



THE LEAST DEVELOPED COUNTRIES REPORT 2019

OVERVIEW

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The present and future of external development finance – old dependence, new challenges



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FOREWORD

A formidable challenge facing the least developed countries is their dependence on external development finance. Their vulnerabilities imply higher investment needs to achieve the Sustainable Development Goals by 2030, but weak productive capacities shackle their financing efforts and dampen their capacity for mobilizing market-based sources of external development finance. As a result, levels of aid dependence in these countries remain among the highest worldwide.

At a juncture when revitalizing international cooperation is as pressing as ever, *The Least Developed Countries Report 2019: The Present and Future of External Development Finance – Old Dependence, New Challenges* discusses the impact of the evolving development finance landscape on the world's poorest countries. In spite of all the talk about “leaving no one behind”, attempts to redress long-standing flaws in the international financial architecture remain elusive, while the interests and needs of the least developed countries are poorly reflected in deliberations of the international community. Amidst heightened uncertainty and a decelerating global economy, this inaction leaves these countries with inadequate access to long-term development finance. Instead, their debt sustainability concerns loom large as external debt stocks and debt servicing surge, draining resources from development spending.

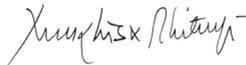
With multilateralism under fire and aid budgets under strain, official development assistance flows to the least developed countries have also slowed down considerably and remain far below the long-standing international commitments reaffirmed in the 2030 Agenda for Sustainable Development. Only a minor share of this assistance is channelled to economic infrastructures or productive sectors (15 and 8 per cent, respectively), and concessional financing terms for most of these countries have worsened.

Meanwhile, an increased focus on mobilizing private sector-led development financing has not helped the least developed countries to transition away from aid dependence. Amounts mobilized to date through incipient private sector instruments remain limited, and the deficit of transparency and accountability in development finance has widened. In addition, the blurring of concessional and non-concessional flows makes previously comprehensible aspects of official development assistance opaque, while undermining key pillars of the development effectiveness agenda: ownership, alignment, harmonization, managing for results

and mutual accountability. This further undermines these countries' aptitude to concretely take responsibility for their own development plans.

Barely two years ahead of the Fifth United Nations Conference on the Least Developed Countries, *The Least Developed Countries Report 2019* makes a call to action for the international community to launch an "Aid Effectiveness Agenda 2.0", taking into account the realities of the evolving aid architecture.

It is my hope that the development policy community finds the proposals put forward in this report an invaluable contribution to unpacking the needs and interests of the least developed countries in pursuit of a revitalized Global Partnership for Sustainable Development that truly leaves no person, nor country, behind.

A handwritten signature in black ink, appearing to read "Mukhisa Kituyi".

Mukhisa Kituyi
Secretary-General of UNCTAD

OVERVIEW

Sustainable Development Goals, structural transformation and financing for development

Dependence on external resources to finance fixed investment and, more generally, sustainable development is a crucial feature of the economies of the least developed countries (LDCs). Consequently, such dependence has a determining impact on the ability of these countries to reach their development goals, especially the Sustainable Development Goals and the objectives of the Programme of Action for the Least Developed Countries for the Decade 2011–2020 (Istanbul Programme of Action).

This report re-examines that dependence and contributes to development policy debates by showing the linkages between development goals, structural transformation, sustainable development and human rights. Human rights are scarcely mentioned in those debates, yet the connection is evidenced by the fact that both the objectives of the Istanbul Programme of Action and the Sustainable Development Goals aim at the realization of human rights in general and, specifically, of the right to development. While no single human right has ascendancy over the various other human rights, the realization of the right to development creates an enabling environment for the realization of all human rights.

International cooperation, which is central to this report, is a key contributor to the realization of human rights. Specifically, the report concentrates on development aid, in the context of the broader topic of international cooperation for development, structural transformation and sustainable development. An “Aid Effectiveness Agenda 2.0”, as proposed in this report, could contribute decisively to structural transformation through better management and delivery of aid. Structural transformation is, in turn, a condition for the realization of human rights – including the right to development – and the realization of the Sustainable Development Goals and objectives of the Istanbul Programme of Action.

LDCs have progressed too slowly towards achievement of their objectives under the Istanbul Programme of Action and of the Sustainable Development Goals, largely due to scant progress in structural transformation. Here, structural economic transformation is understood to mean the transfer of productive resources (particularly labour, capital and land) from activities and sectors of low

productivity to those of higher productivity. One reason for this scant progress is the failure of the international community to create an international economic environment conducive to the structural transformation of LDCs.

Structural transformation plays a crucial role as an enabler of sustainable development. It is also a given that the financial resources available to LDCs are limited. In this report, therefore, the point is made that these countries and their development partners should sequence their policy and spending focus with an eye on the Sustainable Development Goals most relevant to structural transformation – Goals 7, 8, 9, 12 and 17 – initially receiving greater attention and resources. Rapid progress towards achieving these Goals is an enabler of the realization of the other Goals.

In terms of balance of payments, the reallocation of resources towards higher-productivity activities leads to expansion and diversification of exports and lower dependence on imported intermediates and capital goods (as domestic firms narrow their competitiveness gap vis-à-vis foreign suppliers). This gradually contributes to reducing current account deficits, by means of a dynamic relationship between exports, profit and investment.

The positive growth performance of LDCs since the global financial crisis of 2008/09 has not been sufficient for these countries to accelerate structural transformation or reduce dependence on external resources (i.e. foreign savings) to finance fixed investment and development. Despite a difficult international environment, LDC exports of goods and especially services have seen a significant expansion since the outbreak of the crisis. However, two negative developments overshadow this positive development for LDCs: (a) the very limited diversification or upgrading of their export baskets; and (b) the even more rapid expansion of imports (leading to widening current account deficits).

Domestic resource mobilization on a scale commensurate with the enormous investment needs of LDCs is not an option for them, due to their low income and high levels of poverty. By the same token, these countries have little ability to attract market-based forms of sustainable long-term financing.

