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Development finance at a turning point: Effects and policy recommendations

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Development Finance at a Turning Point: Effects and Policy Recommendations

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Abbreviations

DAC	Development Assistance Committee
FfD	Financing for Development
GDP	gross domestic product
GNI	gross national income
GRID	Green, Resilient and Inclusive Development
HIPC	Heavily Indebted Poor Countries
IDA	International Development Association
IFI	international financial institution
IMF	International Monetary Fund
MDBs	multilateral development banks
ODA	official development assistance
SDGs	Sustainable Development Goals
SMEs	small and medium enterprises
UN	United Nations
USD	United States dollar

Executive summary

Development finance is at a turning point, as the macroeconomic environment has changed profoundly and the financing gap for low- and middle-income countries has widened. The events that led to this new situation are the multiple crises that the global economy is facing, such as the climate crisis, the COVID-19 crisis and the war in Ukraine. As a result, interest rates have risen sharply over the past year and are not expected to decline anytime soon. High interest rates further restrict low- and middle-income countries' access to international financial markets by making borrowing more expensive. At the same time, debt levels in several countries are rising to levels that are almost impossible to repay. Poorer countries find themselves in a trap where financing the Sustainable Development Goals (SDGs) becomes a distant goal for them.

To “get back on track” in financing the 2030 Agenda and the SDGs, a number of reform proposals have been put forward within several processes and initiatives, including the Financing for Development (FfD) process, the Bridgetown Initiative and the Macron-led Paris Summit. Despite being initiated by different actors, these proposals all highlight the importance of reforming the international financial architecture in view of the changed macroeconomic environment. The Hamburg Sustainability Conference in June 2024, the United Nation's Summit of the Future in 2024 and the next FfD Conference in 2025 should be used to strengthen and accelerate ongoing reform processes and come up with new, innovative and bold proposals to reshape development finance in these challenging times. Against the background of the multiple crises and its effects, our key recommendations for the reform of development finance are as follows.

First, new initiatives and frameworks are needed to provide urgent debt relief and restructuring for highly indebted countries. The international community should promote a reformed G20 Common Framework for debt restructuring and discuss a green Heavily Indebted Poor Countries (HIPC)-like initiative for debt relief for low-income countries as a solution on a case-by-case basis, integrating short-term shock remedies with long-term sustainable development finance. **Debt and climate risks should be addressed simultaneously** by better incorporating climate risks in debt sustainability analyses conducted by the International Monetary Fund (IMF) and the World Bank, and by considering the volume of investments in climate adaptation because these investments reduce the risks associated with climate change.

Second, tax revenues – the most important source of development finance – need to increase and countries need to expand their fiscal space by reforming their tax administrations and policies. Building fiscal buffers can help countries to become more resilient to future crises. In the short run, eliminating unnecessary tax expenditures such as fossil fuel subsidies is the lowest-hanging fruit to increase tax revenues, while in the long run, more green fiscal reforms (e.g. carbon pricing and environmental taxes) are needed, as well as more effective international tax cooperation. In addition, donor funds should be increased to provide technical assistance and capacity-building to tax and customs administrations.

Third, the Development Assistance Committee member countries should at least halve the gap between their current contributions and the official development assistance (ODA) contribution target of 0.7 per cent of gross national income by 2026, and reach the full attainment of the target by 2030. In particular, donors need to provide ODA in addition to (not as a substitute for) climate finance and channel more ODA to the poorest countries. In this regard, donors should report climate and development finance separately to mitigate the risk of over-reporting.

Fourth, we recall the need to reform multilateral development banks (MDBs). The multiple crises have made the role of MDBs in closing the development financing gap even more important than before. As attracting private capital is becoming more difficult for low- and middle-

income countries, MDBs should harness their proven ability to leverage private finance for financing the SDGs. MDBs should substantially increase their lending capacity, for example by lowering their equity to loan thresholds and raising additional capital from shareholders or private investors. MDBs should be reformed to include in their vision the provision of global public goods, such as tackling the climate crisis and preparing for pandemics. Development banks and private creditors should include clauses on natural disasters and pandemics in their financing instruments.

1 Background

What does “turning point” mean in the context of development finance?

The multiple crises, including the COVID-19 pandemic, the war in Ukraine, the debt crisis and the climate crisis, have brought the global economy to a turning point and affected development finance – first by changing the macroeconomic environment, and second by creating different and greater development finance needs. This requires old paradigms of development finance to change and adapt to the new macroeconomic situation.

The multiple crises have led to a macroeconomic environment characterised by high interest rates, rising inflation and the associated increase in debt levels. Although the main causes of these multiple crises were largely independent of each other, the crises affect each other and are therefore interrelated. For example, the COVID-19 crisis has led to lower tax revenues and higher public spending, while the war in Ukraine led to galloping inflation and subsequently higher interest rates. This, in turn, has led to higher debt service costs and restricted access to international financial markets for low- and middle-income countries, exacerbating their debt situation. In addition, a significant amount of international aid has been directed towards addressing the consequences of the COVID-19 pandemic and continues to be diverted towards efforts to support Ukrainian refugees in Europe (Vohra, 2022), making climate finance unavailable to the extent it would have been in the absence of these crises. Accordingly, these multiple and overlapping crises have led to a deterioration of the economic and financial situations in low- and middle-income countries.

Particularly against the background of high debt levels in many low- and middle-income countries, the crises have increased the need not only for concessional finance, but also for a different type of development finance. Although we believe that donor countries can and should meet their official development assistance (ODA) contribution target of 0.7 per cent of gross national income (GNI) annually, it is important to acknowledge that achieving significant increases in ODA may prove challenging. This is partly due to the fact that high-income countries are also grappling with substantial debt burdens. Therefore, it becomes imperative to explore alternative solutions. At the same time, past paradigms of development finance appear outdated and inadequate to address the current multiple crises. For example, scaling up development finance from “billions to trillions” has not worked over the past decade (Kenny, 2023). Mobilising more market-led capital for development or leveraging capital through blended finance has not raised the expected funds and would not be advisable for highly indebted countries. Nevertheless, the private sector still holds vast financial resources that could potentially be mobilised to finance the Sustainable Development Goals (SDGs), and policies to address regulatory and capacity constraints in low- and middle-income countries, as well as instruments to enhance blended finance, should be further explored.

