Development Finance

Innovations for Sustainable Growth

Edited by
Nicholas Biekpe
Danny Cassimon
Andrew William Mullineux

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Preface

Overview

This textbook brings to focus core areas of development finance with special relevance to the strengthening of development finance research and training in an emerging market context. Unlike professional disciplines (e.g. engineering, accounting and economics), development finance (which is simply finance applied in a developmental context) is a relatively new entrant into the wider fields of research and training. Much work still needs to be done to develop and strengthen development finance capacity building and this book is a first crucial step aimed at establishing and strengthening academic and practitioner engagements in development finance research and training.

Binding Themes and Tone of Book

The chapters of the book were carefully selected to generate and stimulate discussions and debates around key knowledge attributes which define development finance research. Even though development finance is generic in content and applications, the book has been successful in conveying specific high level applied research with critical applications in an emerging markets context.

Subject Areas

The areas selected for the book are broadly specific in content but are closely linked, in their applications, to their applications in the African and other emerging markets settings. The areas covered are as follows:

- Domestic Resource Mobilization in Africa: Capacity Imperatives;
- Tax Buoyancy: A Comparative Study Between Kenya and South Africa;
- The Impact of Microfinance on Household Livelihoods: Evidence from Rural Eritrea;
- Reflections on Microfinance;
- A Chameleon Called Debt Relief: Aid Modality Equivalence of Official Debt Relief to Poor Countries;
- Foreign Direct Investment and Economic Growth: The Structural Vector Autoregressive Approach for South Africa;
- Foreign Capital Flows and Output Growth Volatility in Selected Sub-Saharan African Countries;
- Do Remittances Matter in Accelerating Labour Productivity and Capital Accumulation?

Target Audience

The book serves as a reference text with target audience including academic institutions, researchers, postgraduate students in development finance, development economists and other individuals and institutions interested in learning more about the critically important and fast growing area of finance for development. The book will also benefit researchers working in development finance institutions and research staff of central and investment banks.

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Chapters from the book are from the *2015 Global Development Finance Conference* which took place on 29–30 October 2015 at Cape Town, South Africa. The Conference was organized by *Chartered Institute of Development Finance (CIDEF)* in partnership with Africagrowth Institute, partner academic institutions and other private sector institutions. This book has benefitted tremendously from the expert knowledge and experience of academics and researchers with a passion for development finance research and training. Our gratitude is extended to all contributing authors who have worked tirelessly to ensure that quality and the correct content specifications are achieved. Special gratitude goes to the Co-Editors of the book (Professor Nicholas Biekpe, Professor Danny Cassimon and Professor Andy Mullineux) for providing solid mutual collaborative efforts to ensure that the book meets the expected quality parameters prescribed by the publisher. Special thanks to Karel Verbeke and Dr Latif Alhassan for the excellent research assistance and technical support. Last but not the least, hurray to the hardworking CIDEF staff (Dina Potgieter, Kirk De Doncker and Lydia Le Roux) for organising the 2015 Global Development Finance Conference and for ensuring that the conference papers were ready for inclusion into the book.

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List of abbreviations

AAA	Addis Ababa Agenda
ACBF	African Capacity Building Foundation
ACI	Africa Capacity Index
ACR	Africa Capacity Report
ADF	Augmented Dicker Fuller
AEO	African Economic Outlook
AfDB	African Development Bank
AIC	Akaike Information criterion
ARCH	Autoregressive Conditional Heteroskedasticity
ATT	Average Treatment Effect on the Treated
AU	African Union
BoP	Balance of Payment
C2D	Contrats de Désendettement et de Développement
CBI	Community Based Institutions
CIA	Conditional Independence Assumption
DAC	Development Assistance Committee (of the OECD)
DRM	Domestic Resource Mobilization
ECA	Economic Commission for Africa (of the United Nations)
EITI	Extractive Industries Transparency Initiative
EL	Employee Loan
ER	Exchange rate
EV	Economic Value
FAO	Food and Agriculture Organisation
FDI	Foreign Direct Investment

