JUBILEE DEBT CAMPAIGN

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UK Aid Network

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FOR INTERNATIONAL DEVELOPMENT

The future of UK aid

Should the UK give aid as loans?

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Bond is the UK membership body for organisations working in international development or supporting those that do through funding, research, training and other services. **bond.org.uk**

UK Aid Network (UKAN) is a coalition of UK-based development NGOs working together to advocate for more and better quality of aid through joint policy, lobbying and advocacy work. **ukan.org.uk**

Jubilee Debt Campaign is part of a global movement demanding freedom from the slavery of unjust debts and a new financial system that puts people first. **jubileedebt.org.uk**

Executive summary

In 2013, the UK joins a very small group of countries who have met the historic target to devote 0.7 per cent of gross national income (GNI) to aid.

However this achievement takes place in the context of significant economic and political pressure to reduce spending on aid. As such, it is perhaps unsurprising that different aid modalities and delivery mechanisms are being considered and proposed by many stakeholders including most recently the International Development Select Committee who posed the question of whether the UK government should increase the proportion of UK aid provided as loans to the public or private sector by reintroducing bilateral Official Development Assistance (ODA) loans, and potentially create a new facility to deliver that increase.[1]

While the Secretary of State has ruled out any change in the UK's policy on ODA loans for now[2], were any new aid facility to be created, mandate, delivery mechanism and its relationship to other development organisations in the UK such as CDC[3] is yet to be determined. Several possibilities have been proposed ranging from a small, more virtual lending window to a fully independent investment bank.

This paper briefly explores the purpose of UK aid before looking at the evidence and arguments, both for and against, about the impact of loans on development and poverty eradication. It concludes that there is currently insufficient evidence of impact, improved results or value for money to support the introduction of bilateral ODA loans in the UK. This position was echoed by the Secretary of State in her recent evidence to the Select Committee.

However, if a new loan facility is created in the future, the government must ensure that UK aid remains focused on genuine development outcomes, poverty eradication and tackling inequality. It should not be assumed that benefits will 'trickle down' and reach people living in poverty.

Any new UK development bank or loan facility must follow best practice policy and procedure including to:

- ensure a focus on qualitative development objectives rather than simply ones that are quantitative financial and economic
- ensure civil society and other key stakeholders are included in the design, monitoring and evaluation of project loans to ensure a pro-poor approach
- support host country ownership to ensure the benefits of investments accrue locally
- follow standard investment exclusion lists and adhere to emerging international environmental, labour and human rights norms (for example, the Rugge principles)
- avoid financial intermediaries who use tax havens
- develop systems for full public transparency and accountability (for instance, over commercial confidentiality)
- undertake careful debt sustainability assessments, independently of all creditors such as the IMF and World Bank and with independent civil society participation, to avoid creating new public (or private) debt crises in developing countries
- support the creation of a fair, independent and transparent debt arbitration mechanism if debt problems do arise
- develop a common rating tool that could be used by all European development finance institutions members, in order to facilitate comparability development impacts between development finance institutions

The Prime Minister spoke in December 2012 of the UK's "moral obligation" to help the world's poor, noting that there are still over a billion people living in extreme poverty.

1. The purpose of UK aid

Under the 2002 International Development Act, the central objective of UK development assistance is the reduction of poverty. This can be either as bilateral aid or via support to multilateral agencies. Aid can be targeted towards the public or private sector (or a mixture of the two) as long as it can be reasonably expected to contribute to sustainable poverty reduction.

Overseas aid remains the only source of funding for development that is solely focused on tackling poverty. The Prime Minister spoke in December 2012 of the UK's "moral obligation" to help the world's poor, noting that there are still over a billion people living in extreme poverty.[4] Despite the real improvements in the lives of many people, there remains much more to do and aid will be one important part of the solution.

Any changes in Britain's aid spending must be measured against the impact on reducing poverty and inequality in a sustainable way.

2. A case for loans?

Development finance institutions are usually set up by governments to finance riskier, long-term term ventures, often in the private sector. They provide a wide variety of functions, from direct credit provision to equity purchases, provision of technical advice, leveraging investment from capital markets, and more. They also take on a variety of institutional formats and governance models; from state-owned bilateral development banks, to privately owned investment funds.

Donor governments in particular have historically advanced several arguments in favour of development finance institutions as development 'tools' such as:

- when loans are repaid, the money can be lent out again allowing donors to 'recycle' aid money and theoretically increase the impact of each pound of aid
- to help justify giving aid to middle-income countries and other countries in transition from grant aid
- to stimulate private sector growth in the 'missing middle' of the business world in developing countries (medium-sized enterprises that can't access international markets and are too large for microfinance)[5]

- to potentially reduce long-term aid dependency
- stimulate the development of local financial markets[6]
- potentially reducing the donor country's public spending as outgoing loans may be considered 'off-book' and thus not counted as spending in the same way as grant aid

3. What is the impact of development finance institutions and bilateral loans on development and poverty reduction?

There are serious questions and concerns about the development impact of development finance institutions based on evidence and track-record of others, which calls into question the suitability of loans as an aid modality for the UK. These concerns also raise questions about some of the arguments in favour of development finance institutions/loans listed above. Arguments about the benefit to donors must be seen through the lens of development impact and results first and foremost.