LDCs' sluggish progress on structural transformation is reflected in persistent current account deficits. These deficits need to be financed by foreign capital inflows, hence LDCs' external financing needs and their dependence on foreign savings. From a balance of payments point of view, the main sources of external finance have traditionally been foreign direct investment, traditional official development assistance (ODA), resources arising from South–South cooperation, remittances,

external debt and portfolio investments. More recently, blended finance and public–private partnerships have emerged as alternative sources. These different sources each have, however, a distinct development footprint, degree of alignment with a country’s development strategies and consequences for external indebtedness.

The major source of external development finance for LDCs as a group is ODA, and the vast majority of these countries are dependent on ODA for their development finance. By contrast, for other developing countries, foreign direct investment is the most important source.

The state of LDC aid dependence depicted so far is worrisome per se. Moreover, such dependence has become even more challenging to LDCs as the aid landscape has changed considerably in recent years. The aid architecture has become more complex and less transparent since the early 2000s, which further challenges LDC policymakers’ already constrained capacities to manage the financing of their sustainable development. The aid architecture has been transformed as a result of: (a) changes in the aid policies of traditional donors; (b) the declining role of non-governmental organizations and the emergence of new forms of private sector engagement; (c) the strengthening and broadening of South–South cooperation; (d) the entry of philanthropists; and (e) the development of new modalities and instruments of raising and delivering aid, such as blended finance and public–private partnerships.

The Least Developed Countries Report 2019: The Present and Future of External Development Finance – Old Dependence, New Challenges aims at answering the question of whether, and to what extent, available external resources are contributing to the structural economic transformation of LDCs. The report is intended as an input and contribution to the policy debate and deliberations of the forthcoming Fifth United Nations Conference on the Least Developed Countries, in 2021, leading to the adoption of a new plan of action for LDCs to guide policy actions and international cooperation until 2030.

Official flows and the evolving terms of aid dependence

Despite LDCs’ respectable growth performance since the global financial crisis of 2008/09, their sizeable investment needs coupled with sluggish progress on

the domestic resource mobilization front, imply that current account imbalances will likely persist – and possibly widen – over the medium term. This leaves LDCs largely dependent on external finance to sustain their much needed capital accumulation and redress long-standing infrastructure gaps. With their relatively small economic size and slow move away from commodity dependence, most LDCs remain unable to attract market-based resources commensurate with their financial needs. Indeed, for LDCs as a group, ODA disbursements continued to outstrip other sources of external finance in 2017. This is not to disregard the fact that sources of external finance other than ODA have gradually become more conspicuous, even for LDCs. Yet, foreign direct investment flows continue to be concentrated on a relatively few LDC economies – mainly resource-rich or large enough to attract market-seeking foreign direct investment. Also, remittances play a significant role in only about one third of LDCs. Moreover, with downside risks and uncertainties threatening the global economy, prospects for significant expansion in other sources of external finance remain grim.

As a consequence of these persistent challenges, levels of aid dependence among LDCs remain comparatively high by international standards, reflecting their heightened vulnerability, which justifies dedicated support measures from the international community. Yet this should not overshadow some improvements that have accompanied the recent growth spell, including in the aftermath of the global financial crisis of 2008/09. For instance, economic dynamism in most LDCs has been accompanied by declining levels of aid dependence, as the magnitude of aid flows declined relative to gross domestic product (GDP) or other macroeconomic variables (such as imports or gross fixed capital formation). For the median LDC, the ratio between ODA and gross national income fell from 16 per cent in 1990, to 10 per cent in 2000 and, after picking up in the early 2000s, declined again to some 7 per cent in 2017. Nonetheless, whether relative to GDP or in per capita terms, ODA continues to play a key role for sustainable development financing in many of the smallest and most vulnerable LDCs, including many small island developing States and conflict or post-conflict States. This poses significant challenges not only for the current development finance of LDCs, but also for the future in the medium term. By then, it is expected that many of these countries will reach middle-income status (and possibly graduate) and face the so-called “missing middle of development finance” (i.e. the challenge of a middle-income country in the transition from aid to other sources of development finance).

The world's 47 LDCs received \$52 billion worth of gross ODA disbursements – roughly 27 per cent of total ODA flows – as recorded by the Development Assistance Committee of the Organization for Economic

Cooperation and Development. In addition, they received some \$2.4 billion of other official flows (i.e. other State-to-State transactions that do not qualify as ODA because of insufficient concessionality or because their primary objective is not developmental). While other official flows may have been required to mobilize additional development finance, the scale of development financing, both globally and for LDCs, falls short of the ambitious levels required to achieve the objectives of the 2030 Agenda for Sustainable Development. Despite the arguably sizeable sums cited, in fact larger than foreign direct investment and remittances flows accruing to LDCs, they remain well below long-standing international commitments enshrined in Sustainable Development Goal target 17.2. Had Development Assistance Committee donors met the 0.15 per cent of donors' gross national income target in 2017, net ODA disbursements to LDCs would have increased by \$32.5 billion. If they had met the more ambitious 0.20 per cent target, these disbursements would have expanded by as much as \$58.3 billion.

With the increasing pressure on aid budgets in the aftermath of the global financial crisis of 2008/09, ODA flows to LDCs have expanded only marginally since the Istanbul Programme of Action was adopted, increasing at 3 per cent per year, half the pace at which they had grown under the Brussels Programme, at 7 per cent. The interplay of stagnant ODA flows and sectoral allocation disproportionately geared towards social sectors and humanitarian activities (jointly accounting for 60 per cent of total disbursements) has left economic infrastructures and productive sectors critically underfunded. On average, these two areas, which constitute the backbone of the Aid for Trade initiative, accounted for 15 and 8 per cent of total gross disbursements, respectively. As a consequence, LDC efforts to redress infrastructure gaps and foster technological upgrading have hinged mainly on domestic funding and concessional and non-concessional debt.

