

Strengthening Demand: A Framework for Financing Sustainable Development

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EXECUTIVE SUMMARY

A crisis exists in development finance – one in which steady erosion in official development assistance (ODA), combined with declining effectiveness and legitimacy of domestic revenue-raising efforts have sharply reduced support for programmes of capacity building, poverty eradication, and environmental conservation. While non-concessional financial flows – commercial credit and direct investment – are growing, these continue to focus on large-scale industry and infrastructure projects, which are inadequate vehicles for advancing sustainable development. Small and medium-scale development finance, which holds the potential to create large numbers of sustainable livelihoods, is typically considered by commercial creditors to be too costly a resource to provide. The result is a growing deficit in support for sustainable development, even as the World Summit on Sustainable Development (WSSD) approaches. These trends reflect poorly on the global commitment to the goals of Agenda 21, and beg the question of how commitment can be renewed.

The United Nations Financing for Development (FfD) process is meant to resolve this central points of contention in global agreements – including in particular the process leading up to and beyond the UNCED – namely, the mobilisation of financial resources for sustainable development. Many Southern negotiators also perceive it as a prerequisite for further agreements on thematic or sectoral aspects of sustainable development, such as those

envisaged for WSSD. In other words, the success of WSSD in pulling together the various initiatives launched at Rio and thereafter into a coherent and feasible programme of action will depend critically on success in reaching meaningful understanding of and agreements over the issue of finance.

That this is a highly complex issue hardly needs to be stressed. The complexity is borne out by its very durability as a contentious issue, the intermingling of technical and political dimensions, and the sustained and growing misgivings both about negotiating positions and alternative formulas. The FfD process was obviously intended to break this deadlock and lay the basis of a consensus solution.

Yet, the evolution of the FfD process fails to provide any basis for optimism. Essentially, the FfD documents tend to repeat conventional formulas, which have not resulted in narrowing the gap that separates the different negotiating parties. In practice, the six items on the agreed FFD agenda – domestic resource mobilisation, international resource mobilisation, foreign direct investment, debt reduction, trade and finance, and systemic issues – have been divided between the North and South, the first three viewed as Northern concerns and the latter three as Southern ones. In other words, there is a schism running through the agenda, with one group focusing on *forms* of finance, and the other on the *context* of finance.

Challenging the current FfD impasse

The Ring, an alliance of policy institutes from the North as well as the South,¹ has floated a

KEY CHALLENGES:

- **Secure finance for development can be strengthened by increasing the legitimacy of processes by which resources are transferred and reducing the risk of small-scale investment**
- **A demand-side perspective can help with the creation of capacity, legitimacy, and effectiveness that will attract foreign and domestic resources towards development activities**
- **Instances already exist in which the risk of commercial lending is reduced and the legitimacy of charitable aid is increased – these should be widely replicated in order to foster sustainable development efforts**

number of ideas with a view both to expanding the range of options under discussion and resolving the impasse in the negotiations. The focus of these proposals is the replacement of the current preoccupation with 'supply' issues – meaning the enhancement of the inflow of financial resources into development activities – towards 'demand' side issues – i.e. enhancing the capacity of individuals, communities, governments, and development institutions to access and effectively utilise financial resources. While the conventional approach is concerned directly with identifying new sources of funds, shoring up existing ones, and encouraging the redirection of others, the alternative seeks to accomplish all this by increasing the legitimacy of the process and reducing the risk of small scale investment.

This argument has risen from the experience at local levels in programmes and projects of sustainable livelihoods, poverty eradication, and natural resource conservation – experience that shows that, except in situations of dire emergency, support for capacity building is far more effective and relevant than the provision of concessional assistance. The poor in particular need access, not charity. In the first place, given the existing institutional structure, it is difficult to ensure that the assistance actually reaches its target. Second, capacity building is more sustainable in the long run, since it enables access to relatively stable conventional resources rather than unpredictable charitable ones. Third, this approach does not create a culture of dependence, which is inherent in approaches based on charity. Finally, the major conceptual and practical breakthroughs in this regard (e.g., micro-credit) came from institutions that sought to enhance access to market credit rather than a switch to unsustainable subsidised credit.

