

# Are Development Finance Institutions Good Value for Money?

**Paddy Carter**

## Abstract

Finance institutions take money from foreign aid budgets to invest in private enterprises. How much should they be given? We can make some progress on that question by looking at the return on investment in the form of higher real incomes for workers and customers, and comparing that to a cash transfer benchmark. There is considerable uncertainty, but what evidence we have suggests returns on investment are in a range that compares well to that benchmark. There is also a diversification argument that because we don't know which of the things that aid can finance will ultimately prove most important for poverty eradication, aid allocation should hedge its bets. A low single digit percentage of aid allocated to increase the quantity and quality of private investment in low- and middle-income countries seems reasonable.

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## **Are Development Finance Institutions Good Value for Money?**

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## **Preface**

As the world confronts the aftermath of the COVID-19 pandemic, resources to assist developing countries recover and make the transition to a green and equitable future are scarce—scarcer than before the pandemic, given donors’ own budgetary constraints and the slowdown in global GDP growth. Thus, whatever public financing is available must be used well.

As bilateral donor agencies look at their limited budgets, they face a tough decision: what part of their development assistance should go into grant funded activities, such as in education, social protection and health, and what part should be allocated to the DFIs as capital that can be invested in private enterprises and recycled?

In this paper, former CGD Senior Fellow Paddy Carter puts forward a decision-making framework that could guide these allocations decision. He suggests that the development community, and aid agencies in particular, look at two things. First, the returns on investment in the form of higher incomes for workers and consumers, adjusted for distributional concerns, and how that compares to grant-funded aid programs. Second, a diversification argument that different things may turn out to be more or less important for long run poverty reduction, so it’s worth hedging your bets.

This will not be entirely satisfactory to either DFI cheerleaders or the DFI sceptics, as like any sound economic analysis the answer is “it depends, and more analysis is needed.” While he makes a solid case that some aid should go to DFIs, how much is not clear. The argument identifies several unknowns, and their resolution could either strengthen or weaken the case for DFIs. But the real value of the paper is not in reaching a definitive answer, which nobody has when it comes to deciding between alternative uses of aid, but in putting forward a framework for how donors should think about how much to allocate to grants vs. investing in DFIs.

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## Do DFIs get too much of the aid budget?

Suppose you had the task of allocating an aid budget into two pots: grant funded activities and development finance institutions (DFIs), such as CDC, FMO or the IFC. In an ideal world, you would adjust the allocation until the impact of additional spending on grant programs equals the impact of additional money put into a DFI.<sup>1</sup>

Reality is, of course, rather more complicated. But we can make some progress on this question by starting with the simplest possible approach and then introducing complications later.

This is a value for money question. Of all the things that aid could be spent on, which offer the highest impact return per pound? Quantifying impact would not be wise for everything that aid tries to achieve, but some of the more tangible results can be counted and usefully compared to costs. The UK has championed an evidence-based approach to value for money questions, a recent example of which is a [“smart buys” in education report](#).<sup>2</sup>

The idea of [benchmarking development interventions against cash transfers](#) is also increasingly popular.<sup>3</sup> Taking inspiration from that, the easiest version of this problem is to reduce development impact to the objective of material poverty reduction (raising consumption) and compare investments against a grant-funded transfer spent solely on consumption.<sup>4</sup>

Of course the choice between cash transfers and capitalising DFIs is not a decision that donors are really taking—very little ODA is used to finance cash transfers, most is channelled via governments and NGOs—but a well-defined benchmark is useful. It is an open question whether the typical aid program is more or less effective than a cash transfer.

One final caveat: at the present time, ODA allocation decisions must respond to the demands created by the COVID-19 pandemic. There is a case that support for the private sector should be part of the global COVID response, but this article is not going to consider that question.

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<sup>1</sup> In the simplest case, there would be diminishing marginal returns to both grant aid and DFIs, which would make sense if higher impact projects are selected first and then lower priority projects are taken on as the budget expands. When there are diminishing returns, money can be moved from one bucket to the other until marginal impact is equalised.

