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SOCIAL SECTOR PRACTICE

Innovative development financing

How can more resources be applied toward development in the world's poorest countries? Recent research has pointed to some promising ideas.

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Of all the efforts devoted to improving economic and social conditions in developing countries, the most prominent has been the United Nations' Millennium Development Goals (MDGs), which set targets for reducing poverty and improving education, gender equality, health, and sustainability by 2015. As is true with any type of development, meeting these targets depends on resources, and a large part of the resources devoted to the MDGs come from developed countries' pledges for what is called Official Development Assistance (ODA). However, since peaking at $128.7 billion in annual net ODA in 2010, the annual total paid in ODA has declined for two years running, standing at $125.6 billion for 2012.[1]

Clearly, more funds will be needed if the development goals are to be met. Moreover, market inefficiencies—such as unnecessary transaction costs, misaligned incentives, and lack of performance measures—often prevent the financial assistance that is available from achieving desired results.

[1] *The Millennium Development Goals Report 2013*, United Nations, July 2013, un.org.

Given the level of need, the uncertainty in the general macroeconomic environment, and the pressures on all government budgets, we looked into potential financing mechanisms and sources to complement traditional ODA.[2] We assessed a number of innovative ideas that we think merit further investigation and discussion. In this context, "innovative" refers to finance mechanisms that might mobilize, govern, or distribute funds beyond traditional donor-country ODA. Some have already been tried, others have not, and still others may carry new risks. The point of this article is not to recommend any specific solution but to shine some light on a collection of ideas we found particularly exciting as a way to either raise new funds or unlock value as society works to achieve the MDGs. Many of the ideas have the added benefit of creating a much-needed bridge for new actors, such as individuals, corporations, and emerging economies, to deeply integrate themselves into the development community.

In seeking out innovative sources of development financing, we looked across a wide range of potential contributors, including citizens, corporations, governments (of both developed and developing economies), and multilateral institutions. However, the reality is that even when other contributors are involved, most aid still flows through governments because they have the scale and responsibility to execute meaningful development-aid programs. Since we believe innovative financing should complement, rather than substitute for, government funding, our focus in this paper is on solutions in which governments are still a core part of the solution. However, we recognize there are also many good ideas that require minimal or no government involvement, such as citizen-focused fund-raising initiatives like Product RED or business-driven solutions such as bottom-of-the-pyramid ventures. Four ideas rose to the top when we screened our list based on the size of the opportunity (for example, the ability to unlock a meaningful level of additional financing or to meaningfully engage multiple actors), the technical feasibility of implementation within a short- to medium-term time frame, the potential to gain significant political momentum, and the existence of a clear and compelling role for government: unlocking value from diaspora flows, stimulating private-capital flows, encouraging private voluntary contributions through matching funds, and tackling sector-specific inefficiencies.

Unlocking value from diaspora flows

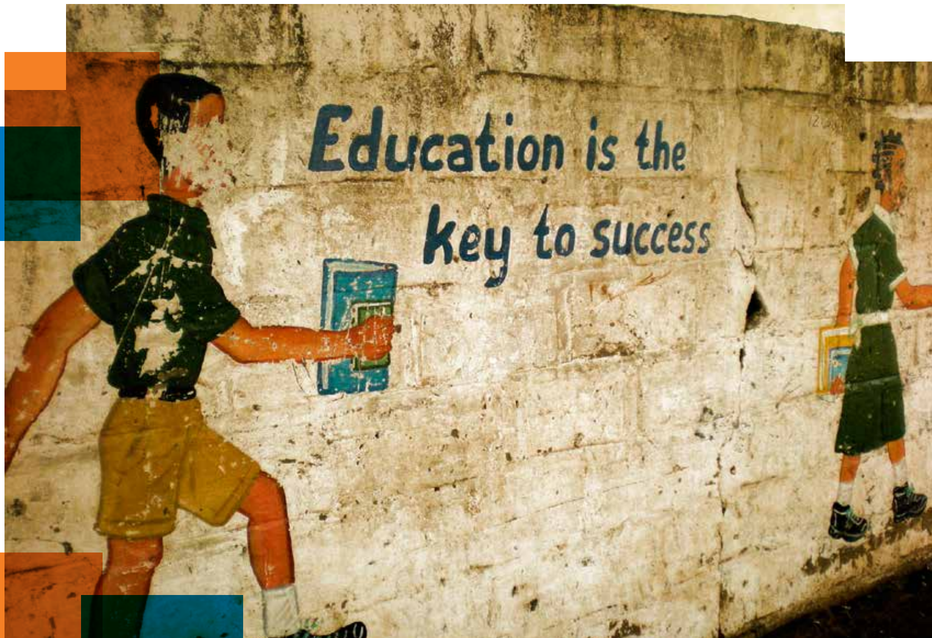
For years, people who have emigrated from developing countries have been sending remittances to support family and friends in their native homelands. Around $325 billion of remittances flow to developing countries every year. There are opportunities to unlock significant additional value from these flows.

