

The Roles of Public and Private Development Finance

Issue Brief

Guido Schmidt-Traub and Jeffrey D. Sachs

May 21, 2015

This issue brief summarizes the key findings of the recently released SDSN Working Paper [Financing Sustainable Development](#) regarding the terminology of international development finance, and the roles that different financing flows and providers will play in financing the SDGs. References and additional supportive evidence are provided in the Working Paper. Citations of this Issue Brief should refer to the Working Paper.

An expanded and harmonized terminology for the types of financial flows is needed in response to the expanded SDG agenda, the need to ensure consistency and integration with climate finance, the rising number of providers of finance, and the growing number of financial instruments. We find that the current development and climate finance terminology lacks clarity in some areas and introduces unnecessary distinctions in others. We therefore propose the following terms summarized schematically below:

		Official		Private	
		Concessional aid	Other Official flows	Private funds mobilized through official flows	Commercial private finance
Domestic		Domestic Budget Revenues (DBR)		Domestic Private Funds Mobilized (PFM)	Domestic commercial
International	Finance for SDGs	Official Development Assistance (ODA)	Other Official Flows (OOF)	International PFM	International commercial
	Additional climate finance	ODA-C	OOF-C	PFM-C	

 Denotes International Development Financing (IDF)

Note: The size of the cells stands in no relation to the relative scale of the financial flows.

Official finance comes from domestic and international sources and is divided into concessional and non-concessional flows. We define Domestic Budget Revenues (DBR) as government tax and non-tax revenues that pass through government budgets, excluding loans and external financing. DBR includes expenditures by central governments as well as local governments, including municipalities. Note that DBR is different from the frequently used term Domestic Resource Mobilization (DRM), which is ill-defined but often includes loans and private financing.

Official Development Assistance (ODA) describes concessional international finance using the definition developed by the OECD Development Assistance Committee (DAC). Other Official Flows (OOF) denotes non-concessional international public flows: primarily loans by Multilateral Development Banks (MDBs), Development Finance Institutions (DFIs), as well as public guarantees, insurance, and export credits. For accounting purposes we separate out ODA and OOF for climate finance (ODA-C and OOF-C, respectively). Currently, development finance flows from non-OECD countries are often referred to as South-South Cooperation. The special responsibilities of high-income countries in providing ODA and OOF are important, but a strong case exists to include financial flows relating to South-South Cooperation in these categories. Since many non-OECD countries do not see themselves as 'donors' we use the more generic term 'provider' in this working paper.

Private financing is separated into two categories: (i) Private Funds Mobilized (PFM) through DBR, ODA, and/or OOF that support sustainable development, and (ii) commercial finance, such as foreign direct investment, that does not rely on public co-financing and may not target sustainable development *per se*. The distinction between PFM and commercial flows is important since many SDG financing challenges require the targeted mobilization of PFM for specific objectives. Collectively these two categories are far larger than official flows. The distinction between domestic and international private finance is of lesser importance, so we group these two flows together.

Moreover, FfD needs to distinguish between two related concepts: the organizational entity leading a particular investment and the source(s) of financing. When the lead investor is a public entity (a government or a public agency) one speaks of a 'public investment.' Alternatively, when the investor is a private company one speaks of a 'private investment.' Similarly, when the main source of financing is the public budget, perhaps augmented by aid flows from abroad, one speaks of 'public financing.' When the financing is from private sources such as loans or bond sales, one speaks of 'private financing.' Many projects and programs involve a mix of public, private, and social investors, and of public and private sources of financing. Often the project design entails a formal partnership of the public and private sectors, or a Public Private Partnership (PPP).

THE COMPLEMENTARY ROLES OF PUBLIC AND PRIVATE FINANCE

Financing can come in the form of private commercial funding that seeks a market-rate return, or as non-commercial funding from governments and private providers who are willing to accept no or below-market rates of return. The fundamental distinction between 'private' (commercial) and 'public' (non-commercial) funding and opportunities for blending public and private finance are at the center of any viable post-2015 framework for development and climate finance.

