Institutions and Financing for Development

SIDA

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1. INTRODUCTION[1]

Purpose

The 2030 Agenda, together with the Sustainable Development Goals (SDGs), is the plan of action for people, planet and prosperity, and the Addis Ababa Action Agenda (AAAA) framework provides the necessary resources for these collective ambitions. Financing for Development (FfD) was revitalized when the AAAA was adopted in July 2015 as a guiding framework for financing the post-2015 development agenda, later agreed and formalized as the 2030 Agenda and the SDGs in September the same year. The challenges are national, regional and global, and the actions need to be collective.

Institution and capacity building are integrated throughout the AAAA, but too often discussed separately to the 2030 Agenda. The 2030 Agenda recognizes that sustainable development cannot be realized without peaceful, just and inclusive societies that are based on respect for human rights, effective rule of law, and transparent, effective and accountable institutions. Correspondingly, the AAAA underlines effective, accountable and inclusive democratic institutions at the subnational, national and international levels as central to enabling the effective, efficient and transparent mobilization and use of resources. It explicitly emphasises systemic issues related to e.g. the need to non-financial means and an enabling environment, trade, capacity building and institutional strengthening.

With the adoption of the 2030 Agenda and the AAAA, new actors have joined the effort to work toward sustainable development and with that the role of ODA has changed. Both Agendas emphasise multi-stakeholder partnership. The private sector, civil society, the scientific community, academia, philanthropy and foundations, parliaments, local authorities, volunteers and others are all required to mobilize and share knowledge, expertise, technology and financial resources to complement the development efforts of governments. It has been clear from the beginning that funding through ODA alone is far from enough to achieve the SDGs and that other types of resources need to be massively mobilized, such as public financial resources and private capital (domestic and international), but also trade, knowledge transfer and innovation, and capacity building. We need to better understand how to harness the potential of different actors and resources, including how they complement and incentivise each other, for a specific problem in a specific context. The role of ODA will differ depending on the development problem, the context, actors and available financing instruments.

FfD and institutions, broadly defined, are interdependent and mutually reinforcing.[2] This paper clarifies how FfD fits within, builds upon and takes forward the established development agenda. By taking a systems approach, highlighting the nexus between financing, institutions and development, it describes how functioning institutions and an enabling environment are fundamental for not only maximizing FfD, but also maximizing the development impact of both the current and mobilized FfD.

There is a need to look at the FfD agenda from a country perspective, just as the 2030 Agenda, as emphasized in several reports, such as OECD's Global Outlook on Development Finance[3] and the 2019 IATF report[4], and further specified through the Integrated National Financing Framework approach[5]. To achieve the SDGs, countries need not only increased FfD, but also fit-for-purpose national and international institutions that facilitate economic, social, political and environmental stability and sustainable development. Hence, the more traditional development agenda on building institutions and capacity is still very much in focus in the new development cooperation landscape.

1 Susanna Gable, Kåre Johard, Erik Korsgren and Erik Ringborg co-authored this report in 2019. The work was developed under the guidance of Alan AtKisson and Cecilia Scharp. We are grateful to Karin Metell-Cueva and Mikael Bodström for valuable comments. The report was updated in October, 2021.

2 Institutions in this paper (further explained below) includes for example government institutions, policies, corruption, global agreements, enabling business environment, organisations, etc.

3 OECD (2018). "Global Outlook on Financing for Sustainable Development 2019: Time to Face the Challenge".

4 UN-IATF (2019) "Financing for Development: Progress and Prospects 2019", Inter-Agency Task Force on Financing for Development.

5 www.inff.org

This paper argues that understanding the interaction between institutions and financing is fundamental to maximize both the quantity of FfD and its development impact. By design the SDGs are an integrated set of global priorities and objectives that are interdependent. Especially understanding the reciprocal interaction between SDG 16[6] and SDG 17[7] and the other SDGs, is key in understanding both the means and the ends. For all SDGs, both the pathway to the goal and the goal itself requires taking into account effective governance systems, institutions, partnerships, and intellectual and financial resources, in an effective, efficient and coherent approach to implementation.

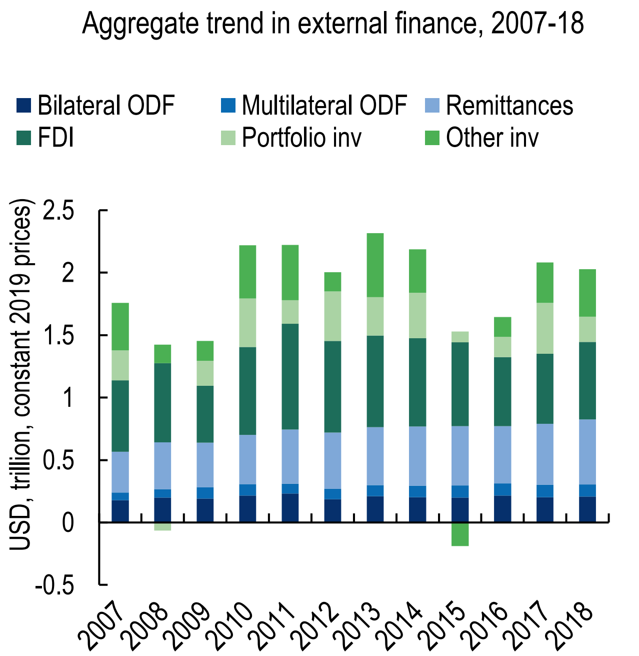
Background and Motivation: Development patterns point to the need to reinforce institutional capacity

There is a shortage of overall development finance and the available finance does not map to the financing gaps of the SDG agenda. Looking at FfD on an aggregate level, there are three immediate challenges, all pointing in the same direction: the need to take institutions into account, for the sake of increasing both the quantity of development finance and its quality, i.e. the ability to turn that finance into spending that efficiently moves the SDG agenda forward.