<sup>2</sup> World Bank (2020) “Cost-effective approaches to improve global learning” Recommendations of the Global Education Evidence Advisory Panel.

<sup>3</sup> Blattman, C and Niehaus, P (2014) “Show Them the Money Why Giving Cash Helps Alleviate Poverty” Foreign Affairs.

<sup>4</sup> Consumption refers to consumption goods but also housing, healthcare, and other elements of a person’s standard of living. One sometimes encounters the idea – not always explicitly stated - that aid is wasted when it is consumed not invested. We see this when the question of whether aid is effective is equated to whether aid causes economic growth. That is wrong. Economic theory says that optimally aid will be split between consumption and investment. It should not be surprising that someone living in poverty might want to spend some income on improving their lives today, rather than investing it all for tomorrow.

## Increasing consumption

DFIs prioritise investments that raise consumption in two ways: by increasing incomes for workers and reducing the prices and increasing the availability of goods and services for consumers. What would it take for investments to be equally cost-effective as grant aid?<sup>5</sup> To answer that question we must make two adjustments: one to account for the fact that money given to a DFI is recycled and a second to account for the fact that investments generate recurring income streams.<sup>6</sup>

We start with the simplest benchmark of a £1 grant-funded transfer that raises consumption by £1. Let's ignore overheads.<sup>7</sup> First, we must account for the difference between a grant, which, from the perspective of the donor, once spent is gone, and an investment, where the money (usually) comes back to be invested again. One way to deal with this could be to calculate the “grant equivalent” of an investment, to put value for money comparisons on an equal footing.<sup>8</sup> But under OECD rules, capital injected into a DFIs can be counted as aid. That gives us an easier way to think about the problem: as money put into a fund and recycled in perpetuity, with the impact coming from repeated investments. To keep it simple we shall also ignore financial returns on investments, which can grow the pot that DFIs have to invest over time.

We cannot avoid thinking about how to compare the future to the present. For the sake of arming ourselves with a mental rule of thumb suppose that DFIs typically recycle every dollar three times over 20 years.<sup>9</sup> Rather than try to pick a rate at which to ‘discount’ impact that happens further in the future, let's say that we care equally about the impact of investments over the next 20 years and zero thereafter. We are replacing a gradual decay with

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<sup>5</sup> The Copenhagen Consensus project is an ambitious attempt to estimate the cost-effectiveness of various ways of spending money to solve the world's development challenges. This article tries to do something different – rather than situate DFIs in a ranking of multiple possible ways of spending aid, the intention is to explore how a comparison would be made against a single, simpler benchmark. The approach taken in this article would not be readily suitable for some aid spending—particularly humanitarian and other life-saving activities. This article is not a commentary on the recent cuts to UK aid.

<sup>6</sup> The approach treats the opportunity cost of £1 given to DFIs as £1 of grant aid. That fits a donor with a fixed aid budget, such as the UK. From the perspective of public finance, however, there is another difference: grant aid is fiscal expenditure, whereas money given to a DFI is not, because it creates an asset of equal or greater value. If capital injected into a DFI was decoupled from grant aid, the value for money argument picture would change dramatically.

<sup>7</sup> Most DFIs cover the costs of making and managing investments out of their financial returns, and most usually make a positive return on net so every \$1 can be recycled into (at least) another \$1 invested. Grant funded programs also have overheads – it takes more than \$1 to fund a \$1 cash transfer. Give Directly reports that for every \$1 spent, 89 cents reaches recipients. The International Rescue Committee says costs can range from 14 cents to \$1.32 for every dollar transferred. Based on incomplete data, Easterly and Pfitze estimate that for the total international aid effort administrative costs are about 9 percent of total spending. DFIs' overheads are a much smaller share of annual investments (typically under 2 percent) but the dominator (grants, investments) are not comparable. Salaries paid by DFIs to retain finance and legal professionals are much higher than in aid agencies.