By a different kind of development finance, we mean, on the one hand, that development finance needs to respond to exogenous shocks. On the other hand, development finance should include sustainable finance, first and foremost to address the climate crisis. Where possible, development finance instruments should address not just one but several crises, for example by linking debt restructuring and sustainable financing. The recent Financing for Development (FfD) report indicates a paradigm shift towards better aligning international and national development agendas for sustainable industrial transformation (United Nations, 2023a). New paradigms for FfD are needed to get back on track for the implementation of the Addis Ababa Action Agenda by 2030. For example, multilateral development banks (MDBs) should be reformed to include in their objectives the provision of global public goods, such as tackling the climate crisis and preparing for pandemics. In this regard, recent changes to the World Bank’s mandate to include addressing global challenges are commendable. MDBs should also substantially increase their lending capacity, for example by lowering their minimum equity to

loan ratio and raising additional capital from shareholders or private investors. Development banks and private creditors should also include clauses on natural disasters and pandemics in their financing instruments.

Several recent events point to an acknowledgement of the need to substantially reshape and adapt development finance towards this turning point. First, the G20 has put massive pressure on the World Bank and MDBs to increase their financing capacity (Oteh, Karsenti, Nelson, & Humphrey, 2022). Second, the Bridgetown Agenda pushes for a major reform of the international financial system (including development finance), which it says is not fit to solve the multiple crises that the world is facing. Reform proposals include providing urgent liquidity support, regaining debt sustainability, mobilising private-sector investment and increasing public-sector development finance for the SDGs to USD 500 billion per year. French President Emmanuel Macron's Summit for a New Global Financial Pact in Paris in June 2023 was an important event, providing a high-level platform to advance reform of the international financial architecture and boost development finance at a time of multiple crises. After all, the unfolding debt crisis makes the achievement of the 2030 Agenda and the climate goals all but impossible – unless development finance is reformed. A new FfD conference is therefore overdue to reset the agenda on financing the SDGs, and to adapt financing instruments to the new macroeconomic environment.

Macro financial vulnerabilities in low- and middle-income countries

The multiple crises have intensified the financial vulnerabilities of low- and middle-income countries. For instance, global inflation rates have risen significantly in 2022 due to higher energy prices as well as other commodity prices and supply chain bottlenecks resulting from the multiple crises. According to the International Monetary Fund's (IMF) latest estimates, global inflation rates rose from 4.7 per cent in 2021 to 8.7 per cent in 2022. For low- and middle-income countries, the estimates are even worse, from 5.9 per cent in 2021 to 9.8 per cent in 2022 (IMF, 2023a). Although inflation rates are projected to fall in 2023, they will remain at very high levels, at 6.8 per cent globally and 8.3 per cent in low- and middle-income countries (IMF, 2023a).

In order to curb inflation, central banks in high-income countries around the world have shifted their monetary policies diametrically from expansionary to restrictive. Specifically, central banks have raised interest rates and provided less liquidity through their monetary policy instruments, such as bond purchases. As a result, central banks in low- and middle-income countries have also had to raise interest rates to prevent capital flight. This collective action, while aimed at controlling inflation, has inevitably increased the cost of capital for both public and private actors.

The COVID-19 crisis and the war in Ukraine as well as the interest rate hikes have exacerbated an already critical global debt situation. In the wake of the COVID-19 crisis, total global debt reached 263 per cent of gross domestic product (GDP) in 2020, the highest level in half a century (World Bank, 2022b). This surge in debt has been widespread, affecting both public and private sectors, encompassing domestic and external obligations, and impacting countries across the globe. Furthermore, countries are now faced with the added challenge of addressing the escalating climate crisis (Berensmann, Heitzig, Ekeruche, Ordu, & Senbet, 2022).

These macroeconomic developments have also been accompanied by the strong appreciation of the US dollar against most other currencies, which contributes significantly to domestic price pressures and continues to fuel inflation in most low- and middle-income countries. For example, wheat prices in Egypt, Ethiopia, Mauritius, Pakistan, Peru and Thailand – all net importers of wheat – increased by on average 89 per cent between October 2020 and October 2022, partly because their national currencies depreciated by on average 10 to 46 per cent against the US dollar over the same period (United Nations Conference on Trade and Development [UNCTAD], 2022a). This significant increase in the cost of living hits the poorer segments of the population particularly hard, as they spend most of their income on food and keep their meagre savings in cash.

Purpose and contribution

The multiple crises have significant implications for development finance. In the following, we assess the effects of the turning point on different sources of development finance and make policy recommendations on how development finance can adapt to these multiple crises. Although some work has already been done on this topic (Ellmers, 2022; Organisation for Economic Co-operation and Development [OECD], 2022a), we aim to contribute to this important debate in three ways. First, unlike papers that focus on the impact of the turning point on specific sources of development finance (Ellmers, 2022), we take a broader perspective on all the major sources of development finance. This helps, for example, to get a fuller picture of the different sources of development finance and to make policy recommendations that take into account their respective contributions and potentials. Second, with more recent data, we can look at the impact of the multiple overlapping crises together and go beyond the analysis of individual adverse shocks to development finance (OECD, 2022a, with a focus on COVID-19). Third, we discuss how development finance needs to change in the face of multiple crises. As the crises are both sudden and long-term in nature, the responses to them should include addressing urgent financing needs and building resilient and sustainable economies.