First, the use of diaspora bonds could be expanded. The issuance of government bonds specifically targeted at a country's emigrant population is a time-tested but underused way to raise money for development. For instance, the pioneers of diaspora bonds, Israel and India, have leveraged them over time to raise more than $25 billion and $11 billion, respectively.[3] For sub-Saharan African countries, the World Bank has estimated that these instruments could raise as much as $5 billion to $10 billion annually, but so far their potential has been almost completely untapped.[4] One could imagine exciting uses for these bonds, such as the funding of education or infrastructure. To assist this expansion, donor-country

[2] This research was conducted with the support of the ONE Campaign and the Bill & Melinda Gates Foundation.

[3] Suhas Ketkar and Dilip Ratha, eds., *Innovative Financing for Development*, World Bank, 2009, openknowledge.worldbank.org. Israel began issuing diaspora bonds in 1951, and the $25 billion raised is from the inception of the program to date. India raised its $11 billion over three separate issuances, in 1991, 1998, and 2000.

[4] Suhas Ketkar and Dilip Ratha, eds., *Innovative Financing for Development*, World Bank, 2009, openknowledge.worldbank.org; Abebe Shimeles, "Diaspora bonds and securitization of remittances for Africa's development," *Africa Economic Brief*, Volume 1, Issue 7, African Development Bank, December 2010, afdb.org.



governments could give their counterparts in developing countries reliable demographic data that would facilitate the marketing of bonds to diaspora. Customizing the regulatory framework for the creation and sale of bonds in foreign countries at the international level could also help spread their use by lowering the costs of compliance across multiple jurisdictions and speed up the regulatory-approval process.

Second, data collected by the World Bank show that the average cost of sending money to a person's home country is about 9 percent. At their 2009 summit in L'Aquila, the G8 countries made a commitment to cut the global average cost of these transactions down to 5 percent. Given the volume of annual remittance flows, each percentage point of lowered remittance costs could unlock as much as $3.3 billion per year for developing-country recipients. All players could continue efforts toward lowering these costs. For example, governments can eliminate exclusivity clauses with money-transfer providers to encourage competition, while the private sector can continue to launch mobile-phone payment systems, learning from programs in countries such as Kenya and the Philippines.

Stimulating private-capital flows

Private capital is an enormous source of global wealth that has not historically played as significant a role in development as its scale would suggest. This is not for lack of interest. Private capital is constantly seeking investment opportunities.[5] However, it only commits to those prospects that meet its appetite for risk and reward. Due to a variety of factors, many opportunities in developing countries are often perceived as overly risky or uncertain for the majority of investors. Institutions that offer to

[5] For more, see the full McKinsey Global Institute report, *Financial globalization: Retreat or reset?*, March 2013, mckinsey.com.

guarantee portions of loans made for such investments help investors rebalance their assessments of risk and reward and subsequently unlock considerable capital into developing countries. For example, in the past decade, the World Bank has approved 28 guarantees worth a total of $1.4 billion. These guarantees have stimulated more than five dollars of private capital for every dollar spent by the World Bank.[6] Yet this type of support remains a very small portion of the bank's approach to financing in developing countries. Since the G20 summit in London in 2009, multilateral development banks have stepped up efforts to do a better job of leveraging private capital. There is an opportunity for the G8, the G20, or individual governments to use their influence and encourage multilateral development banks—and potentially bilateral agencies—to create innovative instruments that stimulate private flows. Since guarantees may be more difficult to get through national budget processes than traditional financing, a starting point could be to work on ways to address these institutional barriers.

One exciting way for private capital to contribute to development is by fueling the growth of small and medium-size enterprises (SMEs) in developing economies. Such companies are often underfunded in these regions because they typically are too small for commercial lending but too large for microcredit financing. There could be an opportunity for multiple players to collaborate in the creation of a set of financial instruments to serve this segment. Local commercial banks could provide the capital and deliver the funds when sharing some of the risk with large multilateral organizations or major foundations that provide first-loss guarantees. Donors could play a role in funding pilot programs or supporting demand-side capacity-building initiatives such as credit-scoring initiatives or skill building for entrepreneurs. One promising area to test this is the agricultural sector, a driving force of growth in many developing economies.

Two other growing sources of capital that hold many trillions of dollars of capital are sovereign-wealth funds and pension funds. Sovereign-wealth funds typically have longer investment time horizons and often have more flexibility in their investment rules than other types of investors. Although sovereign-wealth funds are not new, some recently have been forming innovative coalitions—bringing together such diverse players as Chinese funds, Middle Eastern funds, multinational corporations, and developing-country governments.