Financing sustainable development

This distinction has become more relevant in the charged atmosphere around discussions of sustainable development. On the one hand, there are growing concerns that the decline in official development assistance flows will seriously undermine the prospects for sustainable development.² On the other hand, some point with hope and others with anxiety to the dramatic increase in foreign direct investment. In a number of the wealthiest countries, ODA has sunk to 50-year low levels, coinciding with states' shifting priorities, shrinking autonomy and increased obligations to emerging crises – changes that suggest to many that the era of aid as a force in development is nearing its end. Finally, there is a debate over whether development has to be financed mainly from domestic resources, with foreign resources playing a secondary – and, as some argue, often a deleterious – role; or whether the distinction between domestic and foreign resources has blurred in the age of rapid globalisation.

The demand-side perspective can provide a framework for assessing and even synthesising these diverse arguments. Rather than berating developing countries for not raising domestic resources, it focuses on the creation of capacity, legitimacy, and effectiveness that will attract both domestic and foreign resources toward development activities. Rather than debate endlessly the relative irresponsibility of private

and public flows, it seeks to establish systems that can ensure better accountability and transparency of all such flows. Rather than bemoan the exclusion of particular areas of activities (e.g. poor communities, long-term programmes, mid-sized projects) from financial flows, it seeks actively to develop institutions that will broaden the access of hitherto excluded sectors to finance. Rather than criticising rich countries for not sustaining their ODA levels, it seeks to re-establish the legitimacy of responsible ODA amongst taxpayers in those countries. In other words, this perspective provides an alternative framework for reconciling seemingly irreconcilable positions.

The common attribute of most successful examples of mobilisation and utilisation of scarce capital for sustainable development – whether micro-credit, franchising, partnering – is that they increase the capacity of individuals and organisations to access and use finance, and strengthen the ability of institutions to serve as intermediaries. Widespread replication of this outcome – one in which both the risk of commercial lending is reduced and the legitimacy of charitable aid is increased – is needed to stabilise and foster sustainable development efforts in the current shifting landscape.

Under this approach, a renewed international commitment to Agenda 21 would involve a three-pronged agenda:

- Reversal of the trajectory of declining sources of finance.
- Creation of an institutional framework that will enable and encourage private, non-concessional finance to reach small and medium scale enterprises.
- Strengthening of the capacity of small and medium-scale borrowers to access and deploy resources effectively.

Progress toward these will be rendered more robust and sustainable if the problem is treated not merely as supply enhancement, but as that of building effective demand. ●

Background

The term 'development finance' covers a vast range, from official development assistance (grants, concessional loans by governments and multilateral financial institutions), to commercial loans by multilateral financial institutions and private banks, foreign direct investment, to domestic credit, investment and government transfers. These provide financial resources to an equally broad range of programs: high-tech start-up projects, industrial investment, public infrastructure, and small-scale human development projects.

However, while all of these can be described as 'developmental' activities, only a small subset would qualify as activities that are *sustainable*. Funding for sustainable development activities has tended to come in smaller increments and to be provided to entities with less established track records, thereby creating the perception that such activities entail greater administrative effort, and greater risk. As a result, it is this type of activity that will be most greatly impacted by the changes in available finance.

Finance, in general terms, fills an intermediary function between entities of surplus and those of deficit. By performing two specific functions – channeling money and

distributing risks – the intermediary mechanism makes the movement of finance from the surplus ‘household’ simple and rewarding, and makes the movement of finance to the deficit ‘household’ possible. In channeling, the intermediary simply takes responsibility for the movement, allocation, and accounting of the money it lends. And, through a willingness to bear a higher risk than the risk-averse surplus household, with the expectation of periodic default but generally profitable returns, the intermediary distributes the risk of the finance process.

The most well known example of this type of intermediary is the World Bank.³ A parallel system, known as ‘micro-credit’, has developed in miniature through the work of the Grameen Bank, where it has established the legitimacy necessary to borrow at low rates, and lend to extremely small-scale borrowers at market rates. The success of this system lies largely in the capacity of the institutions involved, and the strong normative culture that the system and its borrowers have cultivated over time. Similar processes can be initiated at multiple levels, providing finance, for example, to medium-scale export industry projects, or small-scale community development activities. A number of methods have in fact been developed for facilitating this finance.