Private commercial finance can support investments in private assets, such as factories and machinery, provided they generate a financial return for their owner that is superior to the risk-adjusted cost of capital. Private investors respond to private returns, not to social returns. Therefore, when price signals do not reflect social costs and benefits (e.g. because of negative or positive spillovers), private incentives will not align with public incentives. Corrective pricing (e.g. a carbon tax in line with the social cost of carbon) is therefore both necessary and effective in many cases to spur the requisite private investments.

Markets do not effectively respond to the needs of the poor. Helping the poor to meet basic needs (such as health, education, safe water and sanitation, and food security) is not simply a matter of correcting prices. The poor lack purchasing power. Various approaches to recover costs for services to the poor have failed relentlessly over the past quarter century. Usually the poor are simply unable to pay for these costs, and end up being excluded from basic goods and services. The poor very often need public financing to meet their basic needs and to build the capital necessary to escape poverty.

Poor individuals also lack creditworthiness. Even if a poor person has the opportunity for a high-return investment (e.g. in education, improved nutrition, or job training) they do not usually qualify for financing in private capital markets. Financing typically requires collateral or sky-high interest rates, neither of which are viable options for the poorest people. Group lending and other initiatives of microfinance have partially relieved the situation for some kinds of loans (e.g. working capital for small-scale businesses), but not for other vital needs, such as health, education, infrastructure, agriculture, and more.

The same is true the governments of low-income countries. They may recognize the vital need and high return of investments in water systems, public health, education, or infrastructure, but banks and bond markets are not able to provide adequate capital. Since the enforcement of sovereign lending is difficult in any event, capital markets are reluctant to invest in poor countries that might later resort to defaults or be pushed into insolvency. Granted, private lending and investments in low-income countries has increased significantly in

recent years. Yet, this increase comes from an extremely low base, and overall volumes remain vastly insufficient for meeting the SDGs in most low-income countries. The result is both inefficient and inequitable: countries remain trapped in poverty even though the public investments needed to escape from poverty are in plain view and the world is awash in liquidity and capital seeking a good return.

In general terms, public financing covers areas where private, for-profit financing is intrinsically insufficient or impossible:

- **Helping the poor to meet basic needs:** Most social services, including health care, early childhood development (e.g. safe childcare and pre-school), education, and job training, are considered 'merit goods' which should be available to all members of society, rich and poor alike. These merit goods are typically described as 'human rights' or 'basic human needs.' They will be at the center of many SDGs and are enshrined in the Universal Declaration of Human Rights. To ensure that merit goods are available to all, including the very poor, public financing is essential. For poor countries, ODA is needed to complement DBR so that national budgets can finance the necessary basic level of social services.
- **Networked infrastructure:** Many types of network infrastructure (rail, roads, pipelines, power distribution, some forms of ICT) are natural monopolies or allow for only very limited competition. In such cases the government is typically the direct provider of the infrastructure or must at least regulate a private provider in order to restrain market power. Since infrastructure is vital for economic development, governments in poor countries will need international support in order to be able to carry out the needed public investments in infrastructure.
- **Post-conflict assistance and peace-building:** International assistance for peacekeeping, peace-building, post-conflict humanitarian aid, and post-conflict development is needed because of the inherent weakness of national and local governments and civil-society organizations in post-conflict conditions. Post-conflict assistance and peace-building are important public goods since stability benefits everyone in a country, as well as neighboring countries and the world at large.
- **Climate change mitigation and adaptation:** In all countries, public investments will be required for climate change mitigation and adaptation such as protection against rising sea levels and increasing storm intensity. Poor countries will also need international financing to respond to extreme climate events. Such financing might in parts be considered 'compensation' for losses incurred by poor countries caused by the greenhouse gas emissions of richer countries and should therefore be financed under the framework

of the UNFCCC. Governments of low-income countries have also been promised financial help to bear the incremental costs of low-carbon energy and other mitigation efforts.