2 Effects of the turning point on development finance

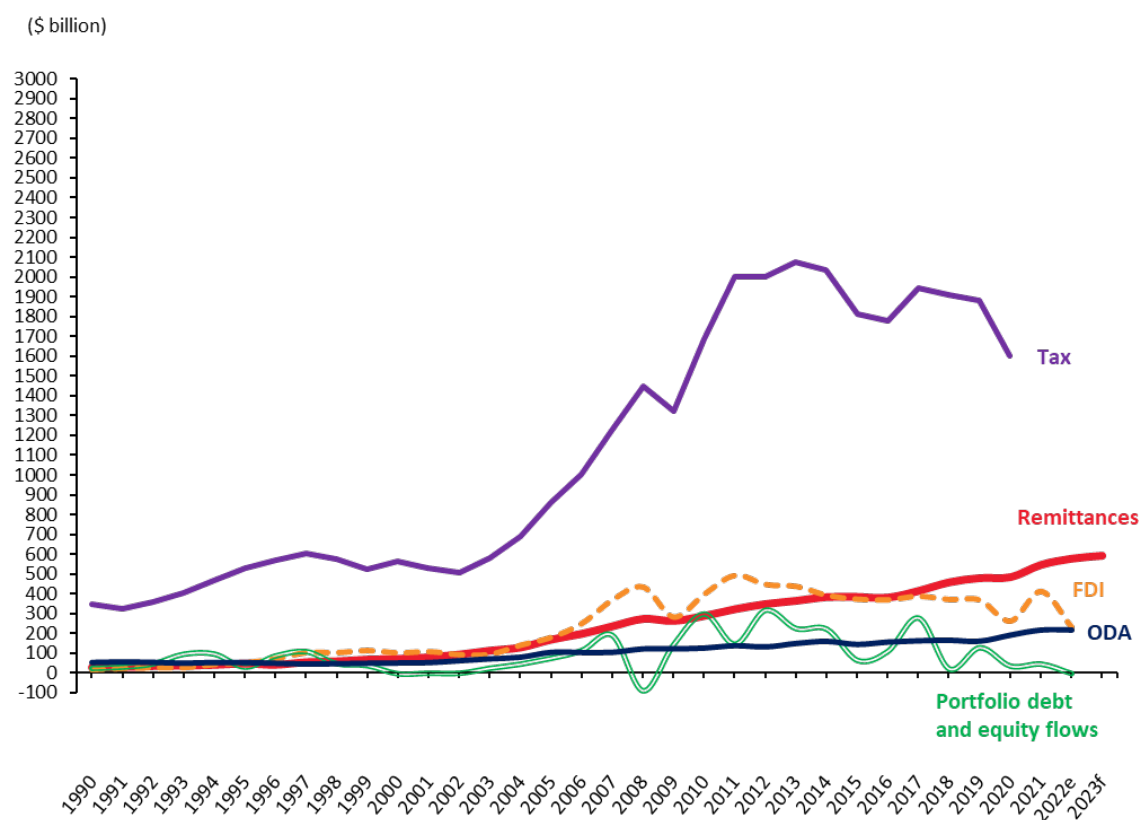
The multiple crises have caused several shocks to the global economy and reduced development financing options for low- and middle-income countries. Development finance is the sum of all sources of finance available to low- and middle-income countries. It includes both domestic and foreign public financial flows (e.g. tax revenues and ODA) and domestic and foreign private financial flows (e.g. remittances and foreign direct investment). Figure 1 shows the composition of sources of development finance before 2020 and projections to 2023 for low- and middle-income countries, excluding China and India. Tax revenues are by far the largest source of development finance, amounting to USD 1.6-5.4 trillion in 2020, depending on the number of countries considered. Remittances are the second-largest source of development finance, at USD 544 billion in 2021, and have been growing steadily over the past three decades. Foreign direct investment (FDI) and portfolio flows are important sources of development finance but have been volatile and generally declining over the past decade. Official development assistance (ODA) is a robust but slowly growing source of development finance, reaching USD 194 billion in 2020.

Increasing the SDG financing gap

In the wake of the COVID-19 crisis, the annual financing gap of low- and middle-income countries to achieve the SDGs has increased significantly. In fact, UNCTAD and the IMF forecast an annual SDG financing gap of USD 4.3 trillion from 2020 to 2025. Compared to OECD estimates for 2019-2020, this represents an increase of USD 400 billion per year (OECD, 2022a; UNCTAD 2022b). The war in Ukraine, and the associated tightened global financing conditions, will further increase this SDG financing gap in low- and middle-income countries.

Higher capital costs for low- and middle-income countries

The current global rise in interest rates increases the cost of capital for all private and public actors. Even before the crisis, interest rates in low- and middle-income countries were higher than in high-income countries because of the greater (perceived) political and economic risks associated with the investments. However, these high interest rates are difficult for many governments to afford, creating significant financing bottlenecks for low- and middle-income countries in raising private capital from the international financial markets (Ellmers, 2022).

Figure 1: Development finance flows to low- and middle-income countries, 1990-2023

Notes: The calculation of the tax revenue flow is based on 69 low- and middle-income countries for which revenue data has been available for all years from 1990-2020, excluding China and India. The other flows are calculated based on the World Bank's classification list of low- and middle-income countries, excluding China. The countries used to calculate these flows might differ from the countries used to calculate the sum of tax revenues. The data for 2022 is based on estimates, and data for 2023 is based on the forecasted estimates of the World Bank.

Sources: This graph is taken from Ratha, Kim, Plaza, Riordan and Chandra (2022), Licence: Creative Commons Attribution CC BY 3.0 IGO. We added the series on tax revenues with data from the Government Revenue Dataset (UNU-WIDER, 2021), and GDP data from the World Development Indicators (World Bank, 2022a).

Deteriorating internal debt situation

Government budgets in low- and middle-income countries are burdened by higher interest costs and associated debt service payments. Government deficits have skyrocketed in many low- and middle-income countries. In sub-Saharan Africa, the budget deficit as a percentage of GDP rose from -3.9 per cent in 2019 to -5.7 per cent the following year (IMF, 2023c).