The risks that such systems, regardless of scale, can encounter are objective risks (i.e., loan default) and moral hazards (creating an expectation of bailout, thereby encouraging risky investment). However, as is discussed below, at these alternative scales objective risks can be overcome through capacity building and technical assistance to both borrowers and small-scale intermediaries. Moral hazards, on the other hand, can be avoided through careful monitoring of lending practices. The result can be a highly legitimate process that brings finance to sustainable development activities that would otherwise go unsupported.

An alternative approach to development finance

Sustainable livelihoods as a development goal

Of the services provided by finance, what is needed to advance sustainable development and alleviate the plight of the poor, is less a handful of expensive, large-scale development projects, but large numbers of sustainable livelihoods – best created by smaller, local, eco-efficient enterprises. Yet, when the distinction is drawn between sources of development finance and *sustainable development* finance, it becomes clear that the former is inclined to benefit from current trends in supply, while the latter is likely to suffer.⁴

How, then, is sustainable development to be advanced? Both the literature and ground-level development practitioners are converging on a set of complimentary principles which can serve to advance this urgent work. Namely, that **human and institutional capacity** can create the ability to act, and that this ability, when directed toward **building sustainable livelihoods**, can go far toward realising the goals of sustainable development.

More than simply job creation and short run interventions, this approach aims at *sustainability*, ecological as well as social and economic. Sustainable

livelihoods programs start from varying entry points – through social mobilization, credit, technology, policy and governance reform – depending on local conditions and needs, to help the poor to build on and expand their asset base. The approach seeks to enhance the social capital of the poor and their access to natural capital, rather than concentrating solely on income or financial/ physical capital. In short, it focuses broadly on livelihoods rather than income or jobs.

While the sustainable livelihoods approach may capture a number of elusive environmental and development goals, it is also recommended by its many practical attributes. Most critically, the capacity in many developing countries of traditional sectors (e.g., agriculture) to absorb more labour is rapidly reaching a plateau, whereas the sustainable livelihoods approach offers an alternative for widespread job creation.

Recognition of alternative scales

Countries now need to create sustainable livelihoods on a large scale, and to accelerate the rate of growth of their economies. Eradication of poverty within a reasonable time frame will need double digit growth rates.

The reasons for failure on these fronts thus far lie, ironically, in the very structure of industrial production that has provided so many benefits for so many people all over the world: its emphasis on mechanisation, centralisation, large scale, and use of energy- and material-intensive technologies. Such systems need great investments, have long start-up periods and create relatively few jobs. There are, of course, sectors for which the economies of scale favour large, mechanised production units (e.g., steel production and auto manufacturing), but there are many sectors where economies of scale are not relevant. Most industries producing basic goods for rural populations are commercially viable even at quite small scales. And because of the low capital requirements, they can have high returns on investment – in some cases even double those for their larger counterparts. Furthermore, in small and mini plants, scarce capital is recovered in a much shorter time, making it possible to reinvest it in further production and job creation.

Today, there exists a widespread recognition among the international development community of the importance of financing sustainable enterprises in developing economies, but very few mechanisms are presently available on the ground to do so. The availability of grants is dropping, and conventional financing institutions remain inaccessible because smaller-scale sustainable livelihoods projects generally have little collateral to pledge and no record to demonstrate a steady cash flow. Given the small size and weighty administrative costs of such allocations, and the sparse credit histories and high perceived risk of many borrowers and grant recipients, finance continues to be the missing link to widespread creation of sustainable livelihoods.

Enhancing demand for finance

Alternative finance mechanisms are clearly an essential component of effective development portfolios. Further, the risk of directing finance through these mechanisms, to sustainable development activities, must be reduced if they

are to be effective. The more ambiguous factors are those needed to make such forms of finance viable to lenders and grant-makers, and accessible to users. The important lessons for this effort, however, are no different from those that have emerged from recent development literature and experience – namely, that capacity building and institutional strengthening lead to greater legitimacy and support, at all levels, of development activities.

When applied to the question of development finance, the innovative attribute of these methods is again that they imply a focus on demand.⁵ The reduction in risk and handling costs (essential to successful lending) and restoration of grant-maker confidence (essential to aid) cannot be addressed through changes in supply. Movement on both fronts is central to future small-scale sustainable development activities, and must each be approached through a strengthening of project efficacy and accountability, and, in the longer-term, records of credit-worthiness. In other words, risk reduction, efficiency and restoration of legitimacy can only be achieved by strengthening the demand for finance.

Capacity building and institutional strengthening

Numerous alternative finance models exist, such as micro-credit, franchising and partnering.⁶ Expansion of the use of these alternative instruments – in the process, proving their soundness and utility – is arguably the cornerstone to more effective use of development finance. However, increased utilization of various forms of credit and aid requires an increase in the capacity of recipients and strengthening and support of intermediary institutions.

The notions of building capacity and strong institutions have received significant attention in recent years, mainly in the context of national development and environmental management. It is now widely held that capacity is required to meet a variety of challenges in these domains.⁷ While attention has been directed toward capacity building of the NGO community, this effort has not undertaken the issue of small-scale finance with adequate rigor. Little direct attention has been geared toward the capacity building of non-governmental organizations to handle and administer this level of development finance, a factor which may have served to slow the evolution of development work in general.⁸

A significant gap exists between the traditional supply-oriented finance framework, and the potential users of sustainable development finance – a gap which could be filled by institutions, provided adequate support. Banks are not prepared to serve as the creditor of many small loans. Nor will finance reach the necessarily diffuse level of small credit in the form of FDI or even ODA. Smaller-scale, intermediary institutions are essential – those to which modest lines of credit can be extended, for subsequent mini-credit distribution. The NGO community is well-poised to fill this niche, and the development of NGO capacity in this realm could essentially lead to the creation of a supplier network and small-scale credit market, and to the support of long-term supplier/purchaser relationships

Strong institutions, in the context of development finance, would mean that the handling costs of large numbers of small grants or loans could be borne more inexpensively, at the NGO level.⁹ A number of NGOs are

currently capable of stepping into both the role of small- or mini-scale intermediary creditor, creating the institutional skeleton of a supplier's market for this type of credit, and the role of project finance monitor.

In addition to institutions, the capacity of recipients to use finance – from identifying, applying for, spending, accounting for and, in the case of loans, paying back – is a second focus of demand strengthening. The demand for finance to launch small enterprises is thought to be vast. However, this demand does not translate into the capacity to effectively use the money. Nor does the ability to launch a small enterprise mean that it will be a sustainable one. Both require skills, support, marketing channels, and access to technology.

The two groups – intermediaries and recipients – possess a number of the tools to build and run alternative scale finance and monitoring systems. They do, however, require increased capabilities – through technical and networking assistance, access to technology, training programs, etc. – to do so. Two factors in particular beckon such an international capacity building effort for both intermediaries and recipients. First, the scope of demand for this sort of credit framework – estimated to be in the millions of borrowers in India alone; and second, the existing capacity and potential which can be capitalized upon through network building, mutual learning, etc.¹⁰ In short, not only is finance needed to meet sustainable development's goal of strengthened capacity – both of the individual, the community and the institution – but capacity is needed now in order to mobilize and utilize this finance.¹¹

Reducing risk and building legitimacy

Legitimacy is a cornerstone of development activities, and with its deterioration come a number of impediments to the development process. These impediments tend ultimately to impact the movement of finance: the approval and release of funding can be obstructed, and finance can be ineffectively disbursed and under-utilized. With a breakdown in legitimacy, the process of financing development activities can fail at a number of points.¹²

In many ways, legitimacy and risk are similar commodities: to the commercial lender, the level of risk determines the viability of a loan; to the supplier of aid, legitimacy of both the players and the goal itself weighs heavily on funding decisions. Approaching again from the demand side, a boost in small-scale commercial lending requires efforts to reduce risk, just as a reversal of the slump in bilateral grants requires a restoration of legitimacy to charitable aid. This decline in confidence is not unwarranted, but comes at a time when real advances in monitoring and accountability have been made in a number of countries. Similarly, empirical studies by the Government of India, the World Bank and others show that among the potential clients for small credit, a significant percentage has high levels of credit worthiness. The paradox of our global economy is that there is virtually no source of funding today that can actually deliver adequate financial credit in this intermediate range where it has the greatest potential impact, both on the generation of employment and on national economies. Carefully designed lending programmes

that fill this gap can therefore be both financially profitable and socially worthwhile.

Thus, the framework through which both lender and donor funds are brought to bear on a development issue needs to be made more efficient, through niche-filling in the supplier chain, more transparent, through improved monitoring and institutional strengthening, and more effective, by bringing finance to the level of the economy where the greatest number of new jobs and real income are generated.¹³ The connection of these 'legitimacy frameworks' requires an effective, transparent intermediary mechanism. The process of coupling these ends of the development finance chain can be initiated with the fostering of:

- a) small-scale credit supplier's markets which would borrow from the lender below market rates and at conventional scales, and lend to the ground level at market rates and appropriately small scales, and
- b) monitoring mechanisms which combine the strengths of normative models (such as Grameen Bank) to build borrower/recipient track records, and network-based reporting systems (such as the Global Reporting Initiative) to increase corporate investor accountability.

For many nations, efforts to provide quality services and products that contribute to national development, through strengthened capacity, are quickly encountered by the larger issues of social instability and economic crisis. A number of socioeconomic and political constraints can affect the performance of the public sector in countries that have experienced economic recession and social conflict.¹⁴ Again, just as the supply of finance for development services can be inhibited – in this case by malgovernance and decayed legitimacy – the demand for development services can also be depressed. Essentially, the utilization of development finance can be impeded through a loss of trust on the part of prospective recipients in the loan- or grant-making process. Potential consumers of credit are less eager to purchase credit when it is supplied through channels – public sector, or private – that have displayed an inability or unwillingness to confer with civil society over development objectives, or worse, have exhibited signs of corruption and mismanagement.

These are longstanding issues, not quickly overcome, which many nations experience to varying degrees. Efforts are ongoing within the UN and other multilateral agencies, to address the impacts of these constraints. However, the particular impact of malgovernance and mismanagement on not only supply, but *demand* of development finance is an area of focus that is currently underdeveloped. Both a reduction in lending risk and an increase in legitimacy of the development finance process, in the eye of both supplier and consumer, can be achieved, but will require programmatic efforts to enhance:

- efficiency, transparency and competence of the public, private and NGO groups involved in the aid and credit processes, through increased managerial and institutional capacity
- public policies that encourage and facilitate private sector investment in alternative scale enterprises

- communication of credit options and alternatives to the pool of potential borrowers
- the process of exploring and developing alternative credit mechanisms
- research capacity in the study of development finance reform
- capacity and network building geared specifically toward a civil society-based intermediary lending community
- capacity and network building geared specifically toward a civil society-based monitoring mechanism
- networking and debate among process participants toward increases, at all levels, of development management capacity
- visibility of the process and its outcomes both for civil society (domestic and international) and for the aid and commercial lending communities
- communication of success stories, and the dissemination of best-practice knowledge.

Conclusions

The credit and aid mechanisms through which sustainable development is most greatly advanced are of multiple scales – the most productive of which can tend, in developing countries, to be quite small. Despite considerable policy-level recognition in many countries of the importance of making finance available through alternative mechanisms and at alternative-scales (beyond the micro-credit market), formal mechanisms to provide financial support to them are quite limited. Where such support exists, it is often limited in scope to financing very traditional economic activities, most of which offer little potential for generating surplus, savings or reinvestment.

Many small-scale potential clients are manifestly more profitable, less risky and better in tune with the needs of the local and regional economy than their larger, well-financed counterparts. These borrowers include a wide range of industries, trades, and communities capable of 'boot strapping' local, and consequently national economies. Among these, a large number could contribute to sustainable development by enhancing coping strategies and protecting communities from shocks, by fulfilling basic needs, creating livelihoods, generating purchasing power and conserving natural resources.

The body of projects and enterprises which create sustainable livelihoods can grow rapidly provided the infrastructure is built up to provide them the needed support. Both the tenets of Rio and conventional development wisdom call for action in this direction. Successful models exist which can be readily replicated, yet real action on the ground remains limited. In its response to the questions of future development finance, the international community would widen the opportunities for sustainable development by encouraging these alternatives, and placing the development of this type of framework and the capacity of participant groups at the center of its strategy. ●

1. The members of the Ring are ACTS (Kenya), BCAS (Bangladesh), DA (India), ENDA (Senegal), IIED (UK), IIEDAL (Argentina), NEST (Nigeria), SDPI (Pakistan), and ZERO (Zimbabwe). More members are being added to the alliance, and there are special partnerships with other institutions and networks.
2. In a number of the wealthiest countries, ODA has sunk to 50-year low levels, coinciding with states' shifting priorities, shrinking autonomy and increased obligations to emerging crises – changes that suggest to many that the era of aid as a force in development is nearing its end.
3. Whereas commercial banks have historically viewed developing country borrowers as high risk and have offered reflectively high rates, the World Bank is considered an inviolate borrower. It has been able to borrow from commercial lenders at below market rates, add its premium, and pass the loan on to the developing country borrower at market rate.
4. Development policy continues to center on industrialization. Current technological options are skewed in favor of the industrial sector. As a result, the capital cost of creating the millions of jobs needed each year in poorer countries, in the modern industrial sector, could be many times higher than a country's GNP. Given the present ecological price tag of modern industry, this approach is clearly not among the solutions to global environmental problems, and given the expense, simply cannot be the solution for eradicating poverty.
5. Indeed, while the policies of key entities on the supply side of the finance issue – the World Bank, commercial banks, aid agencies – are important factors, the key determinants of a lasting solution may be identified through analysis and strengthening of demand.
6. The variety of available supplier/purchaser relationships confirms that development finance need not enlist traditional models in order to be effectively utilized and can, in fact, be hindered through limitation to these models. In cases where proven, smaller-scale applications of development finance are deemed too expensive an undertaking by conventional creditors such as the banking sector, valuable opportunities for job creation and growth are lost.
7. Agenda 21 states, for example, that the “fundamental goal of capacity building is to enhance the ability to evaluate policy choices and modes of implementation of development options, based on an understanding of ... specific needs as perceived by the people of the country concerned”.
8. It is through the framework of the NGO community, after all, that various target groups – rural populations, ecologically vulnerable groups, the informal sector, women – are most readily accessed, and it is through these groups, then, that small-scale development finance can be most effectively utilized.
9. Strong institutions could also create confidence among large lenders, lowering the rate at which loans can be made, and thus the rate at which the loan can be passed on to small-scale projects and entrepreneurs.
10. A third may be new international calls for a global grant-making institution on the scale of the World Bank – if not the Bank itself. Though unlikely, a strong renewal in this type of aid could be greatly encouraged by stronger recipient capacity.
11. In reality, the division employed here, between recipient and intermediary, may be a misleading dichotomy, as the strengthening of demand means a strengthening of the many layers of the finance process. In a strong and transparent system, in other words, an NGO may borrow money from commercial vendors to lend to a community, which may in turn lend to individuals. The issues of scale and layering require exploration and research, ideally through the experiences of an international capacity building effort.
12. At a bi- or multilateral level, trust of the public of the donor countries, the members of a donor foundation, the overseeing agency of the donor government, the public or private recipient agency, and even the financial conduit can be lost. Domestically, the generation of development finance can be hindered by government corruption or public disapproval in the use of taxes, and thus the process of tax collection itself.
13. Similarly, efforts aimed at bringing credit to the small-scale entrepreneur, can help domestic development transfers by restoring legitimacy to domestic, public sector activities, such as tax collection.
14. These constraints include fiscal instability, the effects of income/employment reforms and workplace survival strategies on public sector performance, the impacts of centralization and decentralization on public sector accountability, and the ineffectiveness of emerging democratic governance in crisis-ridden countries (UNRISD, 1999).