Blending private interests with taxpayer's money: Towards a development-investment nexus?

> "Our support is not just about development aid, it's about an investment in our partners, in return we gain stability, peace and prosperity and market opportunities for European companies."
>
> **Neven Mimica**
> European Commissioner for International Cooperation and Development, 2018[1].

Within the framework of the Sustainable Development Goals (SDG), the international community has officially acknowledged that public funding in the form of Official Development Assistance (ODA) will not be enough to meet the investments needed to reach the SDGs by 2030, which represent an estimated funding gap of US $2.5tn per year in Low Income Countries (LICs) and Middle Income Countries (MICs)[2].

Since the adoption of the Addis Ababa Action Agenda on Financing for Development in 2015, private sector investments have been increasingly seen as an untapped resource to financing sustainable development, along with domestic public resources and ODA. Based on the premise that the private sector drives economic growth and creates jobs – which is framed as the most effective trajectory to reduce poverty and improve quality of life – the private sector is seen as one of the 'silver bullets' to financing the SDGs. This resulted in increased rhetoric on mobilising and subsidising private sector investment with international public finance (in particular ODA) to make the jump "from billions to trillions[3]" and fill this funding and development gap.

Donors engage the private sector in development through a variety of channels including "blended finance" efforts, defined by the Organisation for Economic Co-operation and Development (OECD) as "the strategic use of official funds including concessional tools to mobilise additional capital flows (public and/or private) to emerging and frontier markets[4]". Thus, "blended finance" can refer to subsidised loans and guarantees, grants for technical assistance, and direct investments in private ventures (equity shares).

Global Health Advocates France (GHA) is a global health advocacy organisation dedicated to fighting diseases stemming from poverty and inequality. GHA's mission is to advocate for policy change at the highest political level and mobilise resources to tackle major health threats, build sustainable health systems and enhance health equity. GHA has offices in Paris and Brussels.

This brief is part of a series of policy briefs, which aims at analysing political trends in development finance and informing the decision-making process at the French, EU and global levels. GHA analysed new instruments developed by bilateral, regional and multilateral donors and their compliance with internationally-recognised principles of aid effectiveness. Instruments under scrutiny are: the Alliance Sahel, the Emergency EU Trust Fund for Africa (EUTF), the EU External Investment Plan (EIP), the World Bank's Global Financing Facility for Women, Children and Adolescents (GFF) and the Pandemic Emergency Financing Facility (PEF).

We developed and applied an analytical framework focusing on governance set-ups, agenda-setting processes, stakeholder engagement, types of funding mechanisms, implementation channels, transparency and accountability. Our analysis looked at decision-making and power dynamics both at the global and national levels to understand the design and implementation of these instruments.

We used a mix of literature review, official data and interviews with stakeholders based in Brussels, Paris and Washington, as well as fact-finding missions in Burkina Faso (November 2018), Sierra Leone (January 2019) and Uganda (March 2019). We met with representatives of governments, donors, development agencies, parliamentarians, UN agencies, as well as local and international civil society. We would like to thank all stakeholders who agreed to meet with us in Brussels, Paris, Geneva, Washington, Ouagadougou, Bobo Dioulasso, Kampala and Freetown and gave us first-hand accounts on design, implementation and monitoring of these instruments. A list of people interviewed can be found online in Annex I (www.ghadvocates.eu).

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While the EU states that private sector engagement "lies at the heart of the European Union's development agenda[5]", civil society has raised serious concerns about the effectiveness of blended finance[6]. In 2017, US $1.8bn of global ODA was used towards leveraging private sector investments[7]. This represents a 22% increase compared to the total ODA allocated to blending during the 2005-2013 period[8].

This policy brief reviews the lack of evidence regarding blending's financial additionality. It further tries to assess the development additionality of blending through the example of the European Union's largest blending mechanism: the EU External Investment Plan (EIP). It is critical to understand what kind of development model private sector investments promote, to what extent this funding leverages additional financing and delivers pro-poor development outcomes, benefits local initiatives and community actors, and ultimately reduces inequalities. In other words, is there a real "value for money" in using ODA to leverage private sector investments to reach the SDGs and ultimately end poverty?