Deteriorating external debt situation

For low- and middle-income countries, high interest rates are particularly problematic for two reasons. First, many low- and middle-income countries already have large domestic and external debts. Low-income countries are especially affected. According to estimates by the IMF and the World Bank, the share of low-income countries at a high risk of debt or already in debt distress has increased from 30 per cent in 2015 to 52 per cent in 2023 (Georgieva & Pazarbasioglu, 2021; IMF, 2023b). Twenty-five per cent of middle-income countries are also very highly indebted (Georgieva, 2023).

Second, the debt situation in low- and middle-income countries is further aggravated by the increasing share of private creditors in their loan portfolios. Low- and middle-income countries' public and publicly guaranteed debt to private creditors increased from 46 per cent in 2010 to about 61 per cent by the end of 2021. In countries eligible for finance from the International Development Association (IDA), the share of private creditors increased from 5 per cent in 2010 to 21 per cent in 2021 (World Bank, 2022b). This increasing share of private creditors lending to low- and middle-income countries aggravates their debt situation, because private creditors typically charge higher interest rates compared to their public counterparts. The higher share of private creditors also poses the risk of complicating creditor coordination in debt relief efforts.

Debt service payments of low- and middle-income countries are expected to rise on average to USD 375 billion between 2020 and 2025. This is an increase of USD 45 billion compared to the period between 2015 and 2019 (OECD, 2022a). In 2010, 29 countries had interest spending that represented 10 per cent or more of their public revenues. By 2020, this number had increased to 55 (United Nations, 2023b).

Declining domestic revenues

Tax revenues are by far the largest source of development finance in the group of low- and middle-income countries (see Figure 1). After rising steadily over the past two decades, government revenues (tax and non-tax) have declined since 2020 due to some countries going into recession following the outbreak of the COVID-19 pandemic. In 47 low- and middle-income countries, tax-to-GDP ratios fell below 15 per cent in 2020, which is considered the minimum tax-to-GDP ratio needed for a country to provide basic public goods (OECD, 2022a). Upper-middle-income countries experienced a 13.7 per cent decline in non-tax revenues from 2019 to 2020 due to price volatility in global markets (OECD, 2022a).

Domestic revenues generally fall when the economy contracts, but they are more stable than private financial flows from abroad. There are two reasons for this decline: First, governments provide tax relief in times of crisis, which reduces tax revenues, and second, a decline in economic growth shrinks the tax base from which revenues are collected. The decline in government revenues further limits the fiscal space available to governments to respond to the crisis. Although providing tax expenditures, tax relief and subsidies are important countercyclical tools in the short run, many low- and middle-income countries have very little fiscal space to provide these. The levels of fiscal stimulus used by governments in 2020 and 2021 were three to six times lower in low- and middle-income countries compared to high-income countries (OECD, 2022a).

The war in Ukraine and the ensuing global recession halted the recovery in tax-to-GDP ratios in low- and middle-income countries. In response to high food and energy prices, many governments provided tax relief and subsidies to households and firms, on average about 0.5 per cent of GDP (IMF, 2022). Although the tax-to-GDP ratios start to rise again in 2021, they fall in 2022 and slowly recover in 2023. Only half of the low- and middle-income countries' tax-to-GDP ratios had recovered to pre-pandemic levels by 2022 (IMF, 2023a), suggesting that much remains to be done to put tax revenues back on a solid growth path.

Increasing ODA

Although ODA is the smallest source of development finance, it can have a significant leverage effect if used efficiently. Compared to other sources of external finance, ODA has been the most stable resource over the past two decades (see Figure 1). However, many Development Assistance Committee (DAC) countries still do not meet the United Nations (UN) target of dedicating 0.7 per cent of their GNI as ODA (exceptions in 2021 were Luxembourg, Norway, Sweden, Germany and Denmark) (OECD, 2023). If the DAC as a whole had achieved the 0.7 per cent target in 2021, ODA would have amounted to USD 389 billion – more than double the actual

amount of USD 185.9 billion, or 0.33 per cent of GNI (OECD, 2023). In light of the war in Ukraine, several Western donor countries have been raising their public budgets for their own military defence and attempting to cushion the impacts of the war on their own economies. It remains to be seen whether this will be at the expense of countries' ODA contributions. Furthermore, in many DAC countries, ODA is being redirected to support Ukrainian refugees (Vohra, 2022).

ODA has often been used counter-cyclically in times of crisis. For instance, ODA flows increased by 7 per cent from 2019 to 2020 (OECD, 2022a) when the COVID-19 pandemic hit low- and middle-income countries. Additional ODA flows were mainly used to fight the pandemic in low- and middle-income countries. In 2021, ODA increased by 8.5 per cent compared to 2020 levels, with about half of this increase being due to COVID-19-related vaccine donations (OECD, 2022b). ODA flows have also been used to mitigate the climate crisis. In 2020, for example, one-third of bilateral ODA was directed towards climate objectives (OECD, 2022c).

Robust remittance flows

Remittances are part of private financial flows and characterised by their large volumes compared to other financial flows. Remittances represent one of the largest sources of external finance and foreign exchange earnings for low- and middle-income countries. For low- and middle-income countries, excluding China, remittances have consistently outpaced ODA since the mid-1990s, and FDI flows since 2016, as can be seen in Figure 1 (Ratha et al., 2022). In 2022, remittance flows to low- and middle-income countries reached USD 647 billion (Ratha, Plaza, Kim, Chandra, Kurasha, & Pradhan, 2023). Nevertheless, these official figures represent only a part of the total remittance flows, with some estimates putting the share of remittances sent informally at 50 per cent (Freund & Spatafora, 2008).

Remittance flows are also important in the sense that they are counter-cyclical, meaning they do not decline as much as other sources of external finance. For example, between 2019 and 2020, remittance flows to low- and middle-income countries saw only a small decline of USD 5 billion (-1 per cent), from USD 553 to 558 billion (Ratha et al., 2022). Remittance flows have also shown remarkable resilience in light of the war in Ukraine. Initially predicted to decline substantially (Ratha et al., 2022), remittances from migrants in Russia to Central Asia have instead experienced a significant upswing. This has been attributed to increased transfer activity resulting from the relocation of Russian companies and individuals, the strengthening of the Russian ruble and the increased demand for migrant labour in Russia (Ratha et al., 2023). Moreover, the remarkable resilience of remittance flows persists despite the significant erosion of purchasing power caused by rising inflation in OECD countries: Remittance receipts in low- and middle-income countries increased by 8 per cent in 2022 (Ratha et al., 2023).