FfD	Financing for Development
GARCH	Generalized Autoregressive Conditional Heteroscedasticity
GBS	General Budget Support
GDP	Gross Domestic Product
GFDI	Gross fixed domestic investment
GMM	Generalised Method of Moments
GMM-IV	Generalized Method of Moments-Instrumental Variables
GRA	Ghana Revenue Authority
HH	Household
HIPC	Heavily Indebted Poor Countries
IAL	Irrigated Agricultural Loan
IATF	Inter-Agency Task Force on Financing for Development
IDA	International Development Association
IDA-DRF	International Development Association's Debt Reduction Facility
IFF	Illicit Financial Flows
IV	Instrumental Variable
LR	Likelihood Ratio
M&E	Monitoring and Evaluation
MBL	Micro Business Loan
MDGs	Millennium Development Goals
MDRI	Multilateral Debt Relief Initiative
MFI	Microfinance Institutions
MNCs	Multi-National Corporations
NDS	National Development Strategy
NGO	Non-Governmental Organisation
NSEO	National Statistics and Evaluation Office
ODA	Official Development Assistance
OECD	Organisation for Economic Cooperation and Development
OL	Oxen Loan
OLS	Ordinary Least Squares
PPS	Public-Private Partnerships
PSM	Propensity Score Matching
PV	Present Value
RCT	Randomized Controlled Trials
RDF	Rapid Deployment Force (Ghana)
SBL	Small Business Loan
SBS	Sector Budget Support

SC	Schwarz-Bayesian Criterion
SDGs	Sustainable Development Goals
SDI	Sustainability Dependent Index
SE	Standard Error
SMCP	Savings and Microcredit Programme
SME	Small and Medium-sized Enterprises
SSA	Sub-Saharan Africa
SSAL	Small Seasonal Agricultural Loan
SVAR	Structural Vector Autoregressive
TFCA	Tropical Forest Conservation Act (US)
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNU-WIDER	United Nations University World Institute for Development Economics Research
VAR	Vector Autoregressive
VAT	Value-Added Tax
VIF	Variance Inflation Factors
VMA	Vector Moving Average
WC	Windmeijer's Correction
WDI	World Development Indicators
WFP	World Food Programme

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Development Finance and Its Innovations for Sustainable Growth. An Introduction

Nicholas Biekpe, Danny Cassimon and Karel Verbeke

1.1 Introduction

Development finance is all about assuring that the necessary financial resources are mobilized and utilized in an efficient, effective and sustainable way so as to promote development and meet particular (sustainable)

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development outcomes and goals. These goals can be set at different levels, ranging from global, to national (country) and even local level. At global level, the current reference framework is offered by the Sustainable Development Goals (SDGs), to be met by 2030, and the need to mobilize the necessary financial means to 'finance' its realization, which is typically referred to as the 'Financing for Development (FfD)' process. At individual country (and sometimes even sub-national) level, it deals with financing the realization of national development strategy plans, preferably designed and executed through a country-owned inclusive process, which provide similar and complementary framework to meet country-specific development goals, which may or may not be closely linked to the global process. At local level, it refers to the extent to which local communities and even individual households have access to appropriate financial services to meet their specific human development needs.

To the extent that there is a gap between required and currently available funding to meet the goals and needs, the FfD process, at all levels, tries to tackle this problem through a combination of (a) an increase in the level of current existing sources of finance as well as (b) trying to tap additional sources of finance, to make sure that this gap gets closed; often, it also deals with efforts to enhance the efficiency or effectiveness of their use at innovative ways of realizing this process, both in terms of the use of innovative instruments as well as innovative 'technologies' to enhance its effectiveness in producing desired outcomes and meet targets.

This book tries to lend a helping hand to realizing this intrinsic ambition of development finance by bringing together a selection of papers from the *2015 Global Development Finance Conference* by Africa's growth that focus on key thematic areas of the FfD process, highlight neglected areas of research, and/or offer or provide country-level case study evidence in the hope of advancing our knowledge in this field.