Not all sovereign-wealth funds are created equal; each has its own objectives and rules. One characteristic most of them do share, however, is that, like private investors, their investment decisions are driven by a risk-reward equation. Beyond financial rewards, many funds also seek political-security and industrial-policy dividends for their home countries. But the problem in Africa is that, at least for the time being, available capital may exceed the viable investment opportunities. While some asset classes such as infrastructure are more developed, others are not yet deep enough to attract large pools of capital. Multilateral development banks can potentially play a role by offering risk-sharing vehicles to improve the risk-reward profile and, over the long term, help foster an environment that encourages viable businesses to emerge so that capital can flow accordingly.

A new form of multistakeholder partnership intended to leverage private capital for scaling

[6] *Innovative Finance for Development Solutions: Initiatives of the World Bank Group,* World Bank, 2010, worldbank.org.

solutions to social problems is the social-impact bond (SIB). In a SIB, philanthropic funders and impact investors—not governments—take on the financial risk of expanding proven social programs. Nongovernment organizations deliver the social program to more people who need it; the government pays only if the program succeeds.

In the absence of SIBs, philanthropic donors fund pilots that demonstrate the efficacy of preventive programs, but then these programs—even though they work—are not expanded to the entire population that needs them. This is because only government has the reach and the resources to provide the multiyear funding required for scale-up. For their part, governments' existing systems tend to focus on remediation, and fiscal constraints can make it tough for them to introduce alternative approaches. However, SIBs can facilitate the critical handoff from philanthropy—which provides the "risk capital" of social innovation by funding and testing new programs—to government, which has both the capital and policy influence to take programs to scale.

Since SIBs are a very new idea, all the potential applications have not been fully explored. However, SIBs appear best suited for behavior-change programs requiring intense case management and integrated assessment to ensure quality replication. To date, the social-impact bond is being piloted in the United Kingdom in the criminal-justice field. In the United States, New York City and the Commonwealth of Massachusetts recently announced plans to launch SIBs in the area of juvenile justice; Massachusetts also plans to launch an additional SIB to combat homelessness. The Center for Global Development is exploring how SIBs can be applied in international development.[7]

Encouraging private voluntary contributions through matching funds

Governments are in a unique position to encourage large amounts of voluntary contributions from private corporations and citizens by setting up matching programs. They are distinguished in having the credibility to intervene on social issues in a fair and responsible way, as well as the resources to implement matching programs at meaningful scale. For example, in 2010, the Canadian government set up a Pakistan Relief Fund that raised $47 million from individual citizens over a two-month period. This was based on a promise that the Canadian International Development Agency would match all citizen contributions of up to $100,000 each. The resulting total that went to the relief effort ($94 million) was almost five times some of the best-performing corporate matching campaigns. Government matching programs not only mobilize new resources but also, almost more importantly, engage a broader set of players in sharing the responsibility for global development. The GAVI Alliance (formerly the Global Alliance for Vaccines and Immunization) put in place an effort to raise a total of $260 million by 2015, with pledges from the UK government and the Bill & Melinda Gates Foundation to match a total of about $130 million in contributions from private corporations, foundations, and citizens.

Countries could commit to establishing a national-challenge fund that matches commitments from corporations and individuals up to a prespecified limit. Corporations, in addition to contributing their own funds, could employ innovative means to engage and raise funds from their employees and customers. Governments could identify priority development topics and select eligible private-

[7] For more on social-impact bonds, see mckinseyonsociety.com.

sector recipients for challenge-fund proceeds. The most powerful partnerships would be ones where private-sector players could also contribute their core capabilities beyond straight financing, such as having telecom companies offer solutions based on mobile technology.

Tackling sector-specific inefficiencies

The ideas discussed in this article focus on raising revenues, and most could technically be applied to a variety of purposes (for example, health, water, education). Countries could also find powerful ways to unlock the value of their development dollars by examining particular market inefficiencies of specific sectors that can benefit from development aid. Take health, for example. One market inefficiency is that large private-sector pharmaceutical companies have little incentive to invest in research and development for developing-country health issues. To create these missing incentives, several countries created an "advance market commitment" that provided reassurances in the market for a new pneumococcal vaccine. This was a groundbreaking approach that used dollars donated for vaccine purchase to their maximum effect.

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Innovation, which is largely about thoughtful trial and error, is needed to catch up on the world's bold development aspirations. Taking a chance with new finance mechanisms may lead to some failures, but one big success can be a global game changer. Each step along the way can help enrich the global development community by pulling in new resources and helping existing stakeholders work better together.

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