The proportion of Development Assistance Committee donors' bilateral commitments to LDCs targeting gender equality, either as the principal or a significant objective, rose from 24 per cent in 2002 to 46 per cent in 2017. More than half of aid geared at gender equality is concentrated on social infrastructures and the services sector, mainly health and education.

Over the last few years, the level of concessionality has gradually decreased not only for developing countries in general, but also for LDCs. The rise in ODA gross disbursements to LDCs since 2011 is chiefly due to increased ODA loans, whereas grants have remained essentially stagnant, or even declined, for most of the 2010s. The proportion of loans in total ODA disbursements to LDCs increased by more than 10 percentage points between 2011 and 2017, surpassing 25 per cent in 2017,

when it reached levels comparable to those of the early 2000s. The rising prominence of concessional loans in ODA disbursements touches virtually all LDCs and adds to an incipient use of other official flows. The decline in levels of concessionality is driven mainly by multilateral donors resorting increasingly to (non-concessional) loans, especially in relation to infrastructure investments and productive sectors.

Meanwhile, the aid effectiveness agenda – enshrined in the 2005 Paris Declaration on Aid Effectiveness – remains unfinished business, especially in terms of persistent volatility and unpredictability of aid flows, prevalence of tied or “informally” tied aid, fragmentation and limited ownership, needlessly stretching the absorptive capacities of LDCs. Similarly, the institutional capacities of LDCs come up against the development finance landscape’s growing complexity and, consequently, the need to strategically engage a rapidly widening array of development partners, from traditional donors to South–South and triangular cooperation actors, to a range of private players supposedly acting in line with sustainable development objectives. The challenge of such task is heightened by growing diversification of the financial instruments utilized, which at times blur the distinctions between concessional and non-concessional finance or between private and official funds, potentially hampering adequate monitoring of different transactions. This makes the call for greater transparency all the more central, to ensure that the positive effects of the greater availability of instruments are not outweighed by the strains imposed on absorptive capacities.

The remarkable intensification of South–South and triangular cooperation, and broadening of related partnerships, potentially expands external finance options available to LDCs, continues this reshaping of the development finance landscape and contributes significantly to spurring sustainable development. South–South cooperation is already having a visible impact on infrastructure financing and, among other areas, technical assistance, support for productive sectors and knowledge and technology transfer. As LDCs learn how best to harness synergies and complementarities across partners, and as their economies become more closely integrated at the regional level (e.g. through the African Continental Free Trade Area), cooperation and economic integration within the global South could become even more valuable. Challenges remain, however, most importantly in terms of regional imbalances in access to development finance, the need for increased transparency in concessional and non-concessional lending and the additional complexity that growth in South–South cooperation brings to LDCs’ aid management and coordination.

In a context of heightened uncertainty and persistent financial instability, the challenges underpinned by the interplay of these trends are compounded by a worsening debt sustainability outlook. While in itself LDC access to concessional finance might be a positive sign – and indeed typically goes hand in hand with the capacity to raise additional non-concessional resources, the sharp rise in LDC external debt stock raises serious concerns for the sustainability of their indebtedness. The total stock of external debt for LDC more than doubled between 2007 and 2017, from \$146 billion to \$313 billion. Moreover, whereas the weight of concessional debt in total LDC external debt declined steadily between 2004 and 2015, this process came to a halt as interest rates in developed countries began their rebound. Since then, non-concessional lending has largely cooled off, whereas the expansion of concessional debt stock has accelerated further. The shifting modalities in ODA flows to LDCs only make a holistic reassessment of debt sustainability and related systemic issues even more urgent.

If external debt financing inevitably represents a key element of any sustainable development strategy in LDCs, the main policy challenge is how to harness such instruments while minimizing associated risks, such as increasing costs for debt servicing which takes resources away from allocating to investments related to the Sustainable Development Goals. The scale of this challenge can be easily gauged. Even by focusing only on public and publicly guaranteed external debt – which, in the case of LDCs, accounts for some 78 per cent of total external debt stock – debt service has more than doubled since 2010, jumping from \$6.2 billion to \$13.2 billion in 2017. For LDCs as a group, the debt service burden exceeded 6 per cent of exports of goods and services and primary income in 2017 (with several individual LDCs at double-digit rates), approaching levels last seen before the onset of the debt relief initiatives of the early 2000s. This trend also reflects the fact that the composition of LDC external debt has gradually shifted towards more expensive and riskier sources of finance, including a growing share of external debt at variable interest rates. Although concessional debt still accounts for nearly two thirds of LDC debt stock, the importance of commercial creditors and of bilateral non-Paris Club creditors have both been on the rise, which could have profound implications on debt servicing, debt rollover risks and – potentially – the costs of negotiating any restructuring.

As of May 2019, of the 46 LDCs covered by the Debt Sustainability Framework of the World Bank and International Monetary Fund, 5 were in debt distress (the Gambia, Mozambique, Sao Tome and Principe, South Sudan and the Sudan) and 13 more were classified at high risk of debt distress (Afghanistan, Burundi, the Central African Republic, Chad, Djibouti, Ethiopia, Haiti, Kiribati, the Lao People's

Democratic Republic, Mauritania, Sierra Leone, Tuvalu and Zambia). Equally worrying is that most of these LDCs had received debt relief only 10–15 years earlier, under the Heavily Indebted Poor Countries Initiative or the Multilateral Debt Relief Initiative.

This points to the fact that LDCs have a considerable stake in discussions related to so-called systemic issues, notably development financing, international liquidity and debt sustainability. Economically, their weight might be marginal when assessed on a global scale, but the terms of their integration into the global market are profoundly affected by the relevant measures the international community agrees on. It is thus all the more important that LDCs' interests are adequately considered and reflected in global forums for debating systemic issues.

Private development cooperation: More bang for the buck?