- **Biodiversity conservation and ecosystem services:** The preservation of biodiversity and ecosystem services constitutes local, regional, and global public goods, and as such requires a combination of regulation, market-based incentives (taxes and subsidies), and public investments in infrastructure and conservation. This applies to terrestrial biodiversity and ecosystems (forests, savannahs, wetlands, freshwater ecosystems) as well as marine and coastal biodiversity and ecosystems. In particular, global public goods such as the world's oceans, the Arctic and Antarctic, or major terrestrial biomes require targeted public-private policy frameworks and investments.
- **Promoting innovations in sustainable technologies:** As a general matter, governments play a large role in the innovation process because scientific knowledge and technical know-how are public goods. If all knowledge is fully privatized (such as through patents), there will be an under-use of knowledge. By co-financing the research, development, demonstration and diffusion (RDD&D) of new technologies alongside business, governments spur economic progress and find solutions to challenges such as human-induced climate change. It is notable that most of the technological advances of recent decades, including space science, semiconductors, computer science, genomics, molecular biology, nanotechnology, the Internet, and more, were strongly backed by governments in the early stages of their development.

THE SPECIAL ROLE OF PUBLIC-PRIVATE PARTNERSHIPS (PPPs)

In almost all areas mentioned above, business will play a direct and indeed often dominant role in delivery and implementation. Businesses will deliver most investments in infrastructure and can sometimes play an important role in improving social service delivery. They can also leverage public financing, so that scarce public resources can go further. Private companies are also major sources of research and development (R&D), early-stage technology deployment, large-scale production systems, and often have knowledge of the best practices for technology diffusion to low-income settings. Note, however, that in some areas such as health, education, or biodiversity protection, the role of business is typically backed by public funds and public regulation. In other areas, such as infrastructure, private financing will probably account for much or most of the required financing.

Today's markets do not provide adequate incentives for private businesses to contribute to sustainable development. In many instances the private incentives of businesses are misaligned with the social objective

of sustainable development, exacerbating social exclusion and environmental degradation. Many companies are willing to work towards sustainable development, but they lack good interfaces to work with the public sector.

The key towards mobilizing the private sector for sustainable development is to combine public financing, regulation, and private market participation into an effective public-private partnership (PPP). Such PPPs can be structured by national as well as sub-national governments, including local authorities. They can come in a variety of forms:

- **Private provision on public contract:** Business may be the supplier on a publicly-financed contract. This can be for R&D, early-stage technology development, or deployment of infrastructure. Many key technologies, such as the early semiconductor industry, developed on the basis of government procurement.
- **Market price corrections:** A variety of tax and subsidy corrections exist to provide incentives for business in line with social costs and benefits. Examples include tax credits for investments in new (risky) technologies, feed-in tariffs for renewable energy, carbon pricing, tobacco taxes, and investment and export guarantees or insurance.
- **Differential pricing by business:** Business may provide discounts or free supplies for products and services to low-income settings against a promise from governments to maintain (higher) patent-protected pricing in all other markets. An important example for differential pricing is the marketing of essential medicines in developing countries, which has made a tremendous contribution to the fight against many infectious diseases, including HIV/AIDS.
- **Global fund mechanisms:** The Global Fund to Fight AIDS, Tuberculosis and Malaria (GFATM) and the Vaccine Alliance (Gavi) are examples of public-private partnerships organized around health delivery with public financing that can in turn mobilize a significant share of private co-financing.
- **Technology consortia:** The public sector may sponsor a consortium of private and public entities to carry out R&D and pre-commercial trials for new technologies.
- **Market maker:** Publicly (co-)financed institutions may aggregate diffuse demand across a large number of countries and provide long-term visibility to suppliers to support the creation of markets that are financially viable, but too complex to establish for private actors alone.