Less domestic and international private finance

Domestic savings constitute a cornerstone of economic growth and long-term development, since domestic resources finance most of the private investment in low- and middle-income countries. For instance, FDI accounted for less than 20 per cent of gross fixed capital formation in low- and middle-income countries between 2018 and 2020 (OECD, 2022a). During the COVID-19 pandemic, gross domestic savings substantially decreased in middle-income countries (excluding China) from roughly 18 to 16 per cent of GDP between 2019 and 2020, and this subsequently led to a decrease in private investments, as measured by gross fixed capital formation (OECD, 2022a). Gross domestic savings in low-income countries did not drop over the same period, but they were already at a much lower level at 12 per cent of GDP (OECD, 2022a). This has left low-income countries more dependent on external finance. The IMF's savings projections for low- and middle-income countries for 2022 and 2023 indicate that domestic savings cannot be expected to produce a significant spark to close the SDG financing

gap (due to the lack of upward trends in domestic savings and investment over the past decade as well as inflationary pressures resulting from the multiple crises).

The availability of private finance for development finance was further eroded by the decline in international capital flows (FDI, portfolio investments, and other investments) to low- and middle-income countries (excluding China) during the COVID-19 crisis. Between 2019 and 2020, FDI flows dropped by almost a third (from USD 369 to 263 billion), and portfolio investments by as much as 74 per cent (from USD 126 to 32 billion), as shown in Figure 1. The rebound in capital flows in 2021 was short-lived: FDI bounced back above pre-COVID levels in 2021, but it is estimated to have reached its lowest level in the last 15 years in 2022; portfolio investments showed only a small recovery, while estimates for 2022 even predict a reversal of capital flows. This means that (private) international capital flows have started to aggravate financing bottlenecks for private investment in low- and middle-income countries.

3 Policy recommendations

Development finance is at a critical point, as it is confronted with addressing at least four global and overlapping crises: the COVID-19 crisis, the war in Ukraine, the debt crisis and climate change. Against a backdrop of limited public funding and an international financial system that is far from being fit for purpose, addressing these crises requires bold, innovative and coordinated action by low- and middle-income countries, donors and MDBs. The different crises require not only extensive levels of finance, but also different types of development finance instruments. For instance, the duration (e.g. short-term versus long-term financing) and the degree of concessionality of financing sources differ by the type of investment project. In times of shocks, for example, large-scale funding is needed at short notice.

On the one hand, low- and middle-income countries need short-term, preferably concessional and large-scale financing to cushion the short-term consequences of the COVID-19 crisis and the war in Ukraine. On the other hand, tackling the climate crisis requires long-term financing to strengthen the resilience of countries. As donor countries have limited funds for development finance, there is competition between short-term and long-term financing as well as front- versus backloading. In a context of limited public resources, the question is how to allocate development finance between short-term and long-term resources, and between concessional and non-concessional finance as front- versus backloading.

For example, IDA – a World Bank institution – recently faced a difficult trade-off between providing short-term and long-term development finance as front- versus backloading. In the wake of the enormous financing needs of low-income countries due to the COVID-19 crisis, IDA has frontloaded the disbursement of funds. Specifically, it brought forward funding from the 19th IDA replenishment (IDA19) from financial year 2023 to financial year 2022. As a result, IDA19 could only be implemented over two years instead of three, forcing donors to replenish IDA20 one year earlier (International Development Association, 2022).

Another example is the trade-off governments face in terms of prioritising between urgent short-term investments and strategic long-term investments. Whereas short-term investments are needed to address the current crises (e.g. investments in the health sector or to address high food prices), countries need to prioritise some investments for long-term green investment projects. Although green energy and infrastructure projects often have higher up-front costs (plus 33 per cent), these costs are likely to be outweighed in the long run, as countries are expected to follow a higher growth path (OECD, 2022a).

Moreover, these crises are interrelated because the economic and social impacts of the pandemic have amplified the impacts of climate change. Crisis recovery offers an opportunity

to “build back better” in terms of environmentally friendly, resilient and inclusive recovery. In this regard, the World Bank has developed a new approach – Green, Resilient and Inclusive Development (GRID) – that aims to make recovery in low- and middle-income countries more sustainable, inclusive and resilient to future shocks. The novelty of this approach is that sustainability, resilience and inclusiveness are considered simultaneously and systematically in the formulation of development policies. This integrated approach addresses short-term and long-term challenges simultaneously. In doing so, the measures should be coordinated in such a way that they individually consider the needs of the respective low- and middle-income countries (World Bank, 2021; World Bank & IMF, 2021). Although the GRID approach appears to hold great promise for promoting sustainable and inclusive development in the context of multiple crises while increasing resilience to future shocks, it is too early to evaluate its implementation. Even if this means for development finance that in some cases one financial instrument can be used to achieve several goals at the same time, this is not always the case, and the balance between the short-term and long-term needs of development financing remains a major challenge.

Table 1 provides an overview of the short- and long-term policy recommendations in the different areas of development finance in response to the turning point. In the following, we examine short- and long-term actions for different financing sources and whether there are potential trade-offs.