In the face of the ambitious 2030 Agenda for Sustainable Development, donors have turned to the for-profit private sector to supplement the widening gap in official development finance vis-à-vis the heightened financing needs generated by the pursuit of the Sustainable Development Goals. The intention is to scale up investment projects that have an impact on the Goals in cases where the opportunity for private investors (domestic and foreign) may not be clear cut. The Development Assistance Committee is now pursuing a strategy of private sector engagement using private sector instruments and new financing windows to leverage private investment in the Sustainable Development Goals in developing countries based on financial additionality, i.e. an investment that would not have materialized without the official sector's involvement. Donors are tempted to label any investments in LDCs that combine concessional and private finance as additional.

This turn towards the private sector implies sacrificing the long-standing portrayal of ODA as inherently concessional and reserved exclusively for developing country Governments and citizens in poor countries. In addition to introducing commercial financial techniques and instruments into ODA, the donor private sector engagement agenda adopts an array of related jargon for which there are no universally agreed definitions. These are understood and applied in different ways by an expanding cast of development actors. One of the central aims of

the Development Assistance Committee's ongoing modernization of ODA is to incentivize donors to intensify their private sector engagement, including in LDCs.

The role of the private sector is perhaps most controversial in development cooperation. In the business case made to support a dominant role for the private sector, the private sector is praised for being more efficient, capable and innovative than traditional development actors. The hypothesis is that the private sector embodies the relief that developing country Governments, overburdened by risk and debt, desperately need. The perception is that the private sector has a unique ability to deploy innovative and inclusive business models and new technologies to address the needs of poor consumers.

Supporters of this view consider it possible to distinguish two categories of private investment:

- (a) Private investment mobilized using international and domestic public funds to support sustainable development;
- (b) Commercial private investment (such as foreign direct investment).

The main issue with such distinctions between categories of private investment is that it is very difficult to operationalize in the real world. Advocacy on institutional approaches and policies on private sector engagement has not been matched so far by clarity on important aspects such as the criteria for distinguishing these two categories. The framework for the operationalization of donor private sector engagement remains provisional and effectively ill-defined. More worrying, issues of interest to ODA recipients and the risks of private sector involvement in aid get limited attention.

One element of donor private sector engagement that has captured the imagination of donors is leveraging ODA to mobilize significantly greater amounts of private finance for investment in the Sustainable Development Goals, which has led to the catchphrase "billions-to-trillions". Blending complements and engages a variety of sources of finance, including but not limited to the for-profit private sector.

Donor private sector engagement is intended to operationalize this characterization of essentially benevolent private sector investments for the good of society with the backing of official support. Donors have accordingly embraced commercial practices and instruments and agreed provisional arrangements to advance standardized treatment and reporting of practices not previously eligible as ODA

and help mobilize additional private development finance, under a concerted programme of private sector engagement. Private investment has thus become a central component of the Global Partnership for Sustainable Development.

A logical assumption is that the development-conscious role envisaged for the private sector differs markedly from unilateral sustainable actions increasingly adopted by business to incorporate the Sustainable Development Goals into business strategies. Motivated by a variety of business interests, sustainable actions can take a variety of forms, ranging from defensive (in response to market competition), charitable (as part of corporate social responsibility), promotional (linked to marketing), strategic (seeking investors), to transformative (targeting development impact). A further challenge is that business has significant leeway in how it markets its sustainable actions, as such marketing can be mistaken for deeper engagement. Monitoring frameworks for sustainable business actions are multiplying, but they remain non-binding.

The private sector engagement and blended finance agendas are closely linked to the public–private partnership agenda and regulatory reforms typical of the bygone public–private partnership era, pursued especially by multilateral development finance institutions. The implication is that the lessons from the structural adjustment era of the 1980s and 1990s have either not been learned or are not being heeded.

To some extent, donors (or their agents) engage in “picking winners” deemed worthy to receive the embedded subsidies of ODA-backed private sector instruments, which ultimately amounts to a sort of transnational industrial policy initiated and financed by donors that takes place in countries benefiting from aid. The assumption is also that the balance of risks and rewards for all private sector investments can be known in advance.

ODA recipients were not effectively party to the decision-making processes that led to ODA reform. Unlike the expectations and authority vested in business to act on behalf of developing countries, the mechanisms to hold the private sector accountable to recipients of ODA, for which the sector will effectively act as a proxy, remain unclear. At the core of the issue are the right to development, sovereignty and the very fabric of the concept of democracy and the social licence it confers on Governments.

Despite the original high hopes, mounting evidence on low leverage ratios are attracting increased scepticism of the business case for use of scarce official public development finance in private sector engagement. The amount of capital

mobilized from the private sector and channelled to LDCs totalled \$9.27 billion in 2012–2017. LDCs accounted for 6 per cent of the capital mobilized, equivalent to only 5.8 per cent of the volume of ODA disbursed to LDCs. Moreover, distribution of that capital across LDCs is uneven and concentrated in a few countries. The top three recipients accounted for nearly 30 per cent of all additional private finance, while the top 10 countries, for almost 70 per cent. This evidence confirms LDCs' continued need for official development finance. Private sector engagement and blended finance are unlikely to compensate for the structural difficulties that many LDCs confront in attracting private capital. It is not realistic to expect the private sector to be the main source of development finance in LDCs.

The sectoral distribution of mobilized private capital also shows a concentration in revenue-generating sectors in LDCs, especially energy, banking, financial services, industry, mining and construction. These are sectors that would in any case be likely to attract commercial finance, which puts into question the role of blending.

Nevertheless, donors' enthusiasm for this approach has not waned. Still, the lack of standard definitions and methodologies to estimate the amounts mobilized adds further controversy, similar to other areas of the changed development finance landscape. The main challenges of leveraging are difficulties in attracting some classes of investors (e.g. institutional investors), as the blended finance market is dominated by public players (in effect, public–public blending, contrary to the original intention behind blending of leveraging considerably greater amounts of private finance).