PPPs offer great promise for sustainable development, but they can be extremely complex to design and sometimes fail. As underscored by the Intergovernmental Committee of Experts on Sustainable Development Financing, poorly designed PPPs can lead to “high returns for the private partner, while the public partner retains all the risk”. Among the myriad of challenges that must be tackled in designing effective PPPs are:

- **Cost-effectiveness:** In many instances, private companies have proven to be more efficient and cost effective in delivering investments than public entities, but this is not always the case. In particular, networked infrastructure and other ‘natural monopolies’ can give rise to predatory pricing by private entities, which reduces the attractiveness of PPPs. Similarly, the US system of private provision of healthcare based on public funds is one of the causes of extraordinarily high unit costs for care.
- **Efficient scale of investment:** Only public (co-)financing can ensure an efficient scale of public goods provision. The more a PPP requires private entities to provide co-financing for capital or operating expenditure, the bigger the risk that the overall level of investment will be too low or that the outcomes be misaligned with the social objectives (e.g. to provide healthcare services to the poor). Achieving the efficient level of overall investment without squandering scarce public resources requires highly sophisticated service contracts, a careful calibration of incentives, and effective implementation.
- **Equity in financing and service delivery:** Private companies maximize profits and therefore have an incentive to reduce the level of service or infrastructure provision to ‘loss-making’ customers. For example, private utilities may generate financial losses on poor or remote customers. Unless effectively regulated, PPPs can reduce equity in financing and service delivery compared with public provision.
- **Competition and non-capture by incumbent companies:** Many PPPs give rise to natural monopolies, so PPP design must ensure effective competition in the awarding of contracts and proper regulation and price controls in the management of the PPP. These natural monopolies invite collusion between private providers and public regulators, the so-called ‘capture’ of the regulators.
- **Transparency and non-corruption:** In general, PPPs must be transparent and include sophisticated safeguards to minimize the risk of corruption by public officials as well as private employees and to ensure minimum social and environmental safeguards. Such safeguards are hard to enforce in general, especially in places with weak governance.

This list underscores the 'principal agent' problems that PPPs can generate and the complexity that effective design, monitoring, and policing may require. Public institutions may not be strong enough to design and implement effective PPPs, particularly in the poorest countries. Consequently, the transaction costs of PPPs and the ability of a country to manage PPPs must be carefully weighed against the benefits they are intended to generate.

THE LIMITED ROLE OF HOUSEHOLD CONTRIBUTIONS AND REMITTANCES

In poor countries, household contributions to financing the SDGs are very limited. This is simply a reflection of household poverty. In health and education, experience has repeatedly shown that user fees dramatically discourage access to health and education, particularly for girls and women, and they mobilize very limited additional financial resources. As a result, a clear global consensus has emerged that basic education and health care should be free of charge to users.

Infrastructure gives rise to similar issues of access for the poor. On the one hand, utility companies (e.g. for power and water) need to cover their costs. Yet, uniform pricing for all customers would again exclude the poor, just as with healthcare and education. One common approach, therefore, is a subsidy that is applied to all customers. The problem, however, is that middle-income and high-income consumers end up receiving the lion's share of an across-the-board subsidy, even though such a subsidy is ostensibly for the poor. A preferable approach is called a 'lifeline tariff,' which provides free or highly subsidized access for a good or service (e.g. water or power) up to a given quantity that is deemed to be the 'basic need.' Above that level, consumers must pay the full cost of the services. Indeed, the cost of providing the lifeline tariff can be included in the full price paid by the larger (and richer) buyers of the service.

Another case for a lifeline tariff is in smallholder agriculture. In many parts of the world smallholder farmers require subsidized access to basic infrastructure services (e.g. electricity for irrigation) and farm inputs such as seeds and fertilizer. These core inputs can be provided for free or at very low cost, but only up to a given quantity. Beyond that quantity, farmers pay the full cost for further infrastructure services and farm inputs.

Remittances are private flows of financing, usually within families, which support household investments (e.g. in small enterprises, housing) and consumption expenditures (e.g. payment for food, school fees, or medical expenses). They can be an important income source for poor households and can make a significant contribution towards reducing income poverty. Yet, remittances neither finance public goods, nor transfer incomes from rich households to poor households. Increasing the ability of the poor to earn income by

working in richer countries is double-edged. It provides more income for poor families on a market basis, but it can contribute to 'brain drain' and lead to a tragic loss of family cohesion, as children grow up without the presence of one or both parents. For all these reasons, remittances should never be confused with ODA or with public financing more generally. Remittances are unlikely to make a significant contribution towards the financing of the sustainable investments.