Table 1: Policy recommendations for development finance – an overview

Development finance source	Short-term recommendations	Long-term recommendations
Debt	<ul style="list-style-type: none"> Promote debt restructuring for highly indebted countries under a reformed G20 Common Framework Better consider climate risks in debt sustainability analyses 	<ul style="list-style-type: none"> Improve debt management, including transparency Discuss a green HIPC-initiative and an insolvency procedure for states
Tax revenue	<ul style="list-style-type: none"> Abolish unnecessary tax expenditures and subsidies (e.g. for fossil fuels) 	<ul style="list-style-type: none"> Increase fiscal budget buffers Implement medium-term revenue strategies Leverage green fiscal reforms (e.g. carbon pricing) Digitalise tax and custom administrations Promote inclusive international tax cooperation
ODA	<ul style="list-style-type: none"> Increase the volume of ODA for low-income countries Earmark more ODA for green and fiscal policies Reallocate Special Drawing Rights 	<ul style="list-style-type: none"> Reach the 0.7% ODA/GNI target by 2030 Add climate finance on top of ODA Double ODA for domestic revenue mobilisation
Remittances	<ul style="list-style-type: none"> Reduce transaction costs 	<ul style="list-style-type: none"> Promote innovative solutions to leverage remittances (e.g. diaspora bonds)
Private finance	<ul style="list-style-type: none"> Add concessional loans for local banks 	<ul style="list-style-type: none"> Strengthen capacities to mobilise domestic savings for investments
MDB reform	<ul style="list-style-type: none"> Expand MDB mandates to include addressing global challenges such as climate change and pandemics Increase MDB financing power (e.g. by lowering their equity-to-debt ratio) 	<ul style="list-style-type: none"> Substantially increase MDB’s financing power (e.g. through callable capital and hybrid capital)

Source: Authors

Providing debt relief and restructuring

Two things need to be considered in addressing the current debt problems in low- and middle-income countries. On the one hand, many low- and middle-income countries are highly indebted and would need debt restructuring – including, to some extent, debt relief. On the other hand, debt restructuring, and in particular debt relief, would use up scarce ODA resources for existing programmes and projects. In contrast, financial resources for current and future investments in the SDGs would significantly decline, unless debt restructuring is combined with requirements to invest in the SDGs and address the climate crisis. For this reason, precise debt sustainability analyses are needed to decide on whether, and to what extent, debt restructuring is needed and must be combined with investments in programmes that ensure potential returns. Debt policies should be accompanied by measures to strengthen countries' capacities to become more self-reliant upon their domestic resources, that is, by supporting domestic resource mobilisation, as explained below.

As several low-income countries have high debt-risk and are in debt-distress situations, the international community should urgently promote the implementation of the Common Framework for Debt Treatment Beyond DSSI (Debt Service Suspension Initiative), established by the G20 and the Paris Club in cooperation with international financial institutions (IFIs) at the end of 2020. The Common Framework is intended to restructure the debt of low-income countries and, if necessary, to cancel debt. However, only four countries – Chad, Ghana, Zambia and Ethiopia – have participated in this framework so far (Berensmann et al., 2022). Implementation has been delayed mainly due to difficulties in creditor coordination (Georgieva & Pazarbasioglu, 2021).

The international community should put a reformed Common Framework into practice by ensuring equality among creditors through the inclusion of all public and private creditors and the transparency of debt contracts. In addition, debt restructuring should be accompanied by requirements to invest in the SDGs and tackle the climate crisis. Moreover, the Common Framework should be available not only to low-income countries but also to lower-middle-income countries. Similarly, a green Heavily Indebted Poor Countries (HIPC)-like initiative for debt relief should be discussed. This initiative would free up substantial resources for low- and middle-income countries to achieve the SDGs and climate goals (Berensmann, 2024; Volz, Akhtar, Gallagher, Griffith-Jones, Haas, & Kraemer, 2021; Zucker-Marques & Volz, 2023). Besides, the global sovereign debt roundtable should be held regularly to enhance creditor coordination.

Furthermore, the international community should discuss an insolvency procedure for sovereign states and combine this with codes of conduct for creditors and debtors to prevent and deal with debt restructuring (Berensmann, 2018 and 2022). This procedure would be an alternative to the Common Framework, as it would be a comprehensive approach involving the restructuring of all types of debt (Berensmann et al., 2022).

Addressing debt and climate risks simultaneously

IFIs should also incorporate climate risks into their financing instruments (Berensmann et al., 2022). As climate change also poses risks to countries' debt sustainability, debt sustainability analyses by the IMF and the World Bank conducted under the Common Framework for the amount and terms of debt restructuring and/or debt relief should better take into account climate risks. Similarly, debt sustainability analyses should consider the volume of investments in climate adaptation, as these investments reduce climate risks (Volz et al., 2021; Volz, Berensmann, Burke, Gallagher, Griffith-Jones, Kessler, & Monasterolo, 2022). The IMF is currently working on proposals to integrate climate change into fiscal policy (Masseti & Bellon, 2022).

Enhancing debt sustainability

Long-term measures to enhance debt sustainability include, in particular, improving debt management in order to use financial resources more efficiently. In addition, good debt management facilitates the establishment and further development of domestic bond markets, which provide low- and middle-income countries with a domestic source of financing, and thus reduce external debt. Improving debt management mainly involves increasing transparency about the debt structure as well as the appropriate debt structure in terms of domestic and foreign currency weighting, maturity and interest rate structure (Berensmann et al., 2022).

Increasing domestic revenue mobilisation

To increase fiscal resilience, countries need to build up buffers in their fiscal budgets to prepare for future crises. This implies increasing fiscal space and domestic revenue collection. Several short- and long-term reforms of tax policies and tax administrations are advisable, with short-term and long-term policy objectives being complementary rather than substitutes.

In the short term, governments should focus on the low-hanging fruit to raise more revenues. For example, governments should eliminate unnecessary tax exemptions and subsidies (e.g. for fossil fuels). Low- and middle-income countries lose on average about 3.4 per cent of GDP or 23.4 per cent of total tax revenue per year due to tax expenditures (Aliu, Redonda, & von Haldenwang, 2022). By eliminating some useless tax exemptions, governments can quickly increase their tax revenues.

In the long term, supporting tax reforms in low- and middle-income countries requires an integrated approach that takes into account the revenue collection and expenditure sides and provides a medium- to long-term perspective that is in line with the SDGs. The IMF proposes a successful tool, the Medium Term Revenue Strategy, which has been used in five countries so far and will be expanded to 10 more this year. This tool consists of fiscal reform packages tailored to countries' development goals, which are progressive to ensure an equitable distribution of the tax burden within societies. In addition, tax reform packages need to exploit the full potential of different taxes, such as value added tax, property tax and income taxes, to increase overall government revenues in the long run. Key reforms are green fiscal reforms such as carbon pricing and environmental taxes. They aim at both increasing tax revenues and combating the climate crisis.

