rescue and long-term financing for a sustainable recovery. The SDG financing gap in developing countries grew due to a drop in available resources called upon in the Addis Ababa Action Agenda coupled with rising financing needs. Official Development Assistance (ODA), or aid, played an important role to help narrow the gap, but could not do so on its own. Global crises open a window of opportunity for SDG alignment of broader resources to narrow the gap. Growing trillions in developed countries aim to reduce risks, including environmental, social, and governance (ESG) criteria. However, resources are not reaching the countries most in need. Urgent action is needed to remove bottlenecks for a more equitable and needs-based allocation of sustainable finance.

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