- Evidence from other OECD development finance institutions suggests that the priorities and performance measurements are more often weighted towards financial return and evidence of contribution to financial growth than the impact on reducing poverty and inequality.[7]
- Evidence from the aid effectiveness agenda suggests that aid is most effective when it is a genuine transfer that can be spent by a developing country to support national development strategies without incurring future costs in the form of repayments and interest. 'Recycling' aid, certainly in any substantial quantity, would undermine this and potentially reduce the impact of UK aid.[8]
- The question of aid to middle-income countries is complex. However, aid in any form to middle-income countries would still target poverty and development, and therefore in large part target the poorest, most vulnerable and marginalised people. In countries such as India and South Africa, this is best done through targeted grants, rather than lending to governments or companies which already have significant financial resources and access to capital.[9]

- There is a lack of coordination and coherence with development or other relevant agencies even within the same country which undermines harmonisation and effectiveness. In some countries, such as Belgium, there is barely any communication between the two different institutions.[10]
- Bilateral development banks are the least preferred option for recipient countries (DFID was rated the best and bilateral banks the worst in a recent study of 32 heavily indebted poor countries).[11]
- Duplication of costs and work – there are costs involved in running a bank which could increase the amount the UK spends on administration, particularly when there are already other development finance institutions which the UK funds through multilateral aid contributions through the EU and other loan-making organisations such as the World Bank.[12]
- Some development finance institutions have funded projects which have negative environmental, human rights, gender and social impacts despite exclusions supposed to block harmful activities. In recent years, the UK's CDC has invested in the private sector primarily through private equity funds as intermediaries. This means it has no control over the companies in which the money is invested.[13]

Impacts of loans to the private sector

Economic growth is not a proxy for development as growth must be sustainable, pro-poor and inclusive to have genuine development impacts. For example, Mozambique's economy doubled in GDP per capita terms between 1998 and 2010, partly due to investments in extractive and other industries including by development finance institutions. Yet the number of people living on less than US$2 a day actually increased in that time, from 15 million to 18 million. There is currently insufficient evidence to support the argument that the investments of development finance institutions target reducing poverty and inequality rather than financial returns and growth. Given this current lack of evidence, potential impacts on long-term aid dependency are also questionable.

Equally the area of the private market that loans could most usefully seek to target, the missing middle, is potentially hard to reach and requires detailed and appropriate local knowledge suggesting that a donor-based loan facility may not be the most appropriate tool. Furthermore, the investments of development finance institutions potentially undermine local ownership, a key principle of aid effectiveness, as the companies invested in are frequently based or owned outside the developing country.

There is a lack of transparency particularly given the increasingly complex financial structures employed by development finance institutions including the use of financial intermediaries that use tax havens. These structures include direct equity purchases and debt financing, channelling money through pooled intermediary funds and the use of financial intermediaries, private equity funds, and even financial derivatives. Given on-going discussions about the need to harmonise global policies on tax avoidance, the UK government should be particularly concerned about the prevalence of using offshore tax havens by financial intermediaries, including by its own CDC.[14]

Impacts of loans to the public sector

Large levels of loans in the 1970s and 1980s, including aid loans, created a debt crisis which affected most of Latin America and Africa through the 1980s, 1990s and into the 2000s, and continues to affect countries such as Jamaica, El Salvador and Pakistan to this day. In Africa, the number of people living in extreme poverty (on less than US$1.25 a day) increased from 205 million in 1981 to 330 million by 1993.[15] Following the global Jubilee campaign, $130 billion of debt has been cancelled for 35 countries.

- There is already a boom in lending to DFID priority countries. Foreign lending to sub-Saharan African governments has more than doubled between 2006 and 2011, and is due to increase even more in 2013. Of the 29 countries with DFID bilateral aid programmes, half are already in default on their debts or the IMF and World Bank judge that there is a high or moderate risk they could be. The other half include countries with rapidly increasing debt burdens, including Ethiopia, Mozambique and Tanzania, all of which are judged by the IMF and World Bank to be at low risk of not being able to pay their debts, despite the fact they will be spending 10 per cent or more of government revenue on debt payments by 2017.

- There is no international mechanism to resolve debt crises. Governments including Norway and Germany have proposed the creation of a fair, transparent and independent arbitration mechanism for sovereign debts but the UK has opposed it. In the absence of such a mechanism, increasing UK government loans is potentially high risk and could undermine other development efforts including those aimed at fostering macro-economic stability.