Donor funds should be increased to provide technical assistance and capacity-building to tax and customs administrations. The digitalisation of tax administrations and the compilation of comparable tax administrative data is key in this regard. Data and transparency are needed to better assess the efficiency of existing tax structures and design future tax policies. Two successful ongoing initiatives here are the Tax Inspectors Without Borders initiative, which sends tax experts to train staff in partner tax administrations, and the (automatic) exchange of information on tax matters, which tackles cross-border tax evasion and avoidance via increased transparency.

Promoting inclusive international tax cooperation

In addition to domestic tax reforms, low- and middle-income countries also have an interest in shaping the reforms of the international tax system. Many multinational companies operate in low- and middle-income countries, and their corporate tax payments account for a large share of total tax revenues in these countries. However, countries lose billions in revenue each year because companies strategically avoid paying taxes by shifting profits to tax havens. In addition, many wealthy individuals from low- and middle-income countries place their financial assets in offshore bank accounts to avoid paying income tax at home.

Reforms of the international tax system are currently being discussed in several multilateral platforms, such as the OECD-hosted Inclusive Framework on BEPS (base erosion and profit shifting) and the UN Tax Committee. Their common goal is to strengthen international tax cooperation and reduce illicit financial flows, which cause huge revenue losses in all high-tax countries (high- and low-income countries). However, recent reform proposals, such as the two-pillar solution of the Inclusive Framework, often lack simplified solutions for low- and middle-income countries. Furthermore, the implementation of several global tax reforms is based on peer reviewing and exchange of information mechanisms between tax administrations of different countries. Technical development cooperation should further assist low- and middle-income countries to set up the necessary infrastructure to participate and benefit from these mechanisms. There is therefore a need to strengthen the role of low- and middle-income countries in the multilateral platforms to ensure that they participate equally in global tax reforms and benefit from them in the form of increased tax revenues. A promising way forward is to locate some of the resources and decision-making processes for international tax cooperation at the UN, the most inclusive multilateral organisation. The adoption of a UN resolution in this regard in November 2023 – mainly voted for by low- and middle-income countries – paves the way for a bigger role of the UN in international tax cooperation in the future.

Increasing ODA

Rising interest rates in the global capital market and already unsustainable debt levels have made it more difficult for low-income countries and frontier countries (those that have just graduated from the low-income countries' level) to raise funds in the form of loans, FDI and other international capital flows. Donors should therefore increase their ODA and change their funding conditions when a country is highly indebted. First and foremost, donors should meet their ODA target of 0.7 per cent of GNI. To achieve this, the EU should agree on an intermediate target – for example to halve the gap between its current ODA and the 0.7 per cent target by 2026 – and to reach the target by 2030 as agreed. Second, the UN Framework Convention on Climate Change commits to provide an additional USD 100 billion per year in climate finance from high-income countries to low- and middle-income countries. This should not be counted as ODA, and the worrying practice of redirecting ODA must cease. For instance, reports indicate that DAC members allocated 27.6 per cent of bilateral allocable ODA to climate objectives in 2021 (OECD/DAC, 2023). Moreover, donors should report climate and development finance separately to mitigate the risk of over-reporting (Koch & Aleksandrova, 2023). Third, more ODA should be allocated to the poorest countries. The target agreed in 1981 for DAC members to allocate 0.15-0.20 per cent of their GNI as ODA to the least developed countries has not been achieved. In 2021, the allocation amounted to 0.09 per cent of GNI (OECD, 2023).

Fourth, IFIs should increase concessional funds for low-income countries, and there should be a capital increase for MDBs to provide more financial resources to middle-income countries. Both would have to be financed by members of the IFIs. In addition, high-income countries should provide more of their Special Drawing Rights distribution to low- and middle-income countries (Berensmann, 2021; Ellmers, 2022). The German government could support these measures through the various fora (G7 and G20) and through its directors in the IFIs.

Finally, ODA can be used to leverage more domestic public resources and build up financial resilience. The members of the Addis Tax Initiative should set new goals and commitments for the size and use of ODA contributions for domestic revenue mobilisation.

Reducing the cost of sending remittances

At this turning point of multiple crises, remittance flows could act as a stabiliser of government revenue and foreign exchange reserves, mitigating the drop in other external private resources such as cross-border capital flows (OECD, 2022a). Noting that inflation in low- and middle-

income countries is partly fuelled by the rapid depreciation of national currencies (UNCTAD, 2022a), remittance flows could also play a crucial role in slowing down depreciation, and thus stabilising prices in low- and middle-income countries.

One effective means of increasing the flow of remittances is reducing the transaction costs related to sending remittances. Current global average costs (2023, Q2) for sending USD 200 amount to 6.20 per cent, with substantial differences across regions and remittance service providers (World Bank, 2023). This is substantially higher than the SDG target of 3 per cent to be reached by 2030, with a further commitment to keep the cost of transfers under 5 per cent in all corridors (United Nations, 2015).

To reduce the cost of sending remittances, development cooperation and national governments could focus on three policy instruments. First, they should promote digital remittance channels (e.g. mobile money accounts), as transaction costs are significantly lower and most transfers still rely on non-digital channels (World Bank, 2023). Second, the remittance industry should be open to new entrants, as competition in the remittance industry has led to significant reductions in remittance fees in various corridors (Ratha, 2017). Third, closing the gap between the official and parallel exchange rates should be a medium- to long- term policy goal for central banks and national governments in order to increase remittance flows. On the one hand, the real costs of sending remittances are higher in countries with parallel exchange rates (costs comprise fees and exchange margins plus parallel market premiums). Consequently, migrants are more likely to send their remittances through the parallel market as the exchange rate differential widens. This, on the other hand, makes the official remittances-sending business unattractive to new entrants, holding back much-needed competition in the industry.