Opportunities and challenges around the initiation of private sector-led development action and its deployment in LDCs has raised concerns because of possible adverse consequences. First, such action could adversely affect local private sector development. Second, it could flout accepted principles of development effectiveness. Third, it means subsidizing the private sector of donor countries. Strategic interests threaten to undermine development policy and development impact. Changes to the ODA architecture also shift the balance of power between and across an ever-expanding cast of development actors. The aid sector, traditionally dominated by bilateral and multilateral donors and financial institutions, recipient Governments and civil society organizations, is being disrupted by the private sector, philanthropists and many other actors branching out into the area of aid. The clout of these actors is growing, displacing the power relations of actors of the traditional aid architecture. The roles played by philanthropy, the private sector, civil society and donors have become blurred. In addition, different actors' interests and perspectives on development often

do not converge. Moreover, the greater emphasis of donors on private sector instruments leads to lower levels of transparency (as compared to traditional ODA), due to commercial confidentiality in matters linked to the private sector.

While global solidarity around the Sustainable Development Goals is based on the concept of shared value, the relationship between value and strategic interests is not free of tensions. It is generally accepted that national interests are a permanent feature of development cooperation. Nationalist–populist sentiment in many donor countries leads to advocating for greater use of aid to serve strategic national and short-term oriented interests. Headline issues include security and migration, geographic focus and how much aid should go to more advanced developing countries.

The quality of partnerships that LDC Governments will be able to broker with the private sector and other stakeholders thus becomes a key area of concern. LDC Governments are typically constrained in their ability to fulfil their traditional roles, including that of stewarding the development process, due to limited institutional State capacity. But this should not become an excuse to relegate them to the role of bystander. A more constructive attitude by donors would be for donors themselves to contribute to addressing the problem of LDC capacity for aid absorption (and broader aspects of State capacity), rather than accepting shortcomings as a standard. Such a change in attitude could better entrench sustainable development in the long term.

Donors increasingly delegate the task of operationalizing the use of ODA-backed private sector instruments to their development finance institutions. Bilateral development finance institutions operating as State-owned risk capital investment funds have sometimes been characterized as the “third pillar” of international development cooperation, alongside donors and multilateral development banks. Development finance institutions today look to achieve financial results alongside development impact. They invest using their reinvested profits, subventions from their Governments (ODA) and amounts mobilized from their own blending activities. The assets they manage have more than doubled since 2012. At present, flows linked to private sector instruments account for only about 2 per cent of total bilateral flows to developing countries as a group, with grants occupying a dominant position, at 89 per cent. Still, donor countries project to expand the role for these institutions and private sector instruments in developing countries, including in LDCs.

All development finance institutions included in a sample of major institutions of this type list infrastructure (including, energy and communications) as a priority sector, with agriculture or agro-industry also a common priority. They made far fewer investments in social sectors. Achieving greater distribution of private investments across LDCs and their underinvested sectors is an important factor to substantiate the rationale for ODA-backed private sector instruments and the operations of such institutions in LDCs. However, greater distribution is not assured unless these institutions better orient their business models to emphasize high-risk investments with inherently longer gestation periods in LDCs.

Differentiating among LDCs, those with favourable market odds could stand to benefit from private sector engagement. High population, urbanization and middle-class growth rates in LDCs will tend to attract investor interest, but LDCs with smaller markets and higher rates of poverty can be expected to lose out.

There is little evidence that the approach of development finance institutions takes account of the wider context in which they operate in LDCs. There is limited indication of their systematic interaction with LDC Governments or that they structure investment in line with specific components of LDC development plans. Consequently, development finance institutions typically do not set specific targets to address goals according to specific strategies presented by recipient Governments. In other words, there is little evidence of alignment with beneficiary country development priorities. Consultations envisaged with recipients are either promotional in nature, focused on adherence to international standards of interest to investors or, alternatively, aim at influencing regulatory reform in the interests of investors from donor countries.

Ownership information of development finance institution investees is often hard to find and presented in an opaque way. No targets are pursued to achieve a balance of ownership between foreign and indigenous private sectors. This runs counter to evidence that local ownership confers developmental advantages, not least, the opportunity to achieve a more balanced spread of investment and employment creation capacity across a broader spectrum of sectors in an economy. Moreover, local ownership affords citizens the opportunity to accumulate the necessary assets to overcome intergenerational poverty and grow an endogenous base for sustainable development.

Development finance institutions do not design development projects – they accept applications for funding from business whose investment projects carry the prospect of financial returns for these institutions. Their business model, consequently, is

disconnected from country development plans, and the type of development finance institution investment shapes the type of development impact that is achievable. Development finance institutions do not display an appetite for high risk, prioritizing instead investment circumstances with a probability of success higher than 80 per cent, regardless of an investment's capacity for transformative impact.

The nature of development finance institution operations, including the need to minimize costs and make profit on investments, favours larger enterprises and foreign over local entrepreneurs. This is of concern because of the inherent inequality between indigenous and foreign firms, the impact of the composition of firms on local market structure and the ability of indigenous entrepreneurs to compete in the most profitable segments of their home markets. Investees of these institutions are often domiciled in jurisdictions that are advantageous for taxes.

These institutions' business model also implies that the space for LDC Governments to undertake and coordinate industrial policy is shrinking. ODA recipient States, though charged with the primary responsibility for achieving the Sustainable Development Goals by the Addis Ababa Action Agenda of the Third International Conference on Financing for Development, have been given a secondary role in decision-making on private sector engagement.

Furthermore, accountability frameworks for achieving development impact are generally not well developed, and there is little evidence that development finance institutions consult States systematically. Development finance institutions are accountable to their own Governments, while their investees are accountable to these institutions. Transparency in development finance institution activities is complicated by recourse to claims of commercial secrecy. Indeed, even the degree of government oversight over these institutions varies.

