



The Dutch Good Growth Fund has supported rose farming in Ethiopia through blended finance. Photo: DGGF

PRIVATE-FINANCE BLENDING FOR DEVELOPMENT

Risks and opportunities

Aid donors increasingly seek to inject private-sector resources into development by ‘blending’ official development assistance (ODA) with private finance. There is little evidence of the development impact, and projects often do not align with country ownership, transparency and accountability. It is not always clear whether ODA subsidies are necessary. Blending could support pro-poor projects, such as easing credit constraints for small- and medium-size enterprises. At a minimum, donors must subject blending projects to development effectiveness principles.

EXECUTIVE SUMMARY

Over the past decade, donors and international bodies have increasingly looked to inject private-sector resources and expertise into development by using official development assistance (ODA)—public finance—to ‘leverage’ private finance through ‘blending’ the two together. Donors claim that using ODA to subsidize and leverage private finance will bring in new investments to fill the \$2.5 trillion annual funding gap required to reach the Sustainable Development Goals (SDGs). Donors also see blending as a way to support large-scale infrastructure projects in middle-income countries. Blended development finance is also a response to growing pressure among donors to link their own commercial interests with development policy.

This briefing has been prepared by Eurodad to inform Oxfam’s work on the blending of ODA with private finance (PF). It summarizes the findings of an in-depth research paper.

The justification of PF blending is that ODA can be used to remove investment ‘barriers’, making private finance invest in developing countries when purely commercial motives would have precluded this—and, at the same time, to improve development focus and outcomes.

There is considerable uncertainty about how much ODA is currently being used for PF blending. Current figures suggest that usage may be as low as one per cent of total ODA, but donor rhetoric suggests that this may increase in the near future.

There is little evidence about the development impact of PF blending mechanisms. The research on which this briefing is based indicates that PF blending mechanisms suffer from poor levels of ownership by recipient countries. The research also found weaknesses in transparency and accountability.

PF blending often transfers responsibility for ODA to development finance institutions (DFIs). This can create conflict or tension between the expectations, policies and practices of ODA donors on the one hand, and those of the actual managers on the other.

PF blending entails opportunity costs for donors: \$1 of ODA cannot be spent twice, and in the absence of an increase in the overall level of aid, an increase in ODA used for blending could mean a decrease in its use for other, more traditional purposes, such as supporting the delivery of public services.

The concept of additionality refers to the ‘added value’ of a specific form of finance. One of the main challenges of PF blending is ensuring that projects applying for support actually require some form of subsidy. A number of evaluations suggest that additionality is too easily assumed by donors.

Leverage ratios are a controversial area in development finance, including in discussions of PF blending. Too often, donors make bold and unsubstantiated assumptions about the impact of the PF blending element. However, leverage ratios make sense only when some form of additionality can be demonstrated. In reality, a high leverage ratio (such as 1 to 50) means that the ODA element is heavily diluted.

The following broad conclusions can be drawn from the analysis:

PF blending potentially threatens the quality of aid.

- It is much less transparent and accountable than other modalities.
- DFIs used often do not meet basic aid effectiveness criteria, particularly ownership.
- Currently there is poor evidence of impacts, and poor monitoring and evaluation.

- PF blending increases opportunities to use aid to support donor-country firms—incentivizing tied aid.

Opportunity costs mean that more money for PF blending is likely to mean less money available for other uses of ODA, such as financing public services.

PF blending is not likely to be suitable for poorer countries (in effect, it incentivizes aid to middle-income countries with attractive investment climates).

There is a risk that, when it relies on external private finance, PF blending may crowd out the domestic financial sector in the host country.

Nevertheless, most developing-country governments want private investment—both domestic and, frequently, foreign—to help develop their economy and create employment opportunities. **So there is a rationale for PF blending if it supports national development strategies.** PF blending could play a particularly important role in helping developing-country small- and medium-size enterprises (SMEs) overcome credit constraints. Blending could also support projects where private-sector engagement has the potential to make a difference for opening up new markets that can benefit poor people, such as investments in companies producing renewable technologies that prioritize energy access or generic medicine producers.

The following principles can help ensure links between PF blending and sustainable development.

- Whenever donors use ODA and other public funds in support of private investment, they should subject these resources to development effectiveness principles.
- Donors should judiciously monitor the share of their ODA that they devote to PF blending, attempting to minimize the diversion of aid from public investments.
- Donors should carefully target PF blending to circumstances where it can help achieve clear sustainable development outcomes and poverty reduction.
- PF blending should be conditioned upon corporate respect for human rights.
- Donors should only engage in PF blending when they can demonstrate financial and development additionality; effective minimization of risks for people and the environment; promotion of women's rights and economic opportunities; and a strengthening rather than an undermining of the public sector.
- Robust monitoring and evaluation of projects is essential.
- PF blending projects must ensure no false accounting—donors need to measure actual subsidies, measure net flows (*i.e.* money returned to the donor via loan repayments as well as funds provided) and not count as ODA non-flows of aid (e.g. guarantees provided but not drawn down; aid funds actually spent in the donor country).
- PF blending should promote business models that are structured to keep more value with local workers and entrepreneurs, focusing on domestic industry (including the domestic financial sector), particularly SMEs.
- To the extent that companies are paying their fair share of taxes, private-sector development will provide an important source of revenues for the public sector in developing countries.

Going beyond principles of how to engage in blended finance, there is a need instead to change the terms of the conversation: Although there is room for a private-sector approach within development cooperation, the share of ODA going to the private sector needs to be monitored. Overall, ODA should be directed at the public sector, which in turn is crucial to promoting and expanding private-sector investment. A healthy and educated workforce, and well-functioning institutions and domestic markets, are powerful incentives for private-sector investment. Other public goods that leverage private investment are climate change adaptation, infrastructure, and agricultural research and extension. It is often the lack of public sector investments in these areas that creates barriers to private-sector growth.