What do we mean by private sector?

While mobilising the private sector is stated as "indispensable to meet the financing needs of the Agenda 2030[9]", this sector combines a heterogeneous category of actors that range from multinational companies to smallholder farmers. The OECD defines the private sector as "organisations that engage in profit-seeking activities and have a majority private ownership (i.e. not owned or operated by a government)[10]", including "financial institutions and intermediaries, multinational companies, micro, small and medium-sized enterprises (MSMEs), co-operatives, individual entrepreneurs, and farmers who operate in the formal and informal sectors[11]".

Financial additionality? Evidence still missing on blending's leveraging power

One of the main objectives of blended finance is to 'crowd in' commercial finance for development projects in order to increase the amount of money mobilised for each euro invested and ensure development impact. According to the OECD blending principles, blended finance should have financial additionality – meaning, it should "facilitate the unlocking of commercial finance to optimise total financing directed towards development outcomes[12]".

A recent study from ODI revealed that globally, the average leverage ratio of blended finance is US $0.75 for every US $1 invested by Development Financing Institutions (DFIs)[13]. In Low Income Countries (LICs), the ratio drops to US $0.37 for every US $1 invested[14]. Such leverage is significantly less than the 1:11 ratio projected for the EIP by the European Commission. This discrepancy aligns with criticisms of past EU blending facilities, which have failed to produce concrete evidence of a substantial leveraging ratio. Although the European Commission indicates the EIP's €4.1bn to €44bn ratio is based on "assumptions and experience of the last ten years of blending operations[15]", claiming that €3.4bn grant-financed blended projects yielded €26.2bn in loans from European DFIs[16], critics have pointed out that this is misleading, as it is often difficult to determine "who is leveraging who[17]".

> "Existing facilities tend to 'follow the market' by focusing on already popular areas for investment by public and private entities. Existing European-level blending facilities have largely seen both sides of the funding question – grant and loan – provided by European publicly owned institutions. This means there is no real 'leverage' of any additional resources, only a pooling of existing funding[18]".
>
> **Eurodad**
> A Dangerous Blend, 2013.

There is a consensus among civil society and academics that the potential leveraging effect of blended finance is limited[19]. According to ODI, the public sector has contributed up to 57% of blended-finance investments, and a staggering 73% in LICs[20]. This raises the question of whether public funding provides a real incentive for private sector investments. A 2014 report from the European Parliament argues that many publicly-backed investments actually replace or supplant private sector investments, showing that as much as "55% of the projects [undergone by 17 DFIs in Europe] would have gone ahead without the support of public finance[21]". Will instruments like the EIP attract previously untapped capital, or would that private investment have been made anyway?

THE EU EXTERNAL INVESTMENT PLAN 2017-2020

STRATEGIC BOARD

(European Commission, EU Member States, European Investment Bank, EU High Representative)
Mandate: Strategic guidance, overall investment goals, overall coordination

PILLAR 1

EUROPEAN FUND FOR SUSTAINABLE DEVELOPMENT (EFSD) €4.54bn
Managed by the European Commission

Africa Investment Platform | **Neighbourhood Investment Platform** — **€3bn**

Regional Operational Boards

Types of support
technical assistance; investment grants; financial instruments; interest rate subsidy; equity; guarantee

EFSD Guarantee — **€1.54bn**

European Commission in close cooperation with DFIs

Type of support
guarantee: leveraging financing by limiting investors' risks

PILLAR 2

TECHNICAL ASSISTANCE

- Support for partner-country project development
- Support for improvements in regulatory and policy environment
- Capacity support for private-sector representatives

PILLAR 3

IMPROVING THE INVESTMENT CLIMATE

- Strengthened dialogue between EU Delegations and European and local businesses
- Political dialogue to support good governance, regulatory and policy reforms
- Coherence with EU and Member States initiatives

The EFSD Guarantee may mitigate the following types of risks:

commercial risks
losses due to a borrower or counterparty failing to meet its obligations in accordance with agreed terms (e.g. payment risk, performance risk, etc.)

political and country risks
all risks relating to actions of a state or a government, over which the investors have no influence (e.g. expropriation, coup d'etat, civil war, legal and regulatory risk)

currency risks
potential losses due to fluctuations, convertibility, transferability and exchange rates

climate change and environmental risks
(e.g. droughts, flooding, extreme weather events, temperature rises, etc).