1. The amount of investment needed is substantial, but flows are decreasing overall.
Globally, pre-COVID UNCTAD estimated that achieving the SDGs in developing countries would require an annual investment of USD 3.9 trillion annually until 2030, resulting in an investment gap of USD 2.5 trillion, mainly in the areas of basic infrastructure, food security, climate change mitigation and adaptation, health and education.[8] With COVID, the needs increased with another trillion, widening the gap to at least 3.5 trillion and possibly even more as public and private investments are still sensitive to the ongoing pandemic.[9] However, as shown in Figure 1, total external financing to developing countries had already started declining since its peak in 2013. While there are several factors behind these patterns, weak institutions and capacity at both the global and national level have been identified as a major constraint.[10]

6 Promote peaceful and inclusive societies for sustainable development, provide access to justice for all and build effective, accountable and inclusive institutions at all levels
7 Strengthen the means of implementation and revitalize the global partnership for sustainable development.
8 UNCTAD (2014). World Investment Report 2014: Investing in the SDGs: An Action Plan.
9 OECD (2020) "Global Outlook on Financing for Sustainable Development 2021: A new way to invest in people and planet."
10 See for example the G20 Eminent Person Group's "Making Financing Work for All" (2018)

Figure 1: External financing to developing countries.

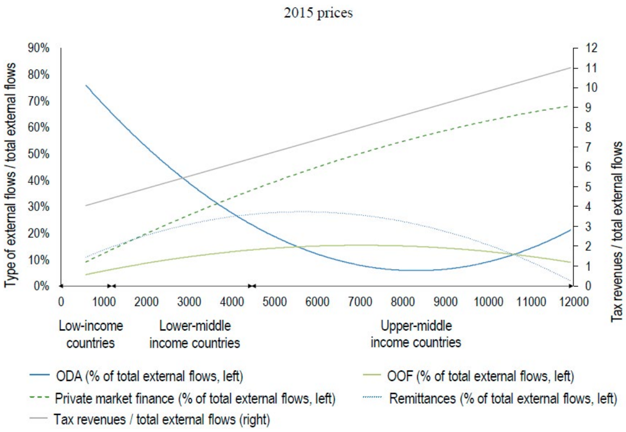


Source: OECD (2020) "Global Outlook on Financing for Sustainable Development 2021: A new way to invest in people and planet.

2. Most capital flows do not go to those most in need.
For a specific country, available financing depends on the presence and quality of its institutions, which to a large extent correlates with the country's income-per-capita level. Figure 2 and 3 illustrates how both the amount of financing and the type of financing change as a country develops from low income (LIC), to lower middle-income (LMIC), to upper middle income (UMIC). This reflects on the one hand the incentives that mobilise a particular financing stream, and on the other hand improvements in the surrounding institutions.

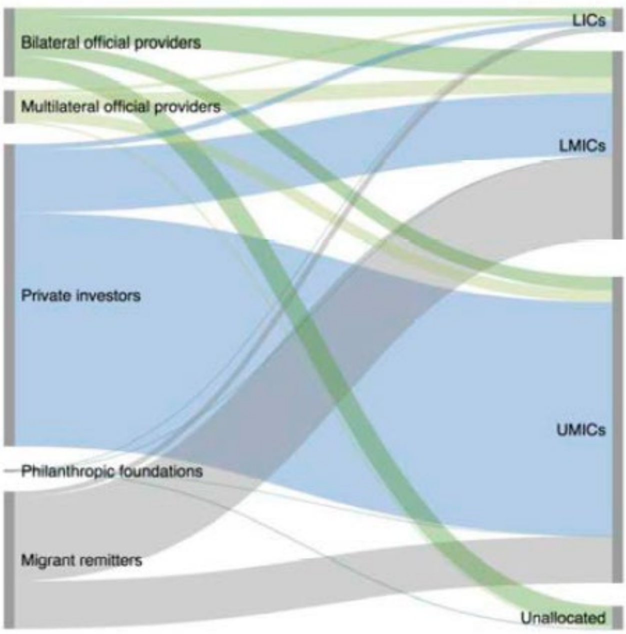
Generally, as countries develop, the financing mix shifts from external to domestic, and from public to private. Overall, less private financing is going to LICs and LMICs since the risk-weighted returns on investments there are more limited, but also because access to capital is limited. Institution building is needed both to increase returns on investments (for example, regulations for doing business or a functioning education system) and to decrease costs of or increase access to capital (for example, bank regulations and innovative financing instruments).

Figure 2: The mix of financial flows varies with income per capita levels.



Source: OECD (2018). "Global Outlook on Financing for Sustainable Development 2019: Time to Face the Challenge".

Figure 3: The allocation of different development finance flows.



Source: OECD (2018). "Global Outlook on Financing for Sustainable Development 2019: Time to Face the Challenge".

It is also interesting to notice the difference in remittances and private sector financing between LMICs and UMICs, reflecting the level of institutional constraints. LMICs receive more remittances than UMICs. Remittances partly go to consumption and, in those cases where they are used for investments, they are less dependent on institutions and more dependent on personal relationships. Private market financing, on the other hand, is strongly dependent on functioning institutions and hence naturally more prevalent in UMICs.