1 INTRODUCTION

Over the past decade, donors and international bodies have increasingly looked to inject private-sector resources and expertise into development by using official development assistance (ODA, or ‘aid’)—public finance—to leverage private finance through ‘blending’ the two together. Many member states of the Organisation for Economic Co-operation and Development (OECD) Development Assistance Committee (DAC) laud the benefits of private-finance blending and proclaim a ‘new path’ for ODA. Their rationale for using ODA to subsidize and leverage private finance is that this will bring in new investments to fill the substantial funding gap necessary to reach the Sustainable Development Goals (SDGs).

This briefing paper on the blending of ODA with private finance, which we shall call ‘private-finance blending’ (PF blending), summarizes the main findings of an in-depth research paper prepared on the topic,¹ with an analysis of three different PF blending facilities:

1. The Dutch Good Growth Fund (DGGF);
2. The European Commission’s (EC) eight regional blending facilities; and
3. The World Bank-managed Global Financing Facility (GFF), a multi-stakeholder partnership that supports efforts to improve the health of women, children, and adolescents.²

The briefing is structured as follows:

- Section 2 presents the main points related to ‘leveraging for development’, including the definition of blended finance, the objectives, and other key aspects related to its functioning and scope.
- Section 3 details the main challenges that arise when analysing PF blending from a development perspective, including principles and criteria for project selection; the discussion around additionality and leverage ratios; and the impacts of ODA reporting rules.

Section 4 presents risks and opportunities of PF blending and actionable policy recommendations.

2 DEFINITION AND OBJECTIVES OF BLENDING

There is no universal definition of ‘blending’, but it is important to distinguish between private-finance blending (PF blending)—the topic of this paper—and the ‘blending’ of several sources of public finance, which might better be termed ‘pooling’:

1. Public finance blended with private finance,³ or PF blending, is the focus of this briefing. In this case, public subsidies are used to incentivize private investment in partner countries. These subsidies come in a variety of forms, explained later in the briefing (see Table 1; see Box 1 for an example).
2. Public finance blended with public finance, which might better be called ‘pooled finance’, as the sources of finance are both public institutions. This is not included in this briefing, partly for reasons of clarity, but largely because such public–public blending should be analysed using an entirely different set of criteria. For example, there can be no suggestion that public–public blending somehow leverages additional financing for development, as both actors likely have been directing their financing capacities towards development in the first place.

Box 1: An example of blending: High-quality rose farming in Ethiopia

The Dutch Good Growth Fund, through its window supporting Dutch small- and medium-scale enterprises, provided a loan of €1m (\$1.07m) and €1.4m (\$1.5m) in guarantees to Lalibela BV. The private-finance element comes from Rabobank Leiden-Katwijk of the Netherlands and Zemen Bank of Ethiopia.

The company has bought a farm in Ethiopia and will invest in 14 hectares of greenhouses with this support from the DGGF. The investment is expected to create 450 jobs, most of which will go to women; transfer knowledge of horticulture, enterprise administration, and sales; and improve productive capacity for export, thereby benefitting Ethiopia’s balance of trade and tax revenues.

Source: DGGF, ‘Transactions Investing Dutch SMEs’, <http://english.dggf.nl/investing-dutch-smes-transactions>, accessed 15 September 2016.

PF blending involves the use of ODA, but confusion is caused by the existence of other terms that define similar—but broader—ideas such as ‘leveraging’, ‘mobilizing’, and ‘catalysing’. A typical definition of leveraging is that provided by the World Bank, which defines it as ‘the ability of a public financial commitment to mobilize some larger multiple of private capital for investment in a specific project or undertaking’.⁴ PF blending is obviously a form of leveraging, but in basic terms, the concept of PF blending should be restricted to projects involving ODA. Leveraging (or mobilizing/catalysing) is a broader concept that does not necessarily involve the use of ODA, as the ‘public financial commitment’ could cover other official funding from a publicly owned institution.

Of course, the meaning of all these different concepts is not standardized, and different actors use them differently, partly for political motives: The idea that new sources of finance can be catalysed or leveraged is an attractive selling point. The OECD’s work on Total Official Support for Sustainable Development (TOSSD) may help to clear this confusion, but early signs are that it also risks becoming a process aimed at maximizing the degree to which donor countries can classify their leveraging activities as ‘development assistance’.⁵

PF blending is not new, but the idea has gained traction in recent years due to an increasingly dominant narrative that places private finance, and the private sector, at the centre of donor policies. In the past, European publicly owned institutions and development banks mostly subsidized loans to the public sector in developing countries; PF blending was a relatively small part of their activities. However, in recent years, this picture has begun to change, and many development finance institutions (DFIs)—both bilateral, such as the German Bank (KfW), and multilateral, such as the World Bank Group’s International Finance Corporation (IFC)—have used PF blending to increase lending to private companies and to partner with private financiers in funding these activities. A heavy focus on PF blending is being vigorously pursued in EU member states, such as the UK, Germany, and Sweden, as well as by the EC.

The growing emphasis on PF blending is due to a mix of motives, not all of them development focused. The official rationale for increasing PF blending is the growing need to mobilize all types of resources to lift people out of poverty, as ODA alone cannot fill the estimated \$2.5 trillion SDG finance gap.⁶ It is also justified by the reasoning that middle-income countries in particular have little need for traditional ODA grants but would prefer big projects—particularly in the areas of energy, water, and transportation infrastructure, as well as in climate change mitigation and adaptation—that mobilize large amounts of additional private-sector finance.