This overview chapter takes off by situating development finance within this FfD framework and its associated current action agenda, the Addis Action Agenda. It then continues by presenting a brief overview of the rest of the book, clustered by some of the major themes identified in the international development finance agenda. For each of these themes treated, this chapter first provides a brief sketch of the key issues at play, followed by a brief presentation highlighting how the particular chapter links to these key issues; consequently, it then summarizes the key conclusions of the chapter and its main contributions and novel insights to the field.

1.2 Development Finance from a 'Financing for Development' Perspective

Financing for development is a broad concept, encompassing not only the use of international financial resources, including Official Development Assistance (ODA), but also the mobilization of domestic resources (including tax revenues), the strengthening of the role of the private sector in financing development or other types of broadening the funding base by innovative financing resources and mechanisms; it even dwells in more diverse areas such as increasing trade capacity and investment to drive economic growth and other more systemic issues related, for example, to the creation of an international enabling environment and global governance.

This holistic approach has been present from the start of the 'FfD' process, kick started at the Monterrey Conference in March 2002 and producing the 2002 Monterrey Consensus (United Nations 2002), as a framework to ensure the financing of the Millennium Development Goals (MDGs), to be reached by 2015. This Monterrey Consensus recognized that all sources of financing, *public* and *private, international* and *domestic*, were needed to finance development; this was reaffirmed in the follow-up FfD Conference of 2008 in Doha, and its outcome 2008 Doha Declaration on FfD (United Nations 2008).

While the Monterrey Consensus still emphasized the crucial and central importance of (public) development cooperation and concessional financing, it was clear from the beginning that this source of finance would not be sufficient to produce the MDGs and close the gap between available and necessary financing and that this source of international finance was dwarfed by other international sources. Figure 1.1, taken from the contribution of Dzeha et al. in Chapter 9 of this book, shows that, whereas in the past, ODA constituted up to 70% of financial

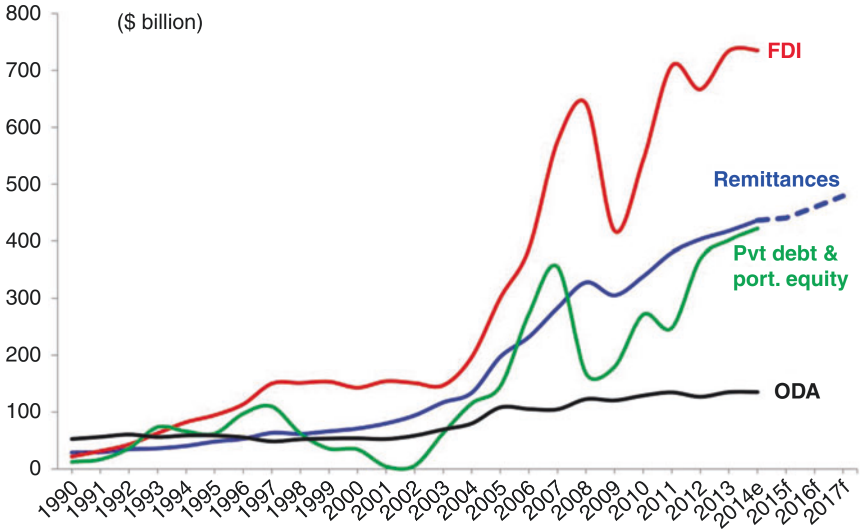

Fig. 1.1 Evolution of different types of external flows.

Source: Ratha et al. (2015, p. 5).

flows to developing countries, its proportion of all financial flows continues to decrease. Flows related to foreign direct investments (FDI), portfolio debt and equity flows, as well as remittances now make up the lion's share of external flows. As such, it was crucial to include these other international flows into the process and enhance their development-orientedness. Moreover, it was crucial to make sure that these other types of external finance became more available to lower-income countries, which remain relatively more excluded from these private flows and continue to rely more on ODA-related flows (see e.g. Cassimon et al. 2013).