5 OPERATIONAL WINDOWS

CONNECTIVITY & ENERGY | DIGITALIZATION | AGRICULTURE | URBAN DEVELOPMENT | MSMES FINANCING

AECID — AFD — AfDB — COFIDES — EDFI — EBRD — EIB — FMO — IFC — KfW

EFSD Guarantee: 28 guarantees signed with Development Finance Institutions and Multilateral Development Banks worth €1.54bn, expected to leverage €17.5bn, much of it from private sources

OVERALL EFSD = LEVERAGE €44BN of PRIVATE INVESTMENTS

In 2017 the European External Investment Plan (EIP) was launched by the European Commission to mobilise private sector investments in Africa and the EU Neighbourhood. The EIP has three operational pillars: (1) the European Fund for Sustainable Development (EFSD) – of which the new EFSD Guarantee, (2) technical assistance, and (3) improving the investment climate. Within the first pillar, there are 28 guarantee schemes, under which several development banks will benefit from the EFSD guarantee which can be called on by these banks if projects encounter challenges that limit their success, including political, commercial, climate and currency fluctuation risks. Essentially, public money can be used to de-risk private sector investments. In other words, the cost of negative externalities and project failure is transferred to the public sector. The EIP aims to "mobilise and leverage sustainable public and private investments to improve economic and social development with a particular focus on decent job creation."[i] The European Commission has committed €4.1bn of public money to the EFSD in the period 2017-2020, which claims to leverage more than €44bn of private investments by 2020 with a ratio of 1 to 11.[ii] To date, only one of the 28 guarantees has been signed, back in December 2018. The European Commission's website claims that others will be signed in early 2019.[iii] This slow take-up, two years after the adoption of the EFSD regulation, perhaps also suggests that the financial approach is posing some serious challenges in its implementation. It is therefore premature to assess EFSD's implementation, and all the more premature to suggest a scale up, as is already the case with the EFSD+ in the next Multi-Annual Financial Framework proposal.

i European Commission, 2019. What is the EU's External Investment Plan? Available at: https://bit.ly/2puydOT
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Due to the lack of clarity around the definition of blended finance, there is a lack of a harmonised framework across financial institutions to calculate leverage effects and ratios[22]. Therefore, there is little evidence that shows additional funding has been made available through blended finance. Unless a common and harmonised framework across donors is developed, the leverage effect is at the sole discretion of each donor agency, which can lead to - or be perceived as leading to claims of a higher return than objectively observed. With constrained development budgets, every euro invested into blending ambitions is one less euro that can be spent on proven pro-poor programming.

> "It is surely not the DFI's fault that the SDGs set such ambitious targets, but it is their fault they suggested they could play such a big role to meet them. Billions to trillions was based on faulty premise that DFIs and multilateral development banks could be a major force behind aggregate private investment decisions when they are only one factor amongst many in terms of investment flows[23]."
>
> **Centre for Global Development**
> Marginal, not Transformational, 2019.

Mutually beneficial in theory; structurally unequal in practice

Beyond the leverage effect, a key argument often raised in support of blended finance, is that it will be mutually beneficial and create jobs, thereby raising the standard of living in partner countries through new investment opportunities[24]. In theory, this would mean that both the EU and partner countries would benefit equally from blending outcomes. Promoters of blended finance in development also claim it represents a new form of "partnership", between donors and recipient countries. This approach has been pushed at the highest level by former European Commission President Jean-Claude Juncker with the launch of the "Africa-Europe Alliance for Sustainable Investment and Jobs". The Africa-Europe Alliance aims to "complement the long-standing political partnership between the two continents" by deepening "the economic and trade relations and goes beyond a donor-recipient approach, an "equals' alliance[25]".