However, PF blending is also a response to growing pressure among donors to link their commercial interests to development policy: PF blending represents a subsidy to a private company, and many of the companies that end up benefiting are from OECD countries. There are geopolitical imperatives involved, as well, since OECD countries want to remain competitive in new markets and emerging economies vis-à-vis the commercial activities of fast-growing Asian and Latin American countries.

Finally, the narrative that supports PF blending—of putting the private sector at the heart of development efforts, and downplaying the traditional use of ODA to finance public services—has been on the agenda in many donor countries for some time, and in some instances, particularly in Europe, has become even more prominent with the rise of centre-right parties.

WHAT IS PF BLENDING? MECHANICS AND FINANCING INSTRUMENTS

The justification of PF blending is that ODA can be used to remove investment ‘barriers’, allowing private finance to invest in developing countries when purely commercial motives would have precluded this, and at the same time improve the development focus and outcomes of private investment (both domestic and multinational). A wide variety of barriers to private investment may exist in specific developing countries, and each case will be different. Frequently stated barriers include:

- Low returns for the level of risks (the investor doesn’t think they will earn enough to justify the risk they are taking with their money).
- High up-front capital costs and a long timeframe for achieving returns (particularly true for projects related to climate change).
- Markets not functioning efficiently (investors may find it hard to access credit markets, for example).
- Knowledge and capability gaps (the investor may not know enough about the country concerned, for example).
- Poor quality of regulatory frameworks (e.g. absence of the rule of law, market failures go unaddressed).

The rationale for PF blending is therefore that ODA can alter the risk/return trade-off for an investor, allowing them to finance a project they would otherwise have turned down.

A number of different PF blending instruments are used, summarized in Table 1.

Table 1: Selected instruments and the mechanics of PF blending

PF blending instrument	Justification for use of ODA
<i>Grants ('Investment Grants')</i>	Fund-specific costs and activities that decrease overall project costs and increase chances of success. These are usually part of a larger package and are mostly used to purchase or upgrade existing fixed capital, such as tools or facilities. Example: giving a grant for a recipient to buy a tractor and storage space to increase overall productivity, making the recipient more attractive to other investors.
<i>Technical assistance (TA)</i>	Various uses. Can do the investors' homework for them, thus lowering the high transaction costs and risks for investors linked to new projects or in uncharted territories. Can also help improve the quality of the project—for instance, by funding impact studies—thus increasing the likelihood of success. Example: a study of the potential increase in project productivity with the provision of a new tractor and storage space to attract private investors.
<i>Loan guarantees</i>	Protect investors against losses and/or improve the financing costs (government guarantees reduce borrowing costs). Example: the new equipment attracts private investors, but they still think the risk is too high, so the public sector provides a guarantee of payment should the expected increase of productivity not materialize.
<i>Structured finance—First loss capital</i>	Absorbs risks by making the public entity the first to take losses that may occur should the project incur losses. Example: a project fails and doesn't leave enough capital to pay back all investors. The 'first loss' investors (in this case, the public entity) lose their money first (and, if the loss is small enough, be the only ones to lose money).
<i>Equity investment</i>	Equity investors take a percentage of the ownership of the company or project. The money provides funding for the project but also demonstrates viability and provides other comfort for investors (for instance, investors could see this as a guarantee of the quality of the project, or of a reduction in the risk that the host government might interfere). Example: the public sector buys 20 per cent of a company in the hope that private investors will see this as a sign of confidence and follow suit.

Source: Adapted from WEF-OECD (2015)⁷

The selection of instruments varies from project to project. Some authors point to a relationship between the choice of the financial instrument and the maturity of the company and market where the investment takes place (classified into five different segments: 'preparing', 'pioneering', 'facilitating', 'anchoring', and 'transitioning'). In general, TA and investment grants would play an important role in the preparing and pioneering stages of investment projects, where high transaction costs and high risk are involved. Risk-absorbing instruments are most likely to be used in the pioneering and facilitating stages, when returns are uncertain and unproven. Equity investments tend to be more important in later stages, with the goal of consolidating projects and attracting additional capital.

CRITERIA FOR PROJECT SELECTION

Institutions adopt and implement their own criteria for selecting PF blending projects. In practice, project selection is the result of the interaction of factors operating at different levels:

- *The broader policy framework* that regulates the operations of the body that manages the facility. Blending facilities are usually managed by units within institutions and, as a consequence, the policies and practices of those institutions also apply to the facility. For example, the World Bank manages the GFF Trust Fund and, as a consequence, projects are subject to a number of World Bank regulations and policies. The broader policy framework can have an impact on criteria similar to those the mandate affects (profitability, instruments, etc.), and it also tends to influence the monitoring and evaluation framework.
- *Mandate of the facility* refers to the goals, restrictions, and other criteria that regulate the operations of the facility and that were set when the facility was created. The mandate can include criteria such as risk/return profile and profitability, type of instruments it can use, preferential treatment for certain companies or countries, geographical scope, etc.
- *Eligibility criteria* are the visible side of project selection. They translate the approach set by the broader policy framework and the mandate into specific guidelines.

The selection of PF blending projects is often the result of the interaction of two processes: one that results from the involvement of the facility and one that results from the involvement of other institutions that act as intermediaries. This is the case of the EU regional blending facilities, where project selection is influenced by the criteria set at the level of the facility and those of the DFIs that screen and propose projects. This interaction can result in additional restrictions, since only projects falling within the area where both approaches overlap would be eligible.

HOW MUCH ODA IS USED FOR PF BLENDING?