Furthermore, focusing solely on international flows to meet these international goals would not only deny the prime responsibility of countries to mobilize resources for development domestically, first and foremost from public (fiscal) sources, but it would also hide its huge relative potential. Clearly, domestic public revenue mobilization (DRM) dwarfs by far any international source of development finance. It more than doubled in developing countries between 2002 and 2011, increases from 838 billion USD to 1.86 trillion USD in that period (Inter-Agency Task Force on Financing for Development 2016, p. 7). Again, the picture is different between low-income and middle-income countries. While the median tax-to-GDP ratio of middle-income countries has increased over time and is now close to 20%, almost half of low-income countries (and 70% of fragile and conflict-affected states) still raise less than 15% of GDP in taxes in 2014 (IMF and World Bank Group 2016), so these are still a lot of potential for improvement and additional revenue mobilization. But still, in 2010, for example, Sub-Saharan African countries in total collected nearly 10 USD in own-source revenue for every USD of foreign assistance received (World Bank Group 2013, p. 10). This DRM should be complemented by domestic private sources, including through an efficient domestic financial system that provides households and SMEs access to appropriate financial services.

The process to develop the 2030 Agenda for Sustainable Development, leading to its adoption at the United Nations Sustainable Development Summit on 25 September 2015, has led to a new impetus of the thinking on how to further broaden financing of development. The Third International Conference on FfD held in Addis Ababa from 13 to 16 July 2015, approved a comprehensive Action Agenda, aimed at supporting the implementation of the 2030 Agenda. This Addis Ababa Agenda (AAA) identifies seven key action areas in the field of FfD, as well as a framework for data collection monitoring and follow-up (United Nations 2015). The main multilateral organizations and agencies involved, with the World Bank Group, IMF, WTO, UNCTAD, UNDP as the major ones and the FfD Office at the UN acting as the coordinator, were joined in an Inter-Agency Task Force on Financing for Development (IATF) responsible not only for implementing key ingredients of the AAA, but also for providing support to this monitoring process (see especially IATF 2016, for their inaugural report). Their activities should be complemented by interventions of national development finance institutions that operate mainly domestically.

These seven action areas of the AAA are

A. Domestic public resources
B. Domestic and international private business and finance
C. International development cooperation
D. International trade as an engine for development
E. Debt and debt sustainability
F. Addressing systemic issues
G. Science, technology, innovation and capacity-building

As such, the AAA clearly builds on and confirms the Monterrey and Doha agendas, while enhancing it on a number of issues. It reaffirms the primary responsibility of (developing) countries themselves, and their public actors, for resource mobilization and development, as well as for the provision of an enabling environment to crowd in private resources for development. And it reaffirms the responsibility of international public actors, through international development cooperation and the provision of an international enabling environment that again crowds in private sector contributions. Furthermore, the important role of science, technology, innovation and capacity-building, touched upon in the previous agendas, is now being accentuated and given more detailed and separate treatment.

The AAA mainly goes beyond the previous ones by focusing on the central concept of 'sustainable' development, introducing policy actions to realize all its three dimensions, *economic, social and environmental*, emphasizing new dimensions such as sustainable global production and consumption patterns, environmental protection and the use of climate finance-specific financial instruments (Inter-Agency Task Force on Financing for Development 2016). Also from this sustainability perspective, it explicitly refers to debt sustainability as a separate key area.

One important additional key area that appears as a key cross-cutting area throughout the whole FfD process, from the beginning at Monterrey until today, is that of innovative finance. As already mentioned in the introduction to this chapter, the need to fill the gap between available and necessary resources fuelled the search for and use of 'new', 'additional' or 'innovative' financing options and instruments, as well as innovative 'technologies' to enhance its effective use in producing the desired development goals. The joint occurrence of tightened aid budgets against a broadening international development agenda has over the past decade led to an intensification of this quest.