Development finance institutions officially aim at financial and development additionality, but these are difficult to measure, and evidence on both is scant. Consequently, these institutions rely on making assumptions and engaging in estimations when striving to gauge their development impacts. The main development impacts they purportedly seek are:

- **Job creation.** While the direct impact on job creation in LDCs is recognized, the impact on job quality is not clear, and private sector engagement risks perpetuating or creating work poverty.
- **Access to finance.** Evidence suggests that development finance institutions tend to favour larger companies (especially those with a

share or majority of foreign capital), rather than small and medium-sized enterprises. The apparent bias might not be a bad thing, if it delivers systemic gains from “high-impact” firms and entrepreneurs whose contribution to structural transformation is more assured than other types of entrepreneurship prevalent in LDCs. Investing in large companies is not in and of itself negative for structural transformation. However, as noted in *The Least Developed Countries Report 2018: Entrepreneurship for Structural Transformation – Beyond Business as Usual*, the central aim of national entrepreneurship policies is to encourage a balanced ecosystem of enterprises of all sizes. Nevertheless, it might disadvantage domestic high-impact microentrepreneurs that already have difficulties in accessing loans for small and medium-sized enterprises.

- **Local ownership.** Development finance institutions emphasize the importance of investor local operations but are largely silent on the issue of local ownership.

ODA reform and, in some cases, a single-minded focus on the private sector of some approaches to Sustainable Development Goal implementation has brought to the fore the widening deficit of accountability in international development finance. The blurring of concessional and non-concessional flows triggered by ODA reform has made previously comprehensible aspects of ODA opaque.

How dependence on external development finance is affecting fiscal policies

Critical to achieving the Sustainable Development Goals in LDCs are the domestic public resources needed for public investments and services to sustain economic transformation and eradicate poverty and hunger. Strengthening domestic public resource mobilization is critical to closing development financing gaps and lowering the pressure on public debt. However, persistent structural deficits and balance-of-payments problems among LDCs suggests a greater need for ODA to supplement domestic public resources. The pace of implementation of the Sustainable Development Goals and the quality of results will also depend on synergy between external and domestic public resources.

Tax capacity, as measured by a tax revenue-to-GDP ratio, has increased tremendously among LDCs, from an average of 11 per cent in 2000 to 19 per cent

in 2017. The median tax revenue-to-GDP ratio for LDCs reached the 15 per cent mark in 2011, widely regarded as the minimum threshold necessary to support sustainable growth and development. In many LDCs, however, tax revenue still amounts to less than 10 per cent of GDP. Most LDCs operate below tax capacity, though Benin, Burkina Faso, Kiribati, Lesotho, Malawi, Nepal and Togo have consistently operated close to full tax capacity. Moreover, countries such as the Gambia, Kiribati, Liberia, Nepal, Rwanda and Timor-Leste have achieved improvements in tax administration – including compliance – that has helped them to better link tax revenue to economic activities.

Over the years, the composition of taxes among LDCs has shifted significantly, from deriving mainly from duties on international trade, to coming from broadly defined consumer and income taxes. Consumer and income taxes amounted, on average, to 32.4 per cent and 23.5 per cent of tax revenues in 2017, respectively.

The main factors constraining the tax potential of LDCs include tax evasion, the relative size of the informal economy compared to the formal economy, weak tax administration systems, corruption, illicit financial flows and underperforming public policy and institutions. Moreover, low levels of GDP and of economic diversification limit the extent to which LDCs can further increase net revenue from taxes on income, profits, and goods and services. Still, efforts to strengthen domestic resource mobilization need to be undertaken.

Fiscal reforms in LDCs should carefully weigh the welfare implications of new taxes or review existing tax components. The focus should be on comprehensively reviewing the tax base, improving tax administration systems, closing loopholes, simplifying the tax system, removing ill-designed tax incentives and tax holidays that fail to balance foreign interests with local enterprise development requirements, and providing adequate tax information to the public. Building fiscal spaces requires a series of budget cycles over which LDCs should cumulatively align fiscal reforms with broader structural transformation objectives. Curbing illicit financial flows has the potential to boost revenue, as such flows averaged an estimated 5 per cent of LDC GDP in 2015. Combating them requires international tax cooperation and enhanced national capacity of regulatory and tax administration bodies to track, stop and prevent illicit activities that drain resources and reduce the tax capacity of LDCs.

Aligning public expenditure with a structural transformation agenda is as strategic as mobilizing domestic and external resources to finance the Sustainable Development Goals. The link between external finance and various categories

of public sector expenditure is critical, particularly how external finance impacts the quality of public financial management institutions and their ability to generate domestic resources. The relationship between traditional ODA and domestic fiscal effort is complex and context specific. Traditional ODA can support or undermine domestic fiscal effort, depending on how aid is delivered and targeted, and how and to what extent recipient countries manage that aid. Creating synergy between ODA and domestic resource mobilization thus depends on sectoral allocation of ODA and the impact of aid on tax effort and public expenditure.

Building the productive capacities of LDCs requires scaling up capital accumulation, through both public and private investment. Despite concerns about volatility of allocations, ODA would in fact have a positive impact on economic growth when used directly in productive activities, e.g. aid earmarked for improving public services and the physical and social infrastructure of a recipient country: transport, communication, energy, water, banking, industry, health, education and population. In most LDCs, tax revenue and ODA fall short of desired public expenditures. The divergence between ODA and public capital expenditure has risen sharply from \$3.5 billion in 2006, to \$92.6 billion in 2017.

Both capital expenditure and current expenditure in LDCs have seen a rapid increase. However, as evidenced by the short trend between 2014 and 2017, capital expenditures decline faster during a recession than current expenditures and recover sluggishly during economic recovery. There is thus a limit to growth based on the expansion of government spending focused on physical and social infrastructure. This is particularly the case if there are no measures to complement domestic resources, including strategies to better align ODA with the priorities of LDCs. Growth is also limited by the absence of domestic policies to crowd in the private sector, which offsets the impact of an expanded Government. A worrying trend is the growing gap between tax revenue and public expenditure, whereas ODA has remained relatively unchanged over the years. Government budget deficits have steadily widened from an average of 1.8 per cent of GDP in 2013, to 3.6 per cent in 2018.