The short answer to this question is 'We don't know'. There is a lack of transparency in the data that leads to considerable uncertainty about how much ODA is currently being used for PF blending. Current figures suggest that usage is low as a percentage of total ODA. Donors' rhetoric around PF blending suggests that this is likely to rise significantly.

Authors adopt their own definitions of PF blending and approaches to measuring the flows involved. A 2015 report reached the conclusion that ODA disbursed for these purposes amounted to approximately \$1.8bn (€1.4bn) in 2013 and that aggregated disbursements in the period 2005–2013 were \$12.5bn (€9.4bn).⁸ This accounts for about 1 per cent of the more than \$1 trillion in total ODA that DAC members provided during this period.⁹ The PF blending figure is probably quite conservative, however, as it does not capture all ODA disbursements to these facilities. The methodology does not measure the amount of money used for technical assistance (TA), which can be significant. Forty-three per cent of projects funded through the EU regional blending facilities use TA exclusively and amounted to \$430m (€400m) between 2008 and 2014.

This discrepancy suggests that current ODA tracking mechanisms are ill-equipped to record and account for PF blending operations.

The lack of credible global figures for the use of PF blending makes it difficult to assess its sectoral focus. It is possible to track specific facilities or donors, as long as they publish relevant information on their websites. Some examples from the background paper produced alongside this briefing can give a flavour, but it would be wrong to assume that we can paint an overall picture from the following examples.

- The eight EU regional blending facilities, managed by the EC, do not have a defined sectoral focus, but the EC database shows that there is a very high concentration in sectors such as energy, transport, water and sanitation and private sector development. No updated information is available, however, on the balance between public sector blending and PF blending. Between 2007 and 2013, approximately 89 per cent of all EC blending projects targeted public sector clients. Only 11 per cent focused on the private sector,¹⁰ but this figure is expected to increase, at least as far as the number of projects is concerned.¹¹
- The EC also provides information about whether each project includes a climate change objective, but the marker is difficult to interpret. On average, 69 per cent of all EU blending facilities' projects include a climate change objective, with a minimum of 50 per cent and a maximum of 93 per cent, depending on the facility. The marker seems to be interpreted broadly, however. For example, waste management, public transport and hydro power projects are consistently labelled with the marker and many road-building projects use the marker because they can allegedly increase access to disaster prone or rural areas.

Of the 32 projects of the Dutch Good Growth Fund (DGGF) that were assessed, eight are industrial projects with a connection with the agriculture sector, three target the agriculture sector, and one relates to fisheries. These data refer to the two funding windows involving Dutch small- and medium-size enterprises (SMEs), since there is no information about the investment funds' window and individual underlying investees.

3 CRITICAL POINTS FROM A DEVELOPMENT PERSPECTIVE

THE IMPACT OF PRIVATE-FINANCE BLENDING

In this section we tackle five key areas from a development perspective:

- *Opportunity costs*, as the use of ODA for PF blending could mean a decrease in its use for other purposes.
- *Measuring development impacts*, where we find that there is currently very little information available to assess the development impacts of PF blending.
- *Designing projects that support developing country priorities*, where we find that developing countries are rarely involved in the governance mechanisms associated with PF blending, nor are there adequate ways of ensuring alignment with recipient country plans.
- *Accountability and transparency*, where we find that there is an absence of adequate complaints mechanisms and that levels of transparency are low.

Opportunity costs

One dollar of ODA cannot be spent twice: in the absence of an increase in the overall level of ODA, an increase in ODA used for PF blending could mean a decrease in its use for other more traditional purposes, such as supporting the delivery of public services.

It is important to remember that it is easier to undertake PF blending in emerging markets and middle-income countries, and much harder in least developed countries, since by definition, PF blending has to go where a private financier is willing to invest. This also implies that PF blending is less well suited to sectors such as education, where the public sector is the major actor. So not only is this diverting aid from other purposes, it is diverting it from the poorest countries to less poor countries and from important poverty-reducing sectors like health and education to other sectors.

Measuring development impacts

There is little evidence of the development impact of PF blending mechanisms, either at an aggregated level or at the level of the three facilities reviewed for the in-depth research.

Information is scarce and often not comparable across donors due to the existence of different definitions and methodological approaches among them. The European Court of Auditors evaluated the effectiveness of the EU regional blending facilities,¹² but the report focuses on procedural and operational aspects rather than the actual development impact of the projects on the ground. A more comprehensive external evaluation was planned for 2016, but it was not publicly available at the time of writing.¹³ The Dutch Ministry of Foreign Affairs has awarded a contract to evaluate the impact of the DGGF to a team of two consultancies, Itad and SEO, which will evaluate the impact of the first five years of the facility (2014–2019). However, the report is not expected until 2020.

This means that it is very difficult to assess, for example, the environmental or climate change impacts of PF blending at present, as there is insufficient information available about most PF blended projects to do this, nor is there sufficient information about the use of PF blending overall and the sectors that it tends to focus on, as noted above. More importantly, concerns about PF blending overall are more linked to significant donor promises to massively increase its usage—as, for example, in the EC's Agenda for Change strategy.¹⁴

The use of standardized indicators focused on the delivery of project *outputs*, by DFIs and other institutions that implement PF blending, means that development impacts are not measured unless there is also a detailed evaluation. There is a tendency among DFIs to use harmonized results indicators across different projects.¹⁵ These indicators are generally sector specific and focus on measuring project outputs. There are two reasons why institutions like the use of standardized indicators: harmonized indicators help to compare performance across institutions; and very specific and easy-to-monitor indicators focused on the project outputs are not affected by the problem of attribution that affects broader indicators, such as impact on income. The main drawback of this approach is that it makes difficult for institutions to assess projects' development impact.

However, examples from the three sets of blending facilities studied in the background research, which focused on pro-poor and gender impacts, show that some approaches are better than others:

- *EU blending facilities*: Proposed indicators are highly standardized and do not provide much information about the actual impact of projects on poor people or their contribution to gender equality. The Africa Investment Facility (AfIF) and the Neighbourhood Investment Facility include a cross-sector indicator that measures the number of beneficiaries below the poverty line who will see their life conditions improved as a result of the project. Combined with the total number of beneficiaries, this indicator can provide an indication about the poverty focus of the intervention, but it can only be measured ex-post and does not represent a design incentive to focus on specific populations.
- *DGGF*: Indicators used to measure development impact are very general, but they do capture gender and other aspects. Projects supported by the DGGF are asked to report on the percentage of female entrepreneurs supported, the percentage of young entrepreneurs supported, and the number and percentage of investments/transactions in fragile states. Although these indicators remain general, they represent an improvement over those used in the EU regional blending facilities.
- *GFF*: Projects were able to provide incentives to target women, poorer areas, and disadvantaged populations. This was possible thanks to the use of a results-based approach to project design, which included incentives, bonuses, and allocation formulas that contributed to direct efforts towards certain population groups.¹⁶

Designing projects that support developing country priorities

An analysis of the three facilities reviewed by the in-depth research indicates that PF blending mechanisms suffer from poor levels of ownership by recipient countries and are rarely aligned with those countries' strategies. This is symptomatic of a general issue: as Eurodad research has shown, there is no formal representation of developing countries' governments on (European) bilateral DFIs that implement PF blending projects, and even multilateral DFIs' governance structures are dominated by developed-country governments.¹⁷ Examples from the three facilities illustrate this point:

- The DGGF's funding windows are managed by different entities, but none of them includes representation from developing countries.
- Projects are initiated by private companies in all three funding windows.

- There is no requirement to consult developing countries or other stakeholders during the design process.
- The EU regional blending facilities consult developing countries' governments when designing and setting priorities of each individual facility, but they do not participate in the board or the operational decisions.¹⁸

It is important to note that most private investment in developing countries is domestic. On average, according to the UN Conference on Trade and Development, foreign direct investment (FDI) inflows accounted for just 8.7 per cent of gross fixed capital formation in the Global South in 2015. In the Least Developed Countries, the figure is higher, at 15.7 per cent, but this is still a low share of the total,¹⁹ and is often focused on sectors like extractives, which provide few jobs. PF blending should not focus exclusively on supporting FDI and neglect the domestic private sector of host countries.

Accountability and transparency

The lack of participation of developing-country governments and other stakeholders in decision-making processes is compounded by weaknesses in transparency and complaint mechanisms.

- The DGGF and EU regional blending facilities do not have an independent complaint mechanism. Although three of the four leading institutions (KfW, the European Investment Bank, and the European Bank for Reconstruction and Development) eligible under the EU regional blending facilities have a complaint mechanism in place, most other eligible European DFIs still lack such a system.²⁰
- Information proactively disclosed by the EU blending facilities is basic, and often outdated, but consistent.
- The DGGF does make up-to-date project information available on its website, since proposed projects are published for 30 days before signature for consultation purposes. However, the DGGF releases only the most basic information about individual projects: project name, brief description, country. Sometimes information about funding and the recipient is available, but this is not consistent (mostly in relation to the investment funds' window). Although the possibility of providing comments can help to increase accountability and improve project design, the limited amount of information available offsets this.
- PF blending projects often treat details as confidential or sensitive business information, and so do not release them to the public.

The transferring of responsibility for ODA to DFIs can create conflict or tension among the expectations, policies, and practices of ODA donors and those of the institutions that manage blending projects. One of the most distinctive features of PF blending mechanisms is that donors have transferred most of their responsibilities to other actors. In the case of the EC regional blending facilities, the EC relies on the lead DFI to perform all tasks related to project design and management, including the pre-selection of projects. The DGGF is managed from the beginning by a government agency, an export credit agency, and the private sector, depending on the funding window. The management of GFF Trust Fund projects is tied to World Bank operations (IDA or IBRD).

These institutional tensions are also to a large extent responsible for PF blending projects' deviating from development effectiveness principles such as ownership, alignment, and accountability. Although ODA donors have committed to implementing a number of development effectiveness principles and are to a certain extent held accountable for delivering on them, many other institutions have not. Additional conflicts arise at the implementation or project level since,

when it comes to issues such as transparency and public scrutiny, businesses have expectations that differ from ODA donors’.

ADDITIONALITY—A KEY ISSUE

The concept of additionality refers to the ‘added value’ of a specific form of finance, i.e. ‘the unique inputs and services that the use of ODA funds provides in addition to those delivered by market and non-market institutions’.²¹ Additionality can be broken down into two main components:

- *Financial additionality*: PF blending is necessary to ensure the project is financed.
- *Developmental additionality*: PF blending helps the project achieve better development results.

One of the main challenges of PF blending is how to confirm that projects applying for support actually require some form of subsidy. On the one hand, the risk/return profile of an investor is usually unknown, and it can be difficult to ensure that only projects requiring some form of subsidy are supported. Subsidies obviously mean PF blending is a popular choice for private financiers, but it can be difficult to differentiate projects that do require a little push to go ahead and those where the subsidy simply translates into better returns for the private financier.

In some markets, competition among project beneficiaries can help to eliminate investors looking for a boost to their returns. However, in developing countries and in certain sectors, it can often be difficult to find comparable projects. On the other hand, public finance institutions of the kind that provide ODA for blending or initiate PF blending projects (European DFIs) usually require advanced project plans from the beneficiary, something that requires a substantial investment of time and money. Often projects are in advanced stages of development, and partners have been identified and contracts awarded when they apply for support. Importantly, the more advanced a project, the more likely it will go ahead without additional support, a point that DFIs have acknowledged. In this context, how does the grant or grant element affect the project?

Many donors tend to separate the concepts, and focus primarily on financial additionality, but ultimately, the balance or combination of both financial and developmental additionality is likely to be important for PF blending.

Measuring additionality

A number of evaluations suggest that additionality is too easily assumed by donors.²² In general, there is a tendency to assume that the fact that an investor seeks public support from a DFI indicates that it cannot get private financing and thus provides evidence of financial additionality.²³ This argument is based on the belief that stricter project monitoring, social and environmental standards and other requirements create additional costs for investors that should discourage them from requesting public finance when private finance is available. However, this argument does not necessarily take into account other positive effects such as the signalling effect (public support suggests that a project will be of high quality) and the fact that public subsidies mean private investors are likely to make higher returns.

Measuring additionality is difficult, for many reasons. First, there are no harmonized definitions, approaches, and methodologies to measure additionality. This makes it impossible to compare additionality claimed by different institutions. Many institutions use definitions that are based on benefits for the private investor, such as whether the investment provided access to finance on better terms, helped access additional sources of finance, contributed to tackling the risk perceived by other investors, or resulted from subjective perceptions about whether technical assistance was useful for the business.²⁴ Similar problems also affect the measurement of developmental additionality. Existing approaches are not comprehensive and usually look at

one or a few of the following elements: improvements in project design, improvement in the projects' social and environmental standards (probably the most common), or operational aspects, such as the use of specialized advice to make up for the knowledge and skills gaps in the project.²⁵ Such partial approaches can lead to counterproductive results, e.g. blended finance might support a road project because of demonstrated additionality in terms of 'climate proofing', when another type of disaster-risk-reduction project might greatly benefit from public finance.

Second, additionality is usually measured before project completion (*ex ante*) on the basis of the information provided by the project promoter. Projects applying for PF blending are typically asked to report on the additionality of the investment. Independent of the requested level of detail, the approach is based on self-reporting by the interested party and it does not seem, from the information available, that additionality is reassessed or revaluated during the project implementation. Judging from existing *ex post* evaluations, donors tend to rely on the initial 'project accounts' and subjective perceptions and do not always have a clear and consistent methodology to measure additionality, especially when it comes to development additionality.²⁶

Third, there is a strong focus on financial additionality and a weaker one on development additionality. Some of the evaluations conducted by the EC on the EU blending facilities predominantly focus on financial additionality.²⁷ In cases where evaluators tried to measure development additionality, the methodology was not clear or was based on narrative accounts and subjective opinions.²⁸

Leverage ratios

Leverage ratios are controversial in development finance, including in discussions of PF blending. A leverage ratio can be defined as the relationship between the amount of finance mobilized and the amount of public finance that has been injected. Currently, there is no consistency in the way different facilities account for other forms of finance they help mobilize or leverage. By definition, leveraging can only occur in the case of PF blending projects, and it cannot be applied to public–public blending (though this does not stop certain donors from claiming to have leveraged resources from other donors—who could presumably claim exactly the same!).

There are not one but several different leverage ratios in every PF blending project, depending on the numbers we compare and on the donors that run the facility. Different types of leverage ratios are currently being used, for example:²⁹

- Investment leverage ratio (or absolute project costs): value of investment divided by total amount of ODA support provided by the facility.
- Financial institution leverage ratio: amount of financing from financial institutions (e.g. leading and co-leading DFIs in the case of the EC blending facilities) divided by total amount of ODA support provided by the facility.
- Private-financing leverage ratio: amount of private-sector financing mobilized as a financial input into the investment project divided by the amount of ODA support provided by the facility.

The use of some of these leverage ratios often involves bold and unsubstantiated assumptions about the impact of the PF blending element. For example, the EC regional blending facilities tend to focus on the investment leverage ratio in public communications, which in effect assumes that all the project financing was caused by the ODA subsidy. The EC has claimed ratios on the order of 1 to 9 or higher on occasion. This approach suggests that ODA has leveraged finance from DFIs and that in turn DFIs' finance has leveraged other forms of finance. Since January 2016, all EC projects are asked to estimate this (as well as the 'private-financing leverage ratio').³⁰

However, leverage ratios only make sense when some form of additionality can be demonstrated and therefore cannot be used as an indicator of financial additionality without this proof. In spite of this, we often see high leverage ratios used as an indicator of significant financial additionality.³¹ This approach is not only wrong but also misleading. In reality, a high leverage ratio (such as 1 to 50) means that the ODA element is heavily diluted, and the more diluted, the less likely that it has had a significant influence on the project.

DEVELOPMENT OF NEW OECD DAC METHODOLOGIES TO MEASURE DEVELOPMENT FINANCE

The OECD is currently working on different methodologies to measure the amount of finance mobilized through complex or combined private-sector instruments.³² Although the methodology focuses on development finance in general, it will allow donors to measure 'mobilized' flows through blending projects. This work is expected to be implemented in the DAC reporting systems starting in 2017 and to have a significant impact on how and what donors report as development finance.

Agreement on a common methodology could increase the consistency of the figures reported by donors and allow a more accurate cross-institutional analysis of development flows. It could also provide an opportunity to allow donors to report blending activities on a project-by-project basis in the long-term. However, if the problems with measuring additionality, and focusing on development impacts, accountability and transparency, support for developing-country priorities, and recognition of macro-economic risks highlighted above are not properly tackled, we risk incentivizing greater use of PF blending without proper safeguards in place, and exacerbating the opportunity costs by reducing ODA for other purposes.

4 RISKS AND OPPORTUNITIES OF PF BLENDING—A PATH FORWARD

We draw the following broad conclusions from the analysis above.

PF blending potentially threatens the quality of aid.

- It is much less transparent and accountable than other modalities.
- DFIs used do not meet basic aid effectiveness criteria—particularly ownership and alignment.
- Currently there is little evidence of impacts, and poor monitoring and evaluation.
- PF blending increases opportunities to use aid to support donor-country firms—incentivizing tied aid.

It also could divert ODA from key development priorities.

- Greater credit for PF blending (for example, claiming that a dollar can leverage \$100) means it is likely to increase, even though there is currently insufficient attention to the impacts.
- Opportunity costs—each ODA dollar can only be spent once—mean that more money for PF blending is likely to mean less money available for other uses of ODA, such as financing public services, or providing technical advice to smallholder farmers.
- PF blending is not likely to be suitable for poorer countries (in effect, it incentivizes aid to middle-income countries with attractive investment climates).

There is a risk that, when it relies on external private finance, PF blending may crowd out the domestic financial sector in the host country.

But there could be a rationale for it, if it supported developing country-led institutions. Most developing-country governments want private investment—both domestic and, frequently, foreign—to help develop their economies and create employment opportunities. There is, therefore, a rationale for PF blending if it supports national strategies (supporting strategic industries or low-carbon development plans, for instance). PF blending could play a particularly important role in helping developing-country SMEs overcome credit constraints; it is noteworthy that one of the DGGF's windows focuses on providing just such support. Blending could also support projects where private-sector engagement has the potential to make a difference in opening up new markets that can benefit extremely poor people. Examples would include investments in companies producing renewable technologies that prioritize energy access for the poorest people, such as off-grid solutions; generic medicine producers; and medical technology companies in sub-Saharan Africa. However, so long as the blending debate is dominated by donor governments and their DFIs, it is unlikely that a strategic approach focusing on how to support a development-friendly private sector in developing countries will be adopted.

Key principles to link PF blending to sustainable development:³³

- Whenever donors use ODA and other public funds in support of private investment, they should subject these resources to development-effectiveness principles, particularly transparency and accountability (give developing countries power in governance, adopt a presumption of disclosure, communicate with affected peoples, introduce independent complaint mechanisms) and alignment with national development plans (ownership).

- Donors should judiciously monitor the share of their ODA that they devote to PF blending, attempting to minimize the diversion of valuable aid dollars from public investments such as education and health in the poorest countries.
- Donors should carefully target PF blending to circumstances where it can help achieve clear sustainable-development outcomes and poverty reduction.
- PF blending should be conditioned upon corporate respect for human rights, which is indispensable to achieving the SDGs.
- Donors should only engage in PF blending when they can demonstrate financial and development additionality, effective minimization of risks for people and the environment, promotion of women's rights and economic opportunities, and the strengthening rather than undermining of the public sector.
- Robust monitoring and evaluation of projects is essential, so that donors can base their aid policy on evidence of the development impacts of blending.
- PF blending projects must ensure no false accounting—donors need to measure actual subsidies (not the amount 'leveraged'), measure net flows (i.e. money returned to the donor via loan repayments as well as funds provided) and not count as ODA non-flows of aid (e.g. guarantees provided but not drawn down, aid funds actually spent in the donor country).
- PF blending should promote business models that are structured to keep more value with local workers and entrepreneurs, focusing on domestic industry (including the domestic financial sector), particularly SMEs.
- To the extent that companies are paying their fair share of taxes, private-sector development will provide an important source of revenues for the public sector in developing countries, so ODA aimed at boosting private-sector activity must support efforts to prevent tax evasion and mobilize domestic resources.

Going beyond principles about how to engage in blended finance, there is a need instead to change the terms of the conversation: Although there is room for a private-sector approach within development cooperation, the share of ODA going to the private sector needs to be monitored. Overall, ODA should be directed at the public sector, which in turn is crucial to promoting and expanding private-sector investment. A healthy and educated workforce and well-functioning institutions and domestic markets are powerful incentives for private-sector investment. Other public goods that leverage private investment are climate change adaptation, infrastructure, and agricultural research and extension. It is often the lack of public sector investments in these areas that creates barriers to private-sector growth.³⁴

NOTES

- 1 J. Pereira (2017) 'Blended Finance', Research Report. Oxford: Oxfam.
- 2 The GFF does not currently engage in blending activities, but its business plan does indicate that such activities may take place in the future. These might include, for example, leveraging the World Bank's AAA credit rating to issue a bond that would attract private investors, which could provide the capital a government is seeking to finance maternal-and-child health programmes. As we discuss elsewhere in this paper, examples from the three sets of facilities studied in the background research, which focused on pro-poor and gender impacts, show that some approaches are better than others. GFF projects were able to provide incentives to target women, poorer areas, and disadvantaged populations. This was possible thanks to the use of a results-based approach to project design that included incentives, bonuses, and allocation formulas which contributed to direct efforts towards certain population groups. Thus, we think that the GFF offers some examples of good practice on which blending facilities can draw.
- 3 The private finance discussed in this paper consists of flows of resources (whether grants, market-term loans, or concessional loans) financed out of private-sector resources, i.e. changes in holdings of private long-term assets.
- 4 World Bank Group et al. (2011) 'Mobilising Climate Finance: A Paper Prepared at the Request of G20 Finance Ministers'. Washington: International Monetary Fund, 35.
<https://www.imf.org/external/np/g20/pdf/110411c.pdf>
- 5 See Eurodad's critique of the TOSSD process here: http://eurodad.org/arguing_the_tossd
- 6 On the funding gap, see UN Conference on Trade and Development (UNCTAD) (2014) World Investment Report 2014. Geneva: UNCTAD.
- 7 Adapted from World Economic Forum-OECD (2015) 'Blended Finance vol. 1: A Primer for Development Finance and Philanthropic Funders—An Overview of the Strategic Use of Development Finance and Philanthropic Funds To Mobilize Private Capital for Development'. Cologny, Switzerland: WEF.
- 8 J. Pereira (2015a) 'Understanding donor engagement with the private sector in development'. In Business Accountability for Development: Mapping business liability mechanisms and donor engagement with private sector in development. Brussels: CPDE in cooperation with ITUC-TUDCN and Eurodad.
- 9 Calculated from www.oecd.org/dac database.
- 10 Highlights of 2015 EU Accountability Report on Financing for Development and interview with Jose Manuel Fernandez—DEVCO C3, Financial Instruments, European Commission.
- 11 In September 2016, the European Commission launched the European External Investment Plan, substantially increasing the use of the blending facilities and creating a European Sustainable Development Fund to offer guarantees to financial institutions or private entities.
- 12 European Court of Auditors (2014) 'The Effectiveness of Blending Regional Investment Facility Grants with Financial Institution Loans to Support EU External Policies'. Special Report 16. Luxembourg: ECA.
- 13 Two individual facilities have made available evaluation reports, but they fail to measure and report the overall development impact or broader spill-over effects of blending mechanisms. For instance, there is a mid-term evaluation and an evaluation of the African Infrastructure Trust Fund (2012 and 2014, respectively), and the mid-term of the evaluation of the Neighbourhood Investment Facility.
- 14 The strategy is posted at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0637:FIN:EN:PDF>. It targets the agriculture, energy, and infrastructure sectors.
- 15 See International Finance Corporation (2013) 'Memorandum Regarding IFIs Harmonized Development Results Indicators for Private Sector Investments'. Washington: IFC.
<http://www.ifc.org/wps/wcm/connect/d7d1128041773cdb9af3bb9e78015671/Harmonization+MOU.pdf?MOD=AJPERES>.
- 16 J. Martinez, M. Pearson, B.H. Sørensen, B. James, and C. Sambo (2012) 'Evaluation of the Health Results Innovation Trust Fund'. Oslo: Norad.
- 17 M.J. Romero (2014) 'A Private Affair'. Eurodad Report. Brussels: Eurodad, 8.
- 18 M.J. Romero (2013) 'A Dangerous Blend? The EU's agenda to 'blend' public development finance with private finance'. Eurodad Report. Brussels: Eurodad.
- 19 UNCTAD (2016) World Investment Report 2016. Geneva: UNCTAD, Annex Table 5.
- 20 C. Daniel, K. Genovese, M. van Huijstee, and S. Singh (eds.) (2016) 'Glass Half Full? The State of Accountability in Development Finance'. Amsterdam: SOMO.
- 21 J. Pereira (2015a) Op. cit.
- 22 See: IOB (2014) 'In Search of Focus and Effectiveness: Policy review of Dutch support for private sector development 2005-2012' (extensive summary). IOB Evaluation. The Hague: Dutch Ministry of Foreign Affairs. See also European Court of Auditors (2014) Op. cit.
- 23 Ibid.

- 24 J. Pereira (2015b) 'Leveraging Aid: A literature review on the additionality of using ODA to leverage private investments'. London: UK Aid Network.
- 25 Ibid.
- 26 See, for example: EY (2012) 'Mid-Term Evaluation of the EU-Africa Infrastructure Trust Fund'. Final Report; CEPA (2014) 'Report of the Development Results of EU-Africa ITF 2007-2012'. Final Report. Luxembourg: European Investment Bank; and DRN-ECDPM-ECORYS-PARTICIP (2013) 'Mid-Term Evaluation of the Neighbourhood Investment Facility Under the European Neighbourhood and Partnership Instrument' (ENPI) 2007-2013. Final Report, vol. 1.
- 27 For example: EY (2012) Op. cit.; J. Martinez et al. (2012) Op. cit.
- 28 DRN-ECDPM-ECORYS-PARTICIP (2013) Op. cit.
- 29 Based on EC (2014) EUBEC Platform—Technical Group 6: Mobilization of private sector resources. Report to the Policy Group. Brussels: EU Platform for Blending in External Cooperation; and European Court of Auditors (2012) 'Financial Instruments for SMEs Co-financed by the European Regional Development'. Special report no. 2. Luxembourg: ECA.
- 30 For example, see: EY (2012) Op. cit.; and DRN-ECDPM-ECORYS-PARTICIP (2013) Op. cit.
- 31 Inter-American Development Bank (2014) 'Mid-term Evaluation of IDB-9 Commitments'. Assessment of IDB-9's Private Sector Development Framework. Background Paper, Office of Evaluation and Oversight. Washington: IADB; and Independent Evaluation Group (2008) 'Independent Evaluation of IFC's Development Results 2008: IFC's additionality in supporting private sector development'. Washington: The World Bank.
- 32 C. Sangaré, G.M. Semeraro, T. Hos, and W. Bartz (2016) 'Measuring mobilisation in the DAC statistical system'. DCD/DAC/STAT (2016) 3. Paris: OECD.
- 33 To some extent, the principles draw on M.J. Romero (2014) Op. cit.
- 34 On the relationship between public investment and private investment see, for example, L. Erden and R.G. Holcombe, 'The Effects of Public Investment on Private Investment in Developing Economies', *Public Finance Review* 33:5 (September 2005): 575-602, which finds that, on average, a 10 per cent increase in public investment is associated with a 2 per cent increase in private investment.

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