The term covers a broad range of new actors and new sources of development funding. While the term is widely used, a universally agreed definition is lacking and the use of the term has changed over time; as a result, the terms mean different things to different people. Some leading fora, such as the so-called 'Leading group on Innovative Financing for Development', a group of 66 states and numerous international and non-governmental organizations, focus on new innovative financing modalities and initiatives at the global level, such as new international taxes such as a Tobin-type tax, an international solidarity levy on air tickets, idea such as Advanced Market Commitments to crowd in private research to cure neglected tropical diseases, or an International Finance Facility for Immunization. Others, often lead by The World Bank, focus more on innovative finance as 'add-ons' to existing instruments, that aim at providing additionality, or enhance its efficiency and/or results-orientedness. They focus more on funding coming from emerging sovereign donors, Public-Private Partnerships (PPS) or other forms of blended financing such as through guarantee instruments (especially in the case of infrastructure finance), the development of local currency bond markets or results-based financing (such as development impact bonds) as innovative solutions for development financing.

A very broad definition, that is often used, refers to innovative finance as 'involving non-traditional applications of solidarity, PPS and catalytic mechanisms that (1) support fundraising by tapping new sources and engaging beyond the financial dimension of transactions, as partners and stakeholders in development; or (2) deliver financial solutions to development problems on the ground' (Ketkar and Ratha 2009). It is in this very broad sense that we will refer to innovative finance throughout this chapter and the book.

While the importance of innovative financing mechanisms is still limited compared to more traditional ODA, the range of instruments and amounts invested in these instruments is growing, certainly when the funds indirectly mobilized from the private sector are taken into account. The broadening of the FfD agenda to sustainable development and the inclusion of climate-finance-related innovative financing (see e.g. UN DESA 2012) will definitely increase the relative importance of innovative finance.

In the next section, we will present a brief overview of each of the chapters of this volume and also show how each of them links to the major themes of the current FfD debate and the AAA.

1.3 An Overview of the Chapters and Their Link with the International FfD Debate

1.3.1 Domestic (Public) Resource Mobilization

As already mentioned in the previous section, in the course of three successive International FfD Conferences, the mobilization of domestic resources has gradually emerged as the priority sector in mobilizing higher and more sustainable levels of development finance. This is particularly true for the low-income or least-developed countries, as their public revenue mobilization rates (tax revenues in percentage of GDP) are particularly low. Moreover, and again especially for these latter countries, mobilization of (public) domestic resources also reduces dependency on aid, encourages good governance and accountability and helps strengthening the social contract between governments and their citizens. Strengthening of tax administration, fight against fraud and tax evasion are recognized as essential factors to increased domestic resource mobilization.

Apart from reaffirming the continued effort to increase tax rates and increase their efficiency, two distinctive new features of the AAA in the field of DRM concern (a) the increased importance attached to efforts of capacity building to increase this performance, and (b) the increased focus on curbing illicit financial cross-border outflows that reduce DRM availability, through techniques such as tax evasion, corruption, smuggling or less illegal (strictly speaking) through tax avoidance or transfer pricing techniques (see e.g. Reuter 2012; HLP 2015). The two contributions in this key area focus exactly on these three elements.

In Chapter 2, Nnadozie, Munthali, Nantchouang and Diawara start form the observation that the capacity component of DRM appears to have received little attention in the development discourse. As such, they attempt to fill this gap by identifying these capacity gaps in and their causal effects on the (lack of) mobilization of domestic resources among African countries. The authors hereby draw on the findings of the Africa Capacity Report 2015, which they analyse using a mixed methods approach. From this analysis, they identify weak tax administration, inefficient collection of tax in the agriculture and informal sectors, financial non-inclusiveness, as well as high levels of illicit financial outflows as the major capacity challenges faced. In their policy recommendations, the authors stress the need to strengthen capacity building of human and institutional capacity, not only at country but also at the regional level. Furthermore, it is crucial to modernize tax administration and promote full financial inclusion. The authors also point at the crucial dimension of political will and mind-set change at all levels.

From a more macroeconomic perspective, Chapter 3, by Mandela and Olukuru, extends the discussion on FfD to cover the efficiency of tax systems to maximize revenue for economic growth. More particularly, the authors employ annual data from 1972 to 2014 to estimate the buoyancies of income, value added, import and excise tax revenues. In doing so, they, interestingly, compare the experiences of a middle-income country, South Africa, with that of a low-income country, Kenya. Using a vector error correction model to estimate the short- and long-run tax buoyancy and its convergence property, the findings indicate the existence of both short run and long run tax buoyancy on economic growth in both countries.