> "Africa does not need charity, it needs true and fair partnerships. And Europe needs this partnership just as much[26]".
>
> **Jean-Claude Juncker**
> State of the Union Speech, 2018

Does this mean that in practice, governance and priority setting will be shared by, and equally driven by both parties? The way the EIP was built tells another story.

Governance – EU as the sole driver

The EIP is governed by a strategic board, which leads the orientation and priorities of the instrument, consisting of the European Commission, the High Representative for Foreign Affairs and Security Policy, Member States and the European Investment Bank (EIB), while the European Parliament acts as observer. The European Fund for Sustainable Development (EFSD) – the main funding window of the EIP – is managed by the European Commission in Brussels through a secretariat and two operational boards. Recipient countries and local civil society are neither represented in the governance of the EIP nor the EFSD, although "contributors, eligible counterparts, partner countries, relevant regional organisations and other stakeholders may be given observer status, where appropriate[27]". In other words, it is neither the countries themselves, nor even the EU Delegations in country, that participate in projects' approval and allocation of funding. This risks undermining country-ownership and questions the narrative of equal partnership behind the instrument.

> "If country ownership was the real priority, then the choice over whether to use blending would be made on a country-by-country basis by national citizens, not imposed top-down through large donor-driven facilities[28]".
>
> **Eurodad**
> Mixed Messages, 2017

Implementation in favour of large and foreign companies

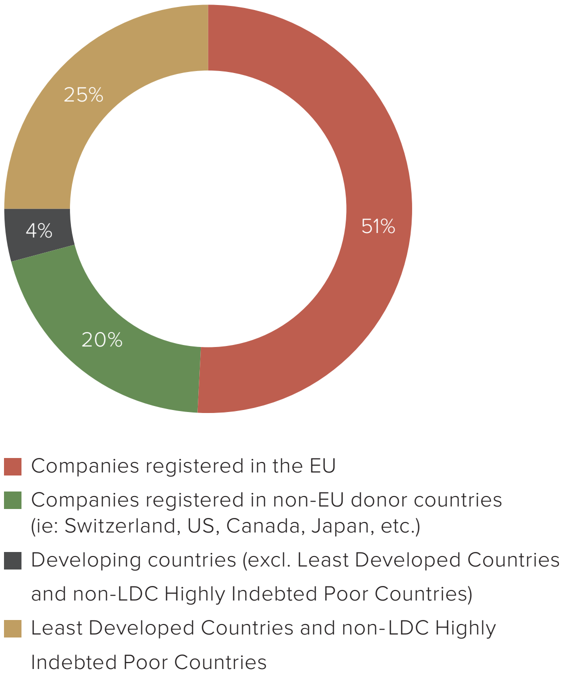
Although the EFSD Guarantee has a specific thematic focus on micro, small and medium-sized enterprises (MSMEs), development banks won't have the administrative capacity to finance individual MSMEs themselves. In order to support MSMEs, the European Commission signs guarantees with development banks, which in turn contract financial intermediaries (national banks, and/or investment funds) that pass credit lines or take equity into MSMEs[29]. Under this setting, evidence shows the number of intermediaries makes it challenging for donors to track which type of actor ends up being supported and evaluate the pro-poor outcomes of public investments[30]. Furthermore, the EU Jobs and Growth Compact for Uganda states that "the EU Delegation will [...] specifically [target] micro and small companies which *cannot have a direct access to the tools provided by the EIP*[31]" (emphasis added), putting into question the ability of the EIP in funding small local economic actors. This concern was further confirmed by an EU development expert who identified a lack of opportunity for informal, micro-enterprises as a main challenge of the EIP[32].

In Uganda, it is acknowledged that companies with full or partial EU-ownership are generally larger and more advanced[33]. This means that they are better suited to take advantage of the financial opportunities of the EIP or other blending facilities than the majority of Ugandan-owned companies. Indeed, the Ugandan economy is dominated by MSMEs, with "more than 93% micro enterprises, engaging at most 4 persons each. The majority of these enterprises are family based, with no formal skills, no clear addresses and usually operating in an informal manner[34]". Unless safeguards are in place to stipulate a prioritisation of local private sector actors, the EIP's potential to effectively engage with the majority of local enterprises is jeopardised. Although the EFSD regulation mentions six times the particular focus on "micro, small and medium-sized enterprises[35]", it only stipulates once that local businesses should be prioritised.