Tax revenue to government expenditure ratios remained relatively high among LDCs between 2002 and 2017, while ODA as a share of GDP has gradually declined from about 16 per cent to 11 per cent over the same period. This implies that most government priorities were financed by domestic resources. However, donor aid and tax revenue are each equivalent to at least two thirds of government expenditure. This implies the existence of parallel donor structures that are bypassing national systems. ODA was less than 30 per cent of

government expenditure only in a few countries between 2009 and 2017, including Angola, Bangladesh, Bhutan, Lesotho, Myanmar, the Sudan and Yemen. LDCs that received aid equivalent to more than 50 per cent of government expenditure but having similarly high tax-revenue to government-expenditure ratios faced significant aid diversion problems.

Fragmented modalities of traditional ODA create and sustain “independent bureaucracies” in both source and beneficiary countries. Parallel donor structures do not have a clear mapping to fiscal accounts on both the revenue and the expenditure side. Developing ODA-recipient countries whose aid is broken up into projects exhibit worse fiscal outcomes than those with streamlined ODA. Overcoming structural bottlenecks and better alignment of donor and national priorities, through a substantial shift away from projects to more programmatic forms of aid that use national systems and reduce donor overlaps, could improve domestic resource mobilization.

Aid coordination and aid effectiveness have re-emerged as topical issues in development financing, as the number of players has increased tremendously and due to the scant level of implementation of the aid effectiveness agenda. The purpose of donor coordination is threefold: (a) ensuring integration of external development assistance with the priorities of recipient countries; (b) asserting recipient countries’ responsibility for national development agendas; and (c) ensuring that any external support adheres to the strategic objectives of national development agendas. LDCs need strong aid coordination strategies, institutional and human capacities and proactive foreign policies that cement the role of national systems over national development. In this report, therefore, it is recommended that donors streamline the aid delivery process to strengthen national systems and thus ensure effectiveness and alignment of donor support with national priorities.

Where aid coordination is institutionalized, a clear mapping exists between national development strategies, external support received through policy on international cooperation and national budget aggregates. A country’s aid coordination mechanism is deemed successful when it gathers donors support to one sectoral programme, rather than to separately conceived donor projects within a sector. LDCs such as Rwanda and the Lao People’s Democratic Republic have achieved strong progress in aid management and donor coordination.

A focus on narrow sectoral themes is, instead, common among bilateral donors. With less than 10 per cent of total aid receipts of LDCs making use of the budget support aid modality, the aid process remains a donor-centric affair despite the

target of the 2005 Paris Declaration on Aid Effectiveness of increasing this type of aid. More than two thirds of total ODA from Development Assistance Committee member countries are provided bilaterally and mainly through project-type interventions. Aid disbursements are weakly associated with national development priorities in LDCs, mainly because aid is delivered in a way that falls outside the policy frameworks of recipients. However, a positive correlation between revenue and aid, and between aid and domestic debt, shows the positive complementary impact of aid when it is fully supportive of national priorities, as has been the case in Rwanda in recent years.

A country-owned institutional approach for aid coordination places high value on country ownership. As intended by the Paris Declaration, alignment in the context of external support refers to the use by donors of partner countries' national development strategies, institutions and procedures and a commitment to contribute to strengthening recipients' capacities. As budget support to LDCs remains fragmented, and less inclined towards developing productive capacities, there is a need to improve coordination of programmatic interventions to avoid a selective focus, misalignment and wasteful allocation of donor support to non-performing sectors.

A critical component of inefficiency in aid allocation arises from the static way in which aid is structured over time, as opposed to changing national priorities.

Several basics of development policy remain relevant for LDCs, including the need for better policies and institutions, diversification and structural transformation, development-oriented public financial management, alignment of external support to national priorities and incrementally raising the profile of domestic resource mobilization to reduce aid dependence. ODA should, however, continue playing a catalytic role in financing development in LDCs.

Policies to enhance the developmental impact and effectiveness of external development finance

Strengthen State capacities to steer structural transformation and its financing. The Addis Ababa Action Agenda affirms that the central responsibility

for economic and social development lies with each country. This means national States have a central role in guiding the pursuit of the Sustainable Development Goals. State capacities of LDCs therefore need to be strengthened, especially the related competences to design and implement development strategies and to perform the long-term planning, execution and management of financial resource mobilization for sustainable development. To enhance the development policymaking capacity of LDCs, partners can set up capacity-building and training programmes for LDC policymakers in the areas of development planning, financial analysis, awareness and understanding the evolution of the aid architecture.

LDC partner countries can strongly contribute to building State capacity in LDCs through elimination (or at least attenuation) of features of the current aid architecture that weaken States. Overall, this is related to the tendency to create a vicious circle between aid dependence and weak State capacity. Specifically, exclusion of LDC Governments from different aspects of delivering and using aid weakens capacity in two key areas:

- LDC Governments are often excluded from decision-making in matters which directly and significantly affect development, such as aid allocation or decision-making on private sector engagement projects and operations. Such exclusion prevents LDC Governments from learning-by-doing in the process of development policymaking.
- When traditional donors establish or use a parallel system of aid delivery, this has the pernicious effect of weakening State capacity by excluding LDC States from policy implementation and causing brain drain from the State bureaucracy to donor-established parallel structures.

LDCs are advised to establish a unit or function in charge of the long-term financial planning of national development plans and to establish domestic systems and an accountability framework. These will allow them to, first, learn how to best harness complementarities and synergies across development partners and engage them in the most effective manner, while retaining ownership of their own development agenda. Second, such a policy could help LDCs to put in place a strong measurement and monitoring framework to better measure concessional resources obtained and gauge the development footprint of an increasingly complex array of transactions. These transactions involve both official and private actors, as well as official external sources from developed and developing countries.