<sup>8</sup> For example: <https://ida.worldbank.org/debt/grant-element-calculations/> A problem with a grant equivalence is the question of how to treat the impact return on investment as the grant equivalent approaches zero, or becomes negative when investments are sufficiently profitable – does the impact return on the dollar become infinite?

<sup>9</sup> DFI investments range from very short duration trade finance to multi-decade loans for infrastructure. A typical private equity fund holding period is 5 years. The impact of an investment is not necessarily independent of its duration, which is a complication we are setting aside here.

a cliff edge, to make the mental arithmetic easier.<sup>10</sup> To have the same impact as a £1 grant that raises consumption by £1, that implies that £1 given to a DFI should fund three investments that each raise consumption by 33.3p.

Next, we must adjust for the way in which investments raise consumption over time. When an investment raises productivity, it creates a flow of real income that can be shared between workers, as higher wages, customers, as lower prices or as new varieties of goods, and shared with investors in the form of financial returns. Conventional economics might weigh what is known as consumer and producer ‘surplus’ equally, but in the context of development let’s say we mainly care about two ways of increasing consumption: raising workers’ wages (not managers) and cutting prices.<sup>11</sup> Observing the impact of investments on wages and prices is difficult, because it is not only the productivity of the firm that received the investment that matters – other firms may also become more productive through spillovers, whilst competition may cause others to shrink or exit. Ideally, we would observe the net change in real incomes across the economy, resulting from an investment.<sup>12</sup> The investments made by DFIs might be expected to differ from the average private sector investment, because DFIs target investments that more generate surplus for workers and consumers.

This will look like cherry picking because it’s such a large impact, but it’s actually one of the only examples I have found of an estimated impact return on investment from price reductions: [a paper by Tarek Ghani and Tristan Reed](#) relates the story of the first industrial ice vendor in Sierra Leone, serving the fishing industry, which was financed by a DFI-backed \$5m private equity fund.<sup>13</sup> Other ice vendors then entered, productivity improved, and fish prices fell. The authors estimate that put \$33m in PPP dollars per year into the pockets of Sierra Leonian consumers. We cannot say how long this impact persisted, relative to the counterfactual price trend, but this was not a one-time benefit. Because this outcome was the result of investments that followed the initial entry, we may not want to attribute it all to the initial DFI-backed investment, but however you cut it the impact return on the DFI investment, in the form of higher consumption for Sierra Leonians, is very high. Here is another example: in Bangladesh the involvement of DFIs in power plant construction is [estimated to have reduced plant-level power prices by 18 percent](#).<sup>14</sup> Multiplied by the volume of power sold every year and projected forward in time, that would add up to a very big number. I don’t know how much money those DFIs put into these power investments, but there is clearly potential for a very large impact return there.

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<sup>10</sup> Choosing an appropriate discount rate is a real can of worms. Some argue it is immoral to value future generations any less than present. The choice of discount rate is extremely contentious in the context of climate change, where it has a large influence on what costs we should incur today to prevent future harms. In that context, most people argue for using a low discount rate; in this context a low discount rate would tilt the grants versus investment comparison in favour of investments.

<sup>11</sup> Although from a macro perspective, reinvestment of returns by investors is important. If we want domestic savings to finance investment via the banking system, that positive financial returns are necessary.

<sup>12</sup> It’s also difficult because we want to know prices relative to a counterfactual. Prices might be rising or falling in a sector for many reasons already, and we want to know if an investment caused price to rise more slowly or fall more quickly than they would have otherwise.

<sup>13</sup> Ghani, T and Reed, T (2021) Relationships on the Rocks: Contract Evolution in a Market for Ice. American Economic Journal: Microeconomics.

<sup>14</sup> Khan et al., (2020). Cheaper, Cleaner Power: De-risking as an Anti-Collusion Strategy in Bangladesh. SOAS ACE Working Paper 023.

We are looking for each £1 invested by a DFI to raise consumption by 33p. But that is a one-off gain whereas returns on investment happen over time. I do not know how persistent the impact of a typical investment is, and again we must decide how to weigh the future against the present. Rather than try to choose a rate of impact decay and a discount rate, we will again use a “cliff edge” function to make the maths easy. Let’s assume the flow of increased consumption resulting from an investment persists for at least 5 years, and again because we are impatient, we discard anything after that.<sup>15</sup> Then we get a net present value of 33p from an investment that raises consumption by roughly 7p per year.