Given the EU's track record in contracting mostly European companies through its ODA-funded procurement, concerns arise that foreign or partly-foreign owned companies will dominate access to EIP funds. The EU reported 72% of its total ODA as untied in 2016[36] (meaning the legal and regulatory barriers are removed to open competition for funded procurement), but the majority of EU aid contracts continue to be awarded to companies registered in the EU (51%) or in other donor countries (20%) (see Figure 1).

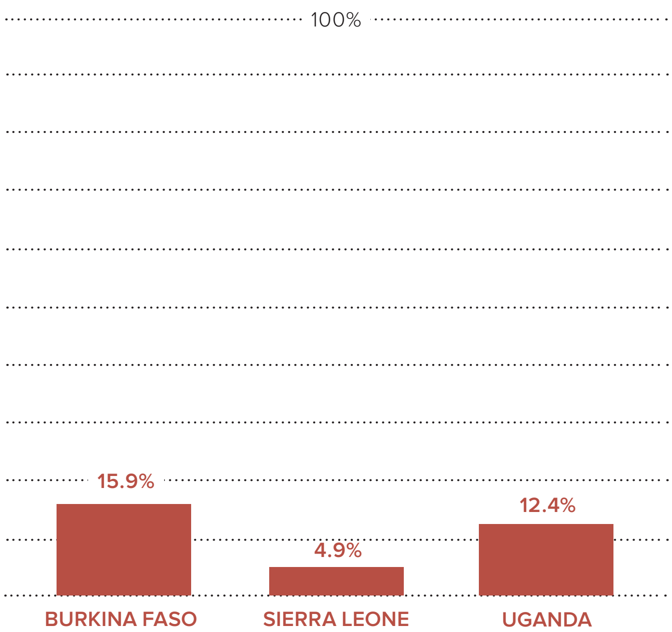
In comparison, only 29% of EU aid contracts were awarded to companies of developing countries. Burkina Faso, Sierra Leone and Ugandan national companies have respectively won 15.9%, 4.9% and 12.4% of ODA contracts implemented in their countries between 2008 and 2016 (see Figure 2).

Figure 1
Total aid contracts awarded by EU institutions in 2016 (USD millions)



Source: OECD DAC, 2018 Report on the DAC untying recommendation

Figure 2
Share of aid contracts awarded to recipients' national companies (2008-2016)



Source: OECD DAC, 2018 Report on the DAC untying recommendation

Global development policy vs EU economic diplomacy: which will prevail?

> *"Many EU Delegations in Africa were set up with development in mind and have not been well suited for pursuing EU interests. This is starting to change. […] The EIP is fully aligned with the EU's economic diplomacy objectives[37]".*
>
> **Representative of the European Union**, 2019

The promotion of European Economic Diplomacy (EED) began four or five years ago, but saw a boost after the publication of the Harnessing Globalisation Reflection Paper in 2017[38]. That same year, guidelines were given to EU Delegations in partner countries to identify economic priorities (by discussing with relevant stakeholders) and submit a report. By mid-2019, 107 delegations had completed the assignment. These reports help inform the overarching EED strategy in each region. The reports are not endorsed by partner countries, but governments are supposed to be one of the parties consulted (along with the local and international private sector). There has been no attempt to include civil society, either local or European, into the consultations. The reports are not public, and they have only been shared with EU Member States. The EED team (located in the European External Action Service) has been coordinating closely with DG TRADE and DG GROW to further develop EU policies around economic diplomacy.

Blending 2.0: equally unresponsive to equity

Evidence shows that blending projects do not always align with development effectiveness principles like country ownership, transparency and accountability and that projects have not focused on reducing poverty[39]. At the EU level, blending facilities have not been shown to have a strong pro-poor dimension, as recognised by the European Commission itself in a recent evaluation[40]. In EIP countries of operations, stakeholders have already questioned the instrument's ability to reach underserved communities, such as those living in poverty, youth, women and other vulnerable groups[41].