Still, the volume of global remittances is substantial and rising. The World Bank estimates that developing countries received \$404 billion in remittances in 2013, and forecasts this figure to grow at an average annual rate of 8.4% to \$516 billion in 2016. Fees for transferring remittances internationally are excessive, at 8 percent on average globally and rising to 12 percent in sub-Saharan Africa. Governments can and should act to reduce the cost of transferring remittances by fostering competition and a level playing field for operators. For example, governments may reduce the scope for exclusivity arrangements between money transfer operators and banks or agents. They may also encourage other institutions, such as post offices, cooperatives, microfinance organizations, or possibly telecom operators to play a larger role in money transfers.

Remittances should not be confused with diaspora bonds or funds that mobilize private diaspora savings for bond-financed public projects. Globally, diaspora funds are estimated at \$400 billion. Such funds may harness patriotism in the interest of development finance, and in a few countries they can contribute significantly to financing sustainable development. For example, India and Israel have successfully mobilized tens of billions of dollars in diaspora bonds. Yet, one needs to be careful before extrapolating from these two examples, one a middle- and the other a high-income country, to opportunities for lower-income economies. Diaspora bonds have a role to play, but for most poor countries their contribution will be modest in scale and limited to investments that offer commercial or near-commercial rates of return.

DOMESTIC VS. INTERNATIONAL PUBLIC FINANCE AND THE CONTINUED NEED FOR ODA

Private finance can be sourced domestically or internationally, and so, too, can public spending, which may come from domestic sources (such as income taxes, indirect taxes, customs revenues, state-enterprise profits) as well as international sources (as ODA, climate finance, public loans, or OOF). As agreed in the Monterrey Consensus and the Busan Partnership for Effective Development Cooperation, each country has primary responsibility for its development and development finance. Concessional international public finance should only be mobilized in areas where domestic public resources are insufficient, and business is unable to mobilize adequate private finance.

The substantial rise in per-capita incomes in most developing countries since 2000 has significantly increased DBR, but most countries can do more. In particular, DBR at the local or municipal level will need to rise steadily. Yet, ODA remains vital for most low-income countries, particularly in sub-Saharan Africa.

ODA will be needed for the foreseeable future to sustain life-saving investments in low-income countries and to finance global public goods. The 2010 African Economic Outlook shows that aid exceeds tax revenues in twelve African countries and is larger or equal to half the tax revenues in 24 countries. The Outlook concludes that if aid “were to disappear, several states would simply collapse.” The Committee on Development Finance cites data from Development Initiatives showing that, in most countries with government spending of less than \$500 PPP per person, ODA accounts for more than two thirds of international resource flows, and about one third of government revenues. Even if ODA and public climate finance make up a modest share of overall development finance globally, they play a vital role in some of the poorest countries, particularly for financing essential public services and for leveraging much larger volumes of private finance. Yet, they are hard to mobilize and to disburse efficiently, so the role of public international finance as an enabler of private finance needs to be further emphasized.

The case for ODA rests mainly on closing financing gaps for the poor. A very clear example is public health. Chatham House estimates that a rudimentary primary health system requires public outlays of at least \$86 (in 2012 dollar terms) per person per year (compared with thousands of dollars per capita spent in high-income countries). Yet consider the case of a low-income country with per capita income of \$1000 per year, i.e. at the upper end of the low-income threshold. The government might be able to raise around 20 percent of GDP in domestic revenues, or roughly \$200 per capita. Given the demands on these funds (for public administration, infrastructure, education, training, law enforcement, judiciary, and more), the health sector might be able to claim 15 percent of the total domestic budget revenues (corresponding to the so-called Abuja Target for health spending). This would leave health spending at \$30 per person per year, slightly more than one-third of the basic need. The gap would have to be closed by ODA. By the same token, a middle-income country at \$2,000 per capita can meet its public health needs out of its own revenues.