Revamp international development partnerships and build up aid management systems. Given the increasing complexity of the evolving aid

system, LDCs need to adopt policies vis-à-vis donor countries and the non-State actors – public or private – of the new aid architecture. Together with donor countries and non-State actors, LDC Governments need to review the terms and modalities of their development partnership. Partnerships should be (re)shaped around the following precepts: national ownership; alignment of projects and activities with national development plans and priorities; mutual accountability; transparency; mutually agreed methodology and measurement to evaluate the development impacts of foreign finance for development; standards of efficiency of financial resource disbursement, allocation and use; and, finally, mutually agreed mechanisms to monitor the implementation of these precepts.

While some of the precepts listed above were already present in the discussions around the traditional aid effectiveness and incorporated into the Paris Declaration on Aid Effectiveness, these precepts refer not only to the relationships between LDCs and traditional donors, but also to non-State agents such as philanthropic organizations and non-governmental organizations. This does not however mean subjecting all partners to the aid effectiveness agenda in the same way. There should be common precepts for all actors, but implementation of those precepts, and their corresponding mechanisms, should be differentiated according to types of players of the new aid architecture. The reason for this differentiated implementation is that there are fundamental qualitative differences in the relationship between LDCs and the various sources of external finance.

Traditional donors and recipient countries – including LDCs – should agree on an Aid Effectiveness Agenda 2.0, as is proposed in this report. This Agenda 2.0 should comprise two components. The first component would aim at addressing the unfinished business of the original aid effectiveness agenda. This includes the need for donors to implement previous commitments on the volume of ODA. It is of paramount importance that traditional partners deliver on long-standing commitments and ODA targets, reaffirmed in Sustainable Development Goal target 17.2, both in relation to LDCs and developing countries at large. This would bring between \$32.5 billion and \$58.3 billion to LDCs in additional inflows of development finance. Moreover, it would also involve donors fully implementing their commitments under the Paris Declaration and the subsequent policy documents agreed between traditional donors and beneficiary countries, including on ownership, alignment and additionality.

The second component of such an Aid Effectiveness Agenda 2.0 would address the challenges that emerge from ongoing changes in the aid architecture. These include, first of all, collaborating on private sector engagement in development

cooperation. Recipient Governments and beneficiaries have so far not been an effective party to the ODA modernization process and to the design of the private sector engagement in development cooperation. Donors could create a platform for joint decision-making with recipient countries on a range of issues, such as methodologies, standards of transparency, expediting decisions on the unfinished business of aid modernization and reaching a common understanding on private sector engagement.

A second challenge is enhanced transparency in project selection and implementation, which can be achieved by proactively delineating the scope and limits of the public and the private sectors' roles in the delivery of public services, and putting in place the necessary institutional frameworks, laws and regulations to align private sector engagement with national development priorities and goals.

Third, the new aid architecture should contribute to the development of the LDC endogenous entrepreneurial base. Fostering local entrepreneurship can have major developmental impact and is a critical part of inclusive and sustainable economic development. LDC Governments need to be proactive in private sector engagement, in ways that define the role and space for the local private sector and its interface with the foreign private sector, and structure investment incentives in domestic economies accordingly. Specifically, LDC Governments can consider identification of strategic national interests (or sectors) in their economies; preservation of the necessary space for local private sector participation in the most profitable segments of their economies; exploration of innovative ways to enhance linkages with foreign direct investment; and revisiting entrepreneurship strategies in line with the contribution of different types of entrepreneurship to structural transformation and wealth generation.

A fourth challenge is to build international consensus on a development impact evaluation framework, agreed by the various actors of the new aid architecture.

South–South cooperation has evolving dynamics where learning by doing is happening on both sides of bilateral (or triangular) cooperation. For South–South cooperation to further enhance its developmental impact on LDCs, projects and financing flows need to be expanded and bilateral policy dialogue, deepened, while continuing to adhere to the well-established principles of South–South cooperation, especially those of respect for national sovereignty, national ownership and independence, equality, non-conditionality, non-interference in domestic affairs and mutual benefit. Discussions are ongoing to build upon

existing country-level efforts to improve transparency and monitoring of the sustainable development footprint.

Bolster LDC fiscal systems. LDCs need to further strengthen their fiscal capacity as this gradually reduces aid dependence, strengthens the ownership of their development policies and strengthens their negotiating position vis-à-vis external sources of financing. This can be achieved by building up the institutional and human capacities of LDC States for revenue collection and expenditure allocation.

LDCs can typically expand their tax base by tapping into revenue and wealth sources that they traditionally tax very lightly, such as natural resources, urban property and luxury consumption. Other revenues can be raised by closing loopholes and exemptions given to transnational corporations and expatriates. Moreover, the development of a new aid architecture and the substantial increase in the number of agents active in the economy of LDCs implies other potential sources of taxation that should be considered but are typically neglected. These include levying income taxes on private sector engagement projects and aid workers and closing ODA loopholes and tax exemptions. LDC States should also have a share of the profits of public–private partnerships.

Reinforce LDCs' voice in international financial forums and restore the primacy of multilateralism. LDCs have a particularly strong vested interest in preserving and strengthening multilateralism. This is the sphere where the voice and interests of small countries and weaker actors of the international community are best represented and defended. Multilateralism is presently under attack in the fields of trade, finance and (geo)politics. Therefore, actions by the international community to reverse the trend of weakening multilateralism will, by extension, benefit LDCs' position. It would be important that LDCs concerns be adequately taken into account, if the promise to leave no one behind is to be taken seriously.

In the field of external development finance, the following areas are especially critical to bolster LDCs' capacity to finance their structural transformation:

- Combating illicit financial flows, achievable only through joint actions of all actors in development. This is indicative of the importance of international cooperation, especially in multilateral forums, where all countries – including LDCs – should be represented;
- Agreeing on a multilateral framework for debt restructuring. LDCs stand to gain the most from the development of a comprehensive multilateral framework to facilitate equitable debt restructuring, given their growing

- external indebtedness in recent years and chronic current account deficits;
- Facilitating access to long-term finance. This is especially relevant for long-term investment in infrastructure and in the expansion of productive capacities.