Blended finance to date has been primarily concentrated in three sectors: infrastructure, banking and "productive" sectors, "possibly due to the fact that there is limited opportunity to invest at scale in the social sectors in a way that is efficient for structuring blended-finance transactions[42]". For example, despite the agricultural window in the EIP, representatives from both EU Delegations and the European Commission in Brussels, confirmed that the agricultural sector is not ideal for blending because of the inherently high risks for investors due to weather, seasons and other unpredictable variables[43]. Yet, in Uganda, the majority of people living in poverty[44], as well as the majority of youth[45], are employed in the agricultural sector[46].

Uganda and Sierra Leone struggle with high interest rates (19.4% and 17.9% respectively[47]), meaning only projects that will have a very profitable return rate will be able to pay back such high interests to the bank. These interest rates may result in the exclusion of micro and small businesses, and enterprises in sectors that have lower return rates, from accessing loans.

> "Many investments in social sectors do not have high return rates, like health care. Even green energy, which does have a huge payback, is not well-suited for the EIP because it has a really big initial investment and the payback is more long-term, which means the interest rate would still be too high for the projects. This is why local banks mostly fund real estate and business finance but not renewables: this is way out of their model[48]".
>
> **Representative of an EU Member State development agency,** 2019

EU representatives claim these issues will be solved by Pillars 2 "technical assistance" and 3 "improving the business climate[49]" of the EIP, despite the fact that these pillars lack clarity at the early implementation stage. In Burkina Faso and Uganda, none of the EU Delegations' officials were able to explain what these two pillars would consist of concretely, beyond informal dialogue between the EU and national stakeholders[50]. They were also unable to disclose how they would roll out these pillars in order to reach those objectives. To date, technical assistance of blended finance has been criticised as a means of building "a pipeline of deals for the lead European DFIs, rather than responding to beneficiary needs[51]".

Another risk identified by stakeholders in country[52] is the EFSD's inability to reach the informal sector, despite the prevalence of the informal sector in most LICs. For example, the informal economy in Sierra Leone was estimated at about 45% of the country's GDP by the World Bank[53]. In Burkina Faso, informal jobs represent 99% of all jobs in rural areas[54]. Since informal companies are not registered, they do not have access to the financial tools of the formal economy or the opportunities provided by blended finance mechanisms.

The informal sector is defined by the EU as the "part of the economy – including enterprises, jobs, and workers – that is not regulated or protected by the State[55]". This generally refers to unregistered establishments and household enterprises, which have no social security.

Since the EIP focuses its accessibility on the formal sector, is it likely to reach youth and women equally? For example, in Burkina Faso, women represent only 24.2% of those employed in the formal sector[56]. Meanwhile in Uganda, the informal sector is the main opportunity for the non-agricultural workforce, with young people occupying 95% of those jobs[57]. Thus, there is a risk of the EIP failing to reach the youth, or be gender equal. How will the EIP contribute to the eradication of poverty – still stated as the primary goal of EU development funding[58] – if it does not serve the groups most structurally affected by poverty?