So, in the simplest possible setting and using some very back-of-the-envelope shortcuts, to match the impact of a £1 grant spent on raising consumption, you would allocate more aid to DFIs until the annual impact return on every pound invested by a DFI falls to 7 percent. Is that realistic?

Estimates of the aggregate marginal return to private capital in developing countries are much higher than 7 percent, at somewhere around 25 percent on average (higher in poorer countries).<sup>16</sup> From a development impact perspective we might want to place less value on some of the those returns, because they accrue to capitalists. But even if we do, a double-digit social return on investment in the form of higher consumption across an economy looks eminently achievable, especially if we are prepared to credit DFIs with making investments that have larger social returns than the average private sector investment, as they intend.

Now it is time to reintroduce some complications.

## **Multipliers**

Investments and grants have second-round effects. A grant spent on consumption will raise incomes for producers. One study found a local ‘multiplier’ of 2.4 from cash transfers in Kenya.<sup>17</sup> Additional spending created by higher wages and lower prices as a result of an investment will also have second-round effects.<sup>18</sup> However, the effect of any positive multipliers from investment should be reflected in the 25 percent estimated aggregate returns to investment reported above.

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<sup>15</sup> The two “cliff edge” functions used here for simplicity (1) assuming impact persists for 5 years and (2) adding up the impact of three investments only with no discounting – produces the same net present of consumption, for any given impact return, as you’d get by assuming impact returns last in perpetuity and using a 15 percent discount rate or by using a 6 percent discount rate but assuming impact decays by 15 percent each year.

<sup>16</sup> Lowe et al, (2019) “The public and private marginal product of capital” *Economica*. These aggregate return estimates should not be confused with the private financial return on investment, which represents only the capital share of the private returns on the individual investment. Estimated aggregate returns on investment are based on the change in total economic output, which will include spillovers such as people having more income to spend on other goods and services when prices fall as the result of an investment.

<sup>17</sup> Egger, D and Haushofer, J and Miguel E and Niehaus, P and Walker, M. (2019). "General Equilibrium Effects of Cash Transfers: Experimental Evidence from Kenya". Working paper

<sup>18</sup> For example, a recent paper estimated that every job created by foreign direct investment in Mozambique indirectly created 4.4 jobs locally.



We may hope that the multipliers from DFIs' investments are often larger than the average private sector investment because DFIs target investments with large expected positive spillovers. When DFIs invest in power generation, for example, it is not to put more money in people's pockets by reducing the price of power, it is because firms react to the availability of affordable and reliable power by investing and increasing their productivity.<sup>19</sup>

Nonetheless, the gap between the 7 percent return we are looking for, and that 25 percent estimate, will be smaller after applying a multiplier to the consumption impact of grants.

## **A hand up not a handout**

People might feel differently about having higher consumption as the result of getting a better job than they do about having high consumption after receiving a cash transfer. An RCT in Rohingya refugee camp found that people far preferred gainful employment over a cash transfer that pays the same, and that employment caused large positive changes in mental health.<sup>20</sup> There is plenty of evidence that work matters for life satisfaction in ways that go far beyond the affordable level of consumption. Investments can also expand the range of goods and services that people can access, which is also a different sort of impact than raising the level of consumption without changing the variety of available goods and services.<sup>21</sup>

## **Grants can be invested**

The choice between grant aid and DFIs is not really a choice between consumption and investment. Grants can fund public investment, but to avoid a three-way allocation problem let's stick with a cash transfer benchmark.<sup>22</sup> Even so, the recipients of cash transfers can invest them and recycle their returns in further investments.

The evidence of returns on investment from household level cash transfers is hard to map onto this exercise, because results are often reported in the form of the change in consumption after a period of time, not as the total increase in consumption summed over time per dollar transferred. However, one meta-analysis of 