A similar pattern emerges when looking at global trade and foreign direct investment (FDI). Even though there has been remarkable growth in global trade during recent decades, and an increasing share represented by developing countries (now at around 50 percent of total trade), LDCs represented less than 1 percent of goods trade in 2017. In absolute numbers LDC exports remain roughly the same as in 2010, but the LDC share of total world trade has actually fallen.[11] In addition, most exports that do occur from LDCs are not especially productive: among African LDCs, three-fourths of exports are in oil.[12] An economy only built on extracting natural resources is not conducive to building strong institutions, but stronger institutions are crucial in order to move to a more broad-based economic system. Similar figures are seen when looking at FDI – most LDCs receive very low levels of foreign investment flows and these are concentrated in natural resource extraction. And of course, we are yet to see the longer terms effects of COVID on total global trade and trade patterns, which may be affected by an increased protectionism to manage the risks of global value chains revealed during the pandemic.

ODA and concessional financing constitutes a large share of financing for LICs, filling gaps from low tax revenues (not least due to low private sector activity) and lack of private investment flows. The purpose of ODA is both to fill direct needs and to catalyse a long-term, self-reliant, sustainable financing flow by investing in institutions and an enabling environment for the private sector. There needs to be a trade-off between the development needs and expected success in catalysing more capital. For the latter, a dollar of ODA would most probably have a larger leverage in MICs, but the needs are larger in LICs. There may be circumstances where catalysing additional private capital is a fruitless endeavour (potentially in difficult conflict contexts) since the supporting institutions are too far behind, and where ODA grant funding is the most efficient way forward. Support to mobilize capital can do much more good in other contexts or at a later stage.

11 World Trade Organization (2018). World Trade Statistical Review 2018. Geneva: WTO.
12 UNCTAD (2017). The State of Commodity Dependence 2016. Geneva: UNCTAD.

Hence, it is not surprising that most private finance and "blended finance" go to middle income countries, but also most "enabling environment" support through ODA goes to countries that already have relatively well-functioning business climates.[13] Not only does private investment not flow to the countries most in need: global development cooperation is in a way exacerbating the discrepancy, by mostly improving business climates in countries that already receive more investment (See Figure 2). Part of the reason could be risk aversion among some development agencies coupled with a pressure to deliver results, which could be more probable in countries already on a positive trajectory. Hence, ODA could be used to improve institutions but is also negatively affected by the current quality of institutions (and other factors affecting risk).

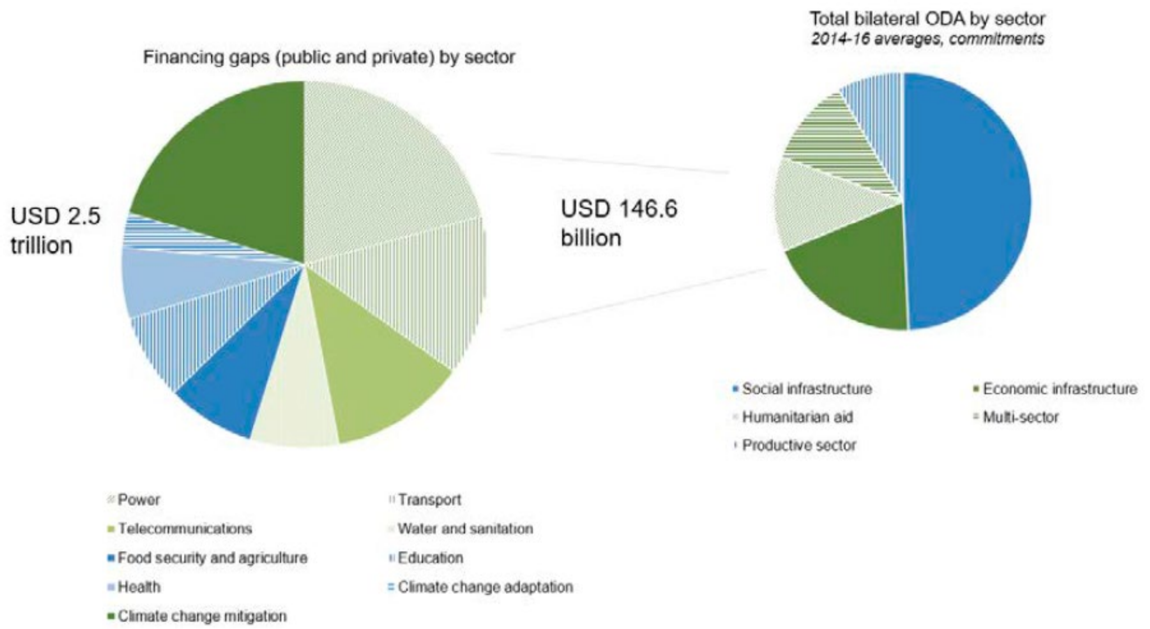
3. There is a sectoral pattern and different financing streams connect to different parts of the 2030 Agenda.

There is a financing gap in all sectors, but the size of the gap varies depending on the sector. Figure 4 shows an estimation of the gap by a selection of sectors, although the reliability of these numbers differs substantially between sectors (financing gaps in education is easier to calculate than in climate adaptation). Looking ahead at the inclusive, green, digital recovery from COVID, the financing gap related to for example social protection, the environment and climate change, and digitalization, has been brought into the limelight.

There is also a pattern when it comes to the type of financing by sector, where some sectors (such as the social sectors) have more challenges in creating markets than others. For example, on-going work by the World Bank, WEF and IDRC (GrowInclusive[14]), show that only 40 out of the 169 SDG targets were involved when studying international business innovations for development. Of those, only 22 were involved more than once. That leaves most of the SDG targets dependent on other types of capital. Moreover, Figure 5 reveals three main points:

- LICs are strongly dependent on ODA flows to the social sectors and infrastructure, followed by the production sectors. Other Official Flows[15] (OOFs) is limited overall with some exceptions in the infrastructure sector.
- LMICs are equally dependent on ODA flows to the social sectors and infrastructure, together with a strongly growing OOF to infrastructure. OOFs to other sectors are growing quickly too.
- In UMICs, OOF to infrastructure is dominating followed by both ODA (infrastructure and social) and OOF (production sectors, social and some banking).