- The IMF and World Bank Debt Sustainability Framework is meant to guide institutions when deciding whether or not to give loans. However, it is only used for low income countries, it does not include the impact of debt burdens on poverty and inequality, it is based on the work of the Fund and Bank who are themselves major lenders and creditors, it does not to take sufficient account of the impact of economic shocks, private sector debts are not given sufficient attention, and it does not assess what lending is used for.

- The current and past UK governments have not always used the Debt Sustainability Framework in their lending decisions. This includes climate loans by DFID, via the World Bank, to Grenada, despite the island being at high risk of debt distress (and now in default), and non-concessional UK Export Finance loans to the Gambia, despite the West African country being at moderate risk of debt distress.

4. Conclusions and recommendations

There is currently insufficient evidence to suggest that a new UK development bank or loan facility would provide true development additionality or that it would be an effective modality to deliver UK aid. Evidence from other development finance institutions suggests that it could in fact be less effective than current modalities and, as such, there is little evidence of either increased results or value for money to support the introduction of bilateral loans in the UK.

There seems to be no evidence to suggest that the existing range of development cooperation tools provided by the UK government, including DFID and CDC,[16] are insufficient to meet recipient country needs.

Therefore, any decision to change the status quo must be based on proof that it would provide true additionality in meeting the poverty reduction and development impact tests. We would recommend that DFID produce a clear and detailed business case to support any such change.

There is a lack of transparency particularly given the increasingly complex financial structures employed by development finance institutions.

If a new loan facility is created, the government must ensure that UK aid remains focused on genuine development outcomes, poverty eradication and tackling in equality and not assume that benefits will 'trickle down' and reach people living in poverty.

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Government must ensure that UK aid remains focused on genuine development outcomes, poverty eradication and tackling in equality and not assume that benefits will 'trickle down'

References

[1] The UK already effectively gives some aid as loans through contributions to multilateral institutions which give loans, such as the World Bank and African Development Bank. Jubilee Debt Campaign has calculated that in 2010, $1.26 billion of UK aid money was given to multilateral institutions to then be used as loans. Jones, T. (2012). The State of Debt. Jubilee Debt Campaign. May 2012.

[2] IDC Oral Evidence Session, The future of UK development cooperation and South Africa, 19 September 2013 available at http://www.parliament.uk/business/committees/committees-a-z/commons-select/international-development-committee/news/future-uk-development-co-operation-/.

[3] The CDC is the UK's Development Finance Institution and is wholly owned by the UK government. The CDC uses public money for loans and equity investments to the private sector, primarily through private equity funds.

[4] The Daily Telegraph, Dec 28, 2012, "Cameron: UK has a 'moral obligation' to help world's poor".

[5] OEFSE (ÖsterreichischeForschungsstiftungfürInternationaleEntwicklung). 2011. Bilateral Development Finance Institutions in Europe: a comparative analysis of DEG, CDC, FMO and Norfund with recommendations for development policy

[6] Tilley, H. and Tavakoli, H. July 2012. Better Aid Modalities: are we risking results? ODI. London.

[7] Hildyard, N. September 2012. More than Brics and Mortar Infrastructure-as-asset-class: Financing development or developing finance? A Critical Look at Private Equity Infrastructure Funds. The Corner House http://www.thecornerhouse.org.uk/sites/thecornerhouse.org.uk/files/Bricks%20and%20Mortar.pdf

[8] Oxfam http://www.oxfam.org/en/policy/busan-nutshell

[9] 11.11.11. June 2012. Doing business to fight poverty? An evaluation of the Belgian Investment Company for Developing Countries.

[10] OECD DAC, 2011. Peer Review of the United Kingdom

[11] Organisation Internationale de la Francophonie, April 2013.

[12] Jones, T. May 2012, The state of debt: Putting an end to 30 years of crisis, Jubilee Debt Campaign.

[13] Kingombe, C; Massa, I; teVelde, D.W. Comparing Development Finance Institutions: literature review, ODI, London, 2011.

[14] See The CDC's use of tax havens: Get the data. http://www.theguardian.com/global-development/datablog/interactive/2013/aug/14/cdc-tax-havens-money-data

[15] The percentage increase was from 51.5 per cent of the population to 59.4 per cent. World Bank, Global Development Finance database.

[16] Please note that civil society has previously raised questions and concerns about the CDC as part of the Future of CDC inquiry – written evidence from UKAN is available online here http://www.publications.parliament.uk/pa/cm201011/cmselect/cmintdev/605/605vw16.htm and from Bond here http://www.publications.parliament.uk/pa/cm201011/cmselect/cmintdev/605/605vw05.htm and from Jubilee Debt Campaign http://www.publications.parliament.uk/pa/cm201011/cmselect/cmintdev/605/605vw12.htm.

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