1.3.2 Mobilizing Private Domestic Resources: The Role of Innovative and Sustainable Micro-Finance

One particularly important component of DRM does not relate to the public sector but relates to mobilizing private savings for ‘productive use’ (from a development goals perspective), as well as assuring that households as well as micro-enterprises and Small and

Medium-sized Enterprises (SMEs) are financially included, for example, have access to appropriate types of finance, in terms of savings, lending and insurance facilities. What is generally labelled as micro-finance has been put forward as the key solution to realizing this goal of universal financial access to finance. Furthermore, it has been shown convincingly that access to financial services can help achieve the SDGs (see e.g. Klapper et al. 2016). However, providing micro-finance in a 'sustainable' way, realizing all three dimensions of the concept, *economic, social and environmental*, has proven quite difficult. More particularly, it proves to be difficult to reconcile the more financial sustainability dimensions with the more social and poverty reduction dimensions. This is especially the case when providing assistance in rural areas, for longer-term agricultural activities (see e.g. Armendáriz de Aghion and Morduch 2010, for a recent, detailed overview).

In Chapter 4, Habte, Visser and Ocran address the shortfalls of the formal financial sector in improving financial inclusion in Eritrea. More particularly, this study examines the impact of microfinance on the livelihoods of households in rural Eritrea. It specifically sought to find out whether the *Saving and Microcredit Programme (SMCP)*, introduced by the Eritrean Government in 1996, to support the poorest of the poor, had a significant impact on the livelihood of its clients. The study employed logistic regression and propensity score matching estimation techniques. The findings reveal that households that participated in the *SMCP* had reported significantly higher profits, had more valuable assets, higher consumption expenditure, significantly improved nutrition, and increased savings. The findings have important social and economic policy implications regarding the role of finance in rural development in an African context.

In Chapter 5, Muriu, Murinde and Mullineux review the theoretical and empirical literature on microfinance to make a general assessment on its performance from a sustainability perspective. They also situate their analysis within the SDG perspective. They examine the tensions between formal and informal credit markets, review a number of regulatory and governance issues, and discuss both the impact of microfinance on poverty reduction, competition and financial performance. They conclude by identifying promising research ideas for future research, including the need for mainstreaming the gender dimension in microfinance to realize both financial inclusion and the SDGs and also suggest special attention to fragile states.

1.3.3 Debt Relief as Innovative International Aid and Vehicle to Restore Debt Sustainability

Apart from trying to increase the volume of aid, the international aid debate during the last two decades was dominated by the search for increased 'aid effectiveness'. Debt relief appeared prominently in this debate, as an intervention that could kill three birds with one stone, that is, restore debt sustainability while at the same time providing additional resources, as well eliminating the disincentive effects on investment and reform of high debt overhang (Krugman 1988), hence proving itself as effective aid.

In Chapter 6, Cassimon and Essers critically review this theoretical assumption through assessing three decades of official creditors' public debt relief practice from a novel angle, namely along debt relief's similarities with aid modalities. The analysis show that debt relief to poor countries is a true 'chameleon' which mimics different sorts of development aid, from traditional project aid to multi-year general budget support. The 'colour' of this chameleon depends on the embedded conditionality, alignment with recipient country policies and systems, and the budgetary resource effect of particular debt relief interventions. They argue that characterizing debt relief from an aid modality equivalence perspective is helpful in better understanding its varying performance track record. In this respect, more recent, comprehensive operations such as the HIPC and MDRI initiatives offer better perspectives in terms of effectiveness and restoration of debt sustainability. On the other hand, they also assess more innovative types of debt-development swaps, such as the Debt2Health swap operations put forward by the Global Fund (to Fight AIDS, Tuberculosis and Malaria) as ineffective interventions. As such, it