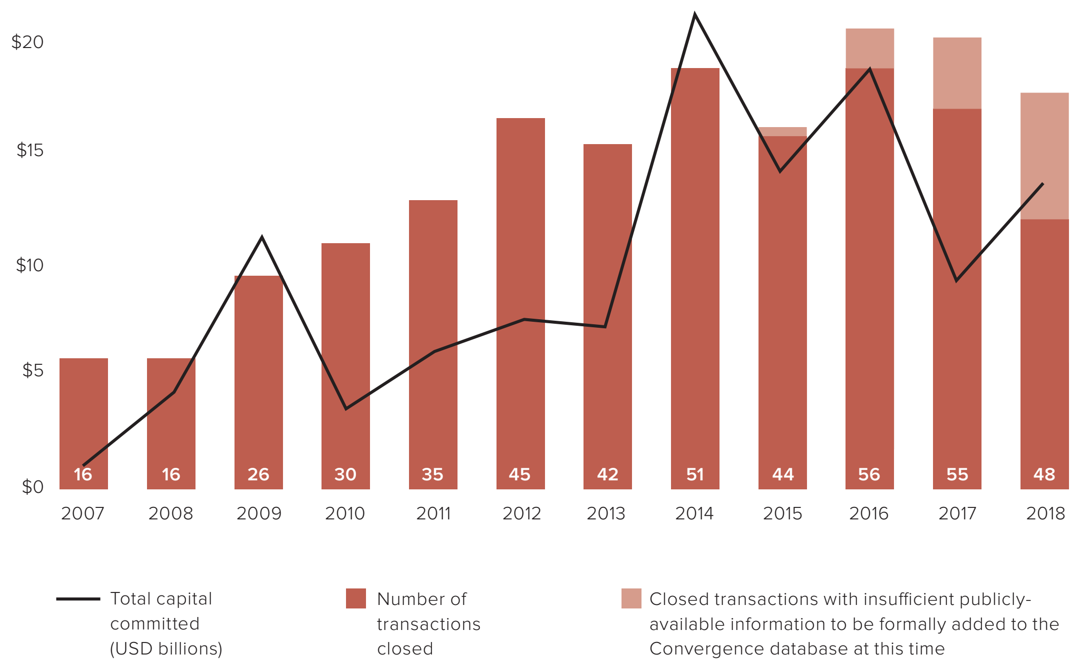
Transparency and accountability: the forgotten piece of the development puzzle

In theory, all sources of ODA should be transparently monitored and subject to public oversight. However, blending projects often lack these oversight and accountability mechanisms, due to claims that the private sector has the right to protect confidential financial details about their projects. The OECD's report "Evaluating Blended Finance" highlighted that "financial information on blended operations is not systematically disclosed, on the grounds of 'confidentiality' for commercially sensitive information[59]" (see Figure 3). Representatives of the EU confirmed[60] this would also apply to the EIP, stating that it will be the responsibility of development banks to operate under the legal guidelines set by the guarantees.

Furthermore, blended finance is generally harder to monitor and evaluate, since each implementer has different mechanisms for evaluation, with a lack of harmonisation between different actors across the blended finance chain regarding monitoring and reporting standards[61]. This raises the question of how transparency with the use of public money will be honoured under this plan. Because the EIP will be outsourced to development banks, which will in turn use local banks and financial intermediaries, there is a need to better understand the due-diligence and grievances mechanisms, and most importantly where the responsibility lies if projects are found to be violating human rights, social or environmental standards.

Figure 3

Growth of annual blended finance activities (2007-2018)



Source: Convergence. The State of Blended Finance 2019.

(The blended finance transactions included in Convergence's methodology must meet three criteria 1) attract financial participation from private sector investor(s), 2) use catalytic funds and 3) aim to create development impact related to the SDGs in developing countries - page 10 of the report)

Conclusion

The political choice to divert scarce ODA from proven development projects towards a model lacking clear evidence of efficacy is attracting growing criticism from civil society and academics[62]. The benefits of blended finance for people living in poverty have not been sufficiently demonstrated yet. This brief has shown that blended finance struggles to reach the informal sector as well as local private actors. Under the claim of equal partnership, blending facilities should more explicitly support the inclusion of local enterprises. This could also reduce to a certain extent the competitive disadvantage of local actors against EU companies.

Without the deliberate inclusion of women, youth and rural populations, the objective of tackling inequalities will be missed. Economic growth doesn't automatically trickle down to those most affected by poverty, on the contrary, it may exacerbate the problem, a position defended by several renowned economists[63].

In the absence of a unified measurement system among DFIs detailing how public funders should measure the catalytic effect of investing ODA in the private sector, including safeguarding and governance regulations, it is extremely difficult to determine the ability of public agencies to support poverty alleviation through blended finance and private instruments.

It appears blended finance is not fit for purpose in human development and social sectors, leaving the question: is the global development community comfortable allocating an increased share of public funding to instruments and actors that do not attempt to eradicate poverty but rather risk to widen global inequalities?

Date of publication: November 2019

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