Figure 4: Financing gap by sector vs bilateral ODA by sector, 2014-16.



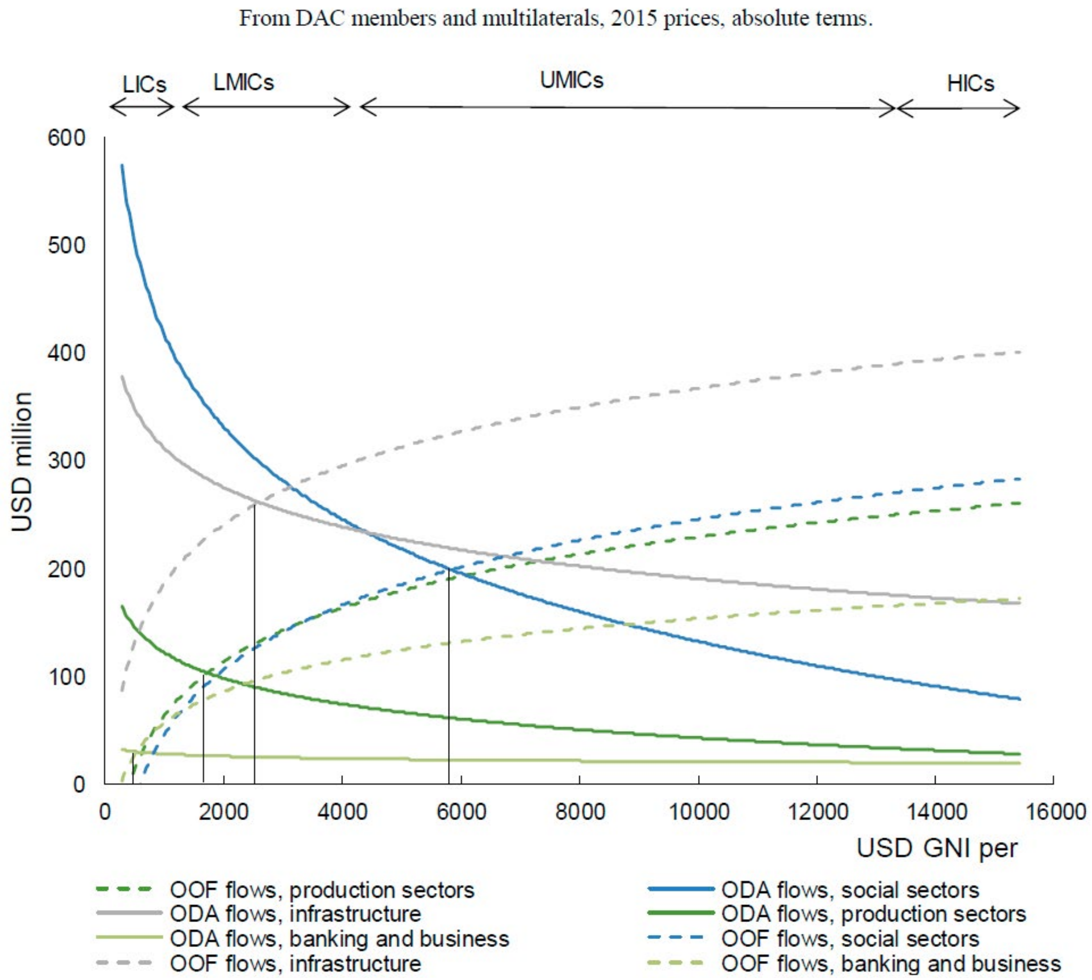
Source: OECD (2018). "Global Outlook on Financing for Sustainable Development 2019: Time to Face the Challenge".

13 Development Initiatives (2018). The Enabling Environment for Private Sector Development. Discussion Paper

14 https://www.growinclusive.org/

15 This is in short official flows that does not meet the ODA criteria and have more of a commercial purpose.

Figure 5: Financing flows to different sectors, given income per capita level.



Source: OECD (2018). "Global Outlook on Financing for Sustainable Development 2019: Time to Face the Challenge".

Hence, when looking at current financial flows and its patterns, it is clear that ODA, apart from financing broad development efforts in the poorest and most vulnerable countries with limited domestic resources, has a key role also in the new FfD agenda—not only to provide and mobilise a larger *quantity* of capital, but to maximize the *impact* of that capital. Simplified, ODA is the main source of finance in LICs (most sectors), and social sectors (both LICs and MICs), including both direct investments and financing the development of institutions—that in the long run aims to catalyse other types of capital. In MICs, traditional ODA could help financing complementary institutions (less than direct investments) to mobilise other capital or improve the development impact of the current flows—even in the short run.

2. MAXIMIZING THE AMOUNT AND IMPACT OF FFD: THE IMPORTANCE OF INSTITUTIONS

The AAAA spells out seven FfD action areas, all essential in achieving the SDGs. Each of these sources of FfD can leverage the others and they are all means to an end, namely to support the implementation of national development strategies and the 2030 Agenda. In addition, there is another fundamental aspect connecting all seven areas, which is the importance of institutions. Throughout the AAAA, a broad definition of institutions is applied, including both general institutions and financial institutions, at the global and national level, affecting citizens as well as businesses (for example, rules and regulations, policies, government functions and services, corruption, education system, etc). Below, each of the seven action areas are described, with particular emphasis given to the importance of institutional aspects. The purpose is not to present an exhaustive inventory of the role of institutions in each case but rather exemplify the broad set of institutions needed both for mobilizing and ensuring impact.