Promoting innovative solutions to leverage remittances

While remittances, as private financial flows, primarily serve as a lifeline for millions of families worldwide by helping them overcome economic difficulties and avoid poverty, they can also be used more effectively for sustainable development. To this end, coordinated and innovative efforts by governments and development partners are essential. For example, well-designed diaspora bonds can enable diaspora members to invest in sustainable development projects, infrastructure and other initiatives in their home countries. Targeted policies that encourage remittance recipients to invest in small businesses and entrepreneurial ventures can create jobs and promote local economic growth. Equally important are vocational training, financial literacy programmes and employability initiatives that enable remittance recipients to use these funds more productively and reduce their dependence on them.

Supporting SMEs through finance

Another group that is particularly affected by constrained access to finance is comprised of small and medium enterprises (SMEs). After all, SMEs provide livelihoods for the vast majority of people in low- and middle-income countries, accounting for more than 60 per cent of formal jobs, and even more of the semi-formal and informal economic opportunities. Continued efforts in development finance to stabilise SMEs' access to finance are paramount in order to dampen the adverse socio-economic effects of the multiple crises within societies in low- and middle-income countries. As a short-run measure, development banks need to provide additional funds to local banks in order to compensate for lower savings levels, which are an important funding source for lending activities. Such funds can be used by local banks for lending to financially sound SMEs in need of external finance for liquidity. However, such short-term emergency measures require additional resources rather than detouring funds earmarked for other areas where development financing is needed.

Fostering domestic savings

In the medium to long run, national financial systems need to be equipped to channel more domestic savings into domestic investments (with the positive side effect of increased resilience against shocks in international financial markets). On the one hand, this requires more “safe” domestic investment opportunities. After all, significant amounts of domestic savings flow into hard-currency assets abroad. As suggested by experts from OECD, SOAS and IDOS in an internal policy paper based on the research by Volz, Lo and Mishra (2024), public development banks in low- and middle-income countries could play an important role in providing such safe assets for domestic (and international) investors due to their proximity to and in-depth knowledge of local markets. MDBs and development finance institutions should support public development banks to fulfil this role through both technical assistance and capacity-building, as well as by strengthening their ratings, and thus their ability to raise low-cost capital; this could include, for instance, the provision of (callable) capital and/or guarantees.

On the other hand, previously untapped potential for mobilising domestic savings should be exploited. Local banks should be enabled to mobilise more domestic resources through savings accounts, which provide cost-efficient and relatively stable funds for banks to engage in lending activities (including SME financing) – that is, to transform domestic savings into investments. Digital finance has great potential, as it increases affordability and widespread accessibility to financial services. This can increase the spread and use of (digital) savings accounts, and thus the volume of domestic resource mobilisation. Development agencies such as Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) should support such digitalisation processes through capacity-building: on the one hand, by strengthening the supply side by facilitating the launch of fully digital accounts that are user-friendly and cost effective; on the other hand, by increasing financial literacy among households to ensure uptake and usage of digital financial services.

Reforming MDBs

The multiple crises have made the role of MDBs in closing the development financing gap even more important than before. As ODA has been stagnating and low- and middle-income countries are struggling to access the international capital markets, MDBs should harness their proven ability to leverage private finance to support the SDGs. For this, the World Bank’s ongoing reform process needs to be strengthened, and other MDBs should also embark on reform processes. In particular, we believe that these reform processes should address the following three main issues.

First, it is imperative to broaden the mandates of MDBs to encompass the provision of global public goods, such as climate change mitigation and adaptation as well as pandemic preparedness and response. This expansion of MDB mandates is important to enable them to respond with scale and speed to global challenges, which are transboundary by nature. However, care must be taken to ensure that scarce concessional resources are not diverted from fundamental development objectives such as poverty reduction to the provision of global public goods – a major concern raised during the World Bank reform process. The risk of this diversion becomes more tangible if MDBs extend their missions without a proportional enhancement of their financial capacity. Additionally, it is crucial to ensure that the MDBs’ focus on financing global public goods does not inadvertently favour middle-income countries at the expense of their low-income counterparts.

Second, a substantial increase in the lending capacity of MDBs is imperative. This augmentation is not only necessary for these institutions to play a more significant role in meeting the extensive financial needs for achieving the SDGs and addressing the climate crisis, but also to avoid undesirable trade-offs between development and global public goods, as mentioned earlier. MDBs should thoroughly implement the recommendations put forth in the G20’s Independent

Review of Multilateral Development Banks' Capital Adequacy Frameworks. Specifically, the independent review underscored that MDBs have the potential to embrace more risk (also by lowering the mandatory equity-to-loan ratio), channelling additional billions of dollars without compromising their esteemed credit ratings. As a crucial recommendation of the independent experts, the exploration of options for enhanced callable capital – whereby MDB shareholders commit to providing additional funding in extreme situations – holds significant promise. By expanding the terms and seeking clarity from credit agencies and shareholders regarding procedures and mechanisms for callable capital, there exists tremendous potential for MDBs to absorb more risk and expand lending. Furthermore, MDBs should explore alternative avenues for increasing their capital, whether through a general capital increase by shareholders or through innovative approaches such as hybrid capital – a form of subordinated debt with loss-absorption characteristics similar to equity but without voting rights.

Third, development banks and private creditors should include clauses on natural disasters and pandemics in their financing. These provisions are crucial to countries as they enable them to secure ample liquidity precisely when it is most needed.

4 Conclusion

To get back on track with financing the 2030 Agenda and the SDGs as well as climate finance goals, reforms and actions are urgently needed in all areas of development finance. Bilateral and multilateral development cooperation should support low- and middle-income countries through immediate debt relief, increased ODA and capacity-building, but it should also push reforms for a fairer international financial architecture. All of the short-term recommendations that we presented here can and should be implemented quickly. The long-term policy recommendations, on the other hand, address systemic issues and need better cooperation at the international level. However, we believe that our long-term proposals are feasible, and not overly ambitious.

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