Action Area A – Domestic public resources

Governments confront the challenge of designing coherent policies that can simultaneously accelerate growth, reduce poverty and inequality, preserve and improve the environment, and help adapt to/mitigate climate change. To successfully achieve these objectives, including capacity to manage financing flows, countries need sound institutional arrangements for integrated planning and policy. Domestic public finance is essential to providing public goods and services, redistribution policies, supporting macroeconomic stability, creating an enabling environment for the businesses and welfare for its citizens. Public finance encompasses raising revenue, budgeting its use, fiscal and monetary stability, and spending on public programs and investment. Anticorruption is a fundamental component in this regard, as misuse of funds poses a serious constraint to reaching to above objectives.

Domestic public resources play a key role in supporting institutions that affects the very core of any society—social trust, among citizens, among businesses, and towards the government itself. Effectiveness and efficiency in revenue collection and public service delivery can boost the link between citizen and State by enhancing accountability and strengthening trust. Conflict-affected countries have unique challenges and fiscal systems are a key to rebuilding social trust and accountability. Data and transparency are necessary on the expenditure side of public finance for delivery of accountable public services and sustainable development, which in turn strengthen the willingness to mobilize more public resources. For example, gender-responsive budgeting can strengthen coherence between government budgets and gender equality objectives.

Action Area B – Domestic and international private business and finance

Private investment and business activity are integral to development and job creation. Without a private sector and economic growth there will be no increase in incomes and tax revenues (and hence public finance). In addition, the AAAA calls on businesses to apply their creativity and innovation to solving sustainable development challenges and invites them to engage as partners in the implementation of the sustainable development agenda.

Hence, the AAAA places private capital and private actors as central stakeholders and actors for international development and as a source for financing, but also as change agents and dialogue partners to official institutions and governments. In order to attract investments and other financial flows government institutions must be functional and responsive to suggestions and demands from private actors. Having the means to engage in public-private dialogue is an important institution in itself.

Public policies set the enabling environment and the regulatory framework for private sector investment and activity. This requires building institutions that are conducive for transparent, stable and predictable investment climates. As a concrete example, in many contexts, it is difficult for micro- or small business owners to successfully engage with the formal banking sector. This is especially true for informal businesses, which make up the majority of firms in many LICs. But even formal ones experience similar problems, e.g. because of low financial literacy or high collaterals. Improving credit markets, expanding financial inclusion and improving regulatory capacity in government are all important parts of strengthening national institutions for maximizing finance.

As another example, although FDI can be an engine for job creation and technology transfer, it is not automatically the case. Poorly designed investment codes can either discourage investors or lead to significant amounts of undesirable investments, e.g. those with harmful environmental externalities or that undermine labour regulations. Foreign investors can also, through government policies, programmes and agreed-upon principles, be incentivized to strengthen linkages with the local economy. Examples include a transferring of technology and knowledge to employees and domestic suppliers.

A final example is that in order to incentivise institutional investors to take a long-term approach, institutions such as regulatory frameworks and the tax structure often need to be reviewed. Without a long-term perspective, certain risks, such as climate risks or even pensions, will not be priced into private decision-making.

Action Area C – International development cooperation

Several of the potential FfD sources are not easily available to the world's poorest and most vulnerable countries. Instead, ODA plays a much more important role, for example in financing essential public services. ODA flows are relatively stable over time but play a less and less important role, relatively and quantitatively speaking, in finance flows to developing countries. In addition, not all donors live up to their commitments of ODA as a share of GDP, and of the ODA available a small share goes to the Least Developed Countries (LDCs) and the Fragile and Conflict-Affected States (FCS). Global institutions play an important role in committing, coordinating and incentivizing donors, as well as for sharing of experiences and lessons learnt.

ODA often serves the purpose of supplementing limited domestic public resources. ODA-financed institution building plays an important part to foster a cohesive policy formulation process that incorporates development objectives across the economic, social, and environmental dimensions of sustainable development. Sometimes the support comes in direct financial contributions, sometimes in policy reform discussion, and sometimes in the form of technical assistance or cooperation between government agencies in the donor and receiving country. ODA can also result in increased financial flows (with different degrees of institutional and capacity building elements) directly aimed at the private sector, for example through guarantees, blended finance, SDG-related bonds and other innovative financing instruments, or through facilitation of cooperation between businesses from both countries.

A key aspect of the interplay of ODA and other FfD sources that is important to note is the catalytic dimension of institution building and finance. Apart from financing essential services, ODA plays a critical role in mobilizing additional resources – e.g. through removing bottlenecks for trade, private sector development or improving domestic tax collection. ODA directed towards and successfully delivering institutional strengthening in the poorest and most vulnerable countries will increase their preparedness for mobilizing additional funding as well as ensuring a developmentally positive effect from these additional resources.

Action Area D – International trade as an engine for development

Historically, in countries where poverty reduction has been the most significant and sustained, increased engagement in international trade has often been a key success factor. However, while world trade has grown immensely over the past couple of decades, many LDCs have been left behind. The AAAA acknowledges that international trade is an engine for inclusive economic growth and poverty reduction, but this is not possible unless these countries become increasingly integrated into the world economy, and in a sustainable manner. In this regard, developing countries benefit from trading arrangements that are open, transparent and predictable, which is why multilateralism and global institutions, such as the World Trade Organization (WTO), are fundamental.

But in order to engage in trade negotiations effectively, and to be able to sign regional or multilateral trade agreements that are truly beneficial, national institutions are crucial. For example, what analysis lies behind a formulated trade policy? How well have different government bodies, private sector and civil society stakeholders been consulted? Do trade negotiators truly understand the implications of the sometimes thousands of pages in a draft text? In short, strong institutional capabilities are needed for effective formulation, negotiation and implementation of trade policy. In addition, especially for SMEs to be able to utilize trade reform and access international markets, additional measures are often needed in the areas of e.g. trade-related infrastructure, trade finance and knowledge on relevant trade regulations and standards.

An open economy provides opportunities, but it also exposes the country to economic transformation that has both winners and losers, and different individuals and communities will be impacted differently. It is essential to ensure that the resulting economic transformation happens in an as efficient and inclusive way as possible. Having in place overall economic policies and systems that promote job growth, decent work, social mobility and social protection can create a conducive framework within which specific policies of trade adjustment can be more successful. Well-designed and gender-responsive policies tailored to country circumstances— such as job search assistance, training programmes, and lifelong education—can augment workers' skills and facilitate employment. Complementary policies in areas across the 2030 Agenda, such as housing, financial inclusion and infrastructure, also play a role in easing adjustment.

Action area E – Debt and debt sustainability

Debt can be a sustainable source of finance if the investments resulting from the debt turns out productive enough to pay back the loan. Hence, it could potentially be used by Governments as they are faced with large financing needs to implement the 2030 Agenda. However, global financial conditions are set to tighten following the increased perceived risks in developing countries as they fall behind in the COVID recovery, while richer countries' demand for investments as they "build back better" may put upward pressure on the interest rate. In addition, many developing countries are constrained from raising resources due to their already high debt burdens. Risks for a renewed cycle of debt crises and economic disruption are growing, posing a significant challenge to the achievement of the SDGs. Many natural-resource producing countries have seen rapid debt accumulation as Governments have attempted to cushion the shock from falling commodity prices.

Recent debt dynamics highlight the need for institutional arrangements, such as the Common Framework, with enhanced measures to manage vulnerabilities. Those include both improving debt management capacities in many developing countries and agreements from the creditors to be transparent, not least private creditors and non-Paris Club creditors, in the levels and type of loans, as well as their conditions. In the long run, it is also essential to develop institutions for early warning systems for debt and improved capacity for macroeconomic planning to predict and deal with potentially alarming situations.

Action Area F – Addressing systemic issues

The AAAA emphasises the importance of the coherence and consistency of the international financial, monetary and trading systems in support of development. These global systems need to be strengthened in order to allow for capital to be mobilized at a large scale. All financial flows are necessary to achieve the SDGs but only through strong global systems, in combination with the de-risking in the countries enabling environment, will large enough resources flow in a sustainable way. In many cases, global institutions and rule-making processes need to increasingly consider the interests of developing countries and allow them to have a seat at the table. In addition, a lack of transparency and predictability is especially harmful for development and multilateralism is an inherent fundament in this regard.

In addition, touching on several different SDGs, the AAAA highlights how human trafficking and terrorism have serious implications for development prospects, and that migration can entail both opportunities and challenges. In all these cases, international cooperation together with national and subnational institutions for enforcement is crucial.

Action Area G – Science, technology, innovation and capacity-building

Science, technology and innovation (STI) are key means of implementation of the SDGs. Expectations about the contribution of STI have increased in recent years as fast-evolving technologies are rapidly changing the development landscape. They open new possibilities to address long-standing development challenges across the SDGs—from poverty and hunger, access to health care and education, to low-carbon energy, combatting climate change, and financial inclusion. They are also changing the development finance landscape, creating opportunities across the action areas of the AAAA.

STI play an important enabling and driving role in empowering developing countries to lift themselves out of poverty, whether by increasing their productive capacity to trade or by delivering more effective services at a lower cost. Transfers of technology alone are not sufficient to ensure that the technology transferred will be taken up in developing countries. Efforts to build institutions facilitating local innovation systems and an enabling environment of technical know-how and skills, business readiness and conducive policy frameworks are needed. Transfers of technologies that are in the public domain or available on affordable terms can help developing countries accelerate technological adoption for development and environmental purposes.

Capacity building is essential to the whole agenda of building institutions. In many cases, it is not the lack of an institution that is the problem but rather its function and the capacity to ensure it is implemented in an efficient and impactful way.

3. TOWARDS A HOLISTIC FINANCING FRAMEWORK WITH INSTITUTIONAL CHANGE IN THE CENTRE

The dramatic increase in resources to developing countries that were pledged in the AAAA have not materialised during the first six years after the conference. In most cases, the resources are declining. The financing gap for the remaining nine years to 2030 has thereby increased. The gaps are especially acute in some sectors, and/or in some countries reflecting the different incentives of each financing flow and the institutional context in the country or sector. The development community stands at a crucial juncture and the time to act is now.

In the heart of guidance around the FfD and development is the importance of (i) country ownership and country context (including available finance), and (ii) taking the development problem rather than the financing instrument or a specific actor as the starting point. Development and financing strategies remain too often disconnected, even though the lack of financing to begin with can as often be a problem of the cost or access of financing, as the lack of potential returns from the investment in question (i.e. structural constraints in the real economy). Any blended finance or aid financed operation must be, in the same way as a grant-financed intervention, anchored to a development rationale. Only thereafter should an appropriate financing solution be designed that consider the local complexity, including the capacity of local actors and institutions to attract and manage different forms of resource flows. For example, private sector actors' primary objective is normally not to achieve the SDGs, but profitability. For them the contribution to the 2030 Agenda is additional resources and trade, motivated by profitability, that *also* contribute to growth and employment and indirectly to social benefits. However, they are also concerned with long-term profits which may be more directly connected to the 2030 Agenda (creating markets within sustainable energy or using locally produced input, for example).

The 2030 Agenda and the FfD agenda need to be seen as interdependent and the role of institution building in that process needs to be made explicit. The "one-way model" of the FfD agenda goals resulting in the SDGs, needs to be replaced by a "two-way model" between the progress (or lack thereof) of the FfD and the progress (or lack thereof) of the 2030 Agenda, recognising the diversity of financial flows, the role of institutions and the reinforcing systemic relationship. This also clarifies how the longstanding development agenda of building institutions and capacity for an enabling environment for the private sector, accountable and transparent government providing high-quality services, and democratic systems that ensures an open dialogue with citizens, is still at the core of the current development cooperation landscape.

Once these connections are made explicit, as in the previous sections, it becomes clear how context specific the FfD agenda needs to be for maximum, sustainable development impact. Different types of financing are *incentivised* in different ways and their *development footprint* depends on the different types of contexts and its current institutions. In addition, the actors behind the financial flows and the magnitudes of the flows themselves are also shaping the institutions they are themselves affected by or dependent upon, creating a two-way relationship. Finally, different financing flows can both *enhance and weaken each other* which raises the need to talk about financial packages ra ther than instrument by instrument. It is beyond the scope of this paper to go into the details of each flow, but there should be no doubt that the mix of FfD instruments and institution building interventions need to be tailored to the country or regional context.

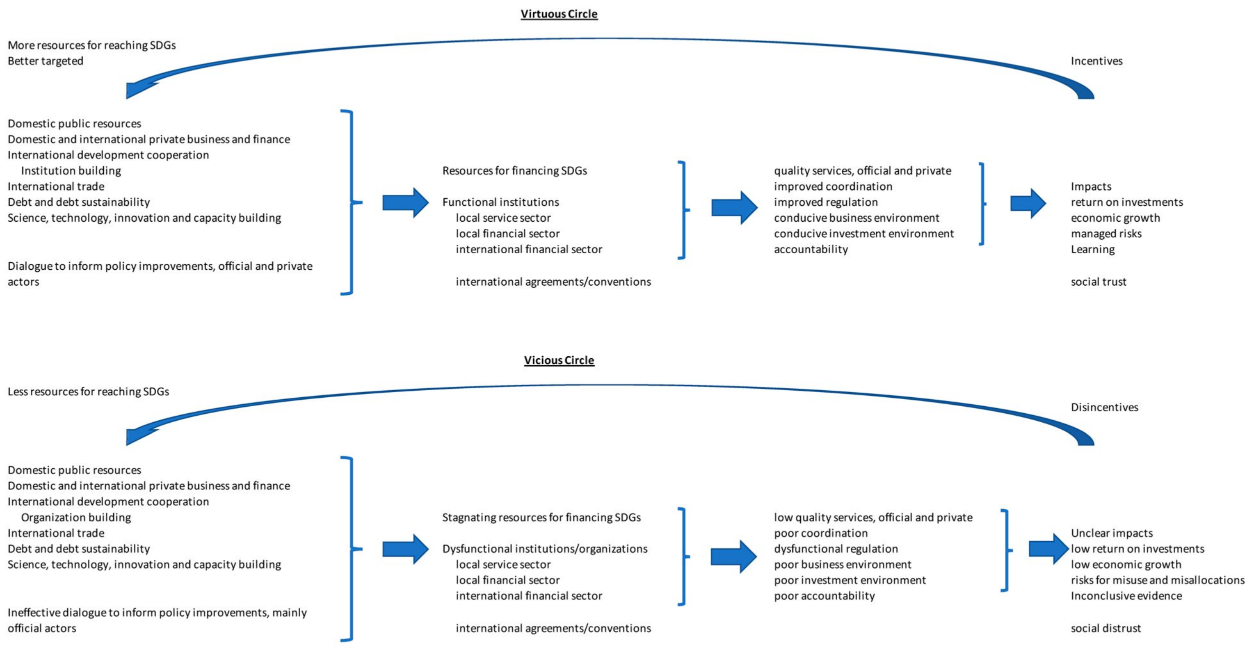
The model in Figure 6 illustrates that functioning institutions and an enabling environment is fundamental for maximizing the quantity of FfD flows but also for ensuring the quality of FfD flows. Effective use of financial and other resources, public or private, is contingent on functional financial institutions at both the global and country level. At the global level, functional financial institutions include e.g. finance regulators, rating agencies and DFIs, and more general institutions such as international agreements, WTO, etc. At the country level, institutions in the business and financial sector such as central banks, tax authorities, investment promotion institutions and credit bureaus are crucial for creating a conducive business- and investment environment. Functional service institutions are necessary for efficient use of public money and for overseeing private service providers. Referring to the enabling environment in countries in the broadest of manner, it includes a peaceful, stable and open society with institutions ranging from educational systems and efficient customs, to a functioning rule of law and policies as well as the actual implementation of these. There remains significant scope for structural reforms to lift unnecessary barriers to trade and private investments in support of the SDGs and to develop accountable and efficient service institutions. It refers to national capacity not only to attract financing but also to the capacity to regulate and monitor investors and their externalities. It also refers to new markets, platforms and channels for development-friendly finance—e.g. through remittances, domestic resource mobilization, impact investors, etc. Well-functioning institutions are also key for knowledge transfer, e.g. with regard to spill over effects on the local economy from FDI or linkages between research institutions and the private sector.

The model in Figure 6 also stresses that the system is self-reinforcing, and a better understanding of the incentives and roles of each actor, as well as their interactions, could help leverage more resources and have a greater impact where they are most needed. The feed-back loop from the sources of FfD flows, such as private sector companies and investors, to demand functional institutions is key. A virtuous circle of mutual adaption can be envisaged. Non-State stakeholders, such as the private sector, need to be invited to have a more distinct role in informing much needed policy reform programs if they are to play a partnership role in achieving the SDGs. Institution building programmes and policy dialogue supported by donors should benefit from drawing on private sector views and advise. In context with governments that are keen on attracting additional private capital private actors have a strong position since they can find investment opportunities elsewhere. The objective should be to increase the development footprint of all financial flows, which means involving actors ranging from donors, central- and local governments, private business, investors, and philanthropists, to civil society organizations and academia.

Monitoring and evaluation must go beyond tracking resource flows from all stakeholders. Understanding impacts under each SDG will be important for continuous learning and efficient adjustment to attract further resources. For private flows it is of particular importance to create awareness of potential, returns on investments in developing countries and under which circumstances they also contribute to pro-poor growth and sustainable development. The combination of understanding development impacts and financial returns will attract further interest and money that will be better targeted to where they make best use.

A virtuous circle of mutual adaptation can be envisaged. The feed-back loop from the private sector and investors to demand functional institutions is key. A virtuous circle of interaction between all partners, where mutual linkages and interdependence between additional resources, including multi-stakeholder dialogue, and institution building should be able to generate a perpetually reinforcing movement. However, in a situation with stagnating resources for development and capacity building of official offices in developing countries that focus more on form than on function, the risk for a trajectory following a vicious circle is far too likely. Action, is therefore needed urgently to deliver on all aspects of the AAAA, which means simultaneously looking at catalysing initiatives within the 2030 Agenda itself—not least Goal 16 on Peaceful and inclusive societies and Goal 17 on Partnership. For donors, rethinking and revitalising their approach to FfD and institution building will be key contributions.

Figure 6: The virtuous and vicious circle of institutional building between Agenda 2030 and the Addis Abeba Action Agenda.



Source: Own illustration.

4. SUMMARY AND CONCLUSIONS

Bilateral as well as multilateral donors invest in both institution building and catalytic FfD, in order to support the 2030 Agenda. They engage in both traditional development cooperation and in the more recent emphasise on mobilising capital. This paper elaborates on the key role of institutions in understanding the interdependence of the FfD agenda and the 2030 Agenda, and presents an integrated, systemic approach to institution building and FfD. It clarifies how to harness the different potentials of different actors and resources (not least aid), including how they complement and incentivise each other, for a specific problem in a specific country context.

Support to institution building is key for several reasons:

- FfD and institutions, broadly defined, are interdependent and mutually reinforcing
- Functioning institutions and an enabling environment are fundamental for both 1) maximizing FfD, and 2) maximizing the development impact of both the current and mobilized FfD
- Ensure sustainable, country-owned development and trust among government-businesses-community

Patterns in global financial flows seem to confirm these statements. In particular we see:

1. The amount of investment needed is substantial, but flows are decreasing overall despite recent efforts to mobilise global capital.
2. Most capital flows do not go to those most in need, where low-income countries are still struggling to attract all types of financial resources – including ODA.
3. There is a sectoral pattern and different financing streams connect to different parts of the 2030 Agenda, suggesting that different flows are incentivised differently and more suitable for different purposes.

The statements are also confirmed when systematically going through the importance of institutions within each of the seven action areas of the AAAA[16], as well as their mutual interdependence. For example, the role of ODA will differ depending on the problem, the country context, and other available financing instruments that can either replace, complement or be catalysed by aid.

When moving towards a more holistic financing framework with institutional and capacity building in the centre, several principles emerges.

First, the 2030 Agenda and the FfD agenda need to be seen as interdependent and the role of institution building in that process needs to be made explicit. The "one-way model" of the FfD actions resulting in the achievement of the SDGs, needs to be replaced by a "two-way model" between the progress (or lack thereof) of the FfD and the progress (or lack thereof) of the 2030 Agenda, recognising the diversity of financial flows, the role of institutions and the reinforcing systemic relationship. In addition, the actors behind the FfD flows and the magnitudes of the flows themselves are also shaping the institutions they are themselves affected by or dependent upon, creating a two-way relationship. The feed-back loop from the private sector and investors to demand functional institutions is key.

Second, an FfD and development framework needs to recognise the importance of country ownership and country context (including available finance) and take the development problem as the starting point and seeing the financing instrument or a specific actor as part of the solution. This means shifting part of the current conversation on mobilising capital from the supply side to the demand side and look at it from the perspective of the countries. Different types of financing are incentivised in different ways and their development footprint depends on the different types of contexts and its current institutions. Finally, different financing flows can both enhance and weaken each other which raises the need to talk about financial packages rather than instrument by instrument.

16 Action Area A – Domestic public resources
Action Area B – Domestic and international private business and finance
Action Area C – International development cooperation
Action Area D – International trade as an engine for development
Action area E – Debt and debt sustainability
Action Area F – Addressing systemic issues
Action Area G – Science, technology, innovation and capacity-building

Third, country-tailored functioning institutions and an enabling environment is fundamental for maximizing the quantity of FfD flows but also for ensuring the quality of FfD flows in terms of development impact. Each country context is unique and operate under constrained resources, which means prioritization that makes sense to the country at this specific point in time is necessary. It also means moving away from form and organization building to function and institution building, including looking closely at local interests and the political dynamics that drive policy, and after that arrive at the most efficient country-specific instrument. In practice this demands new ways of working with an increased attention to iterative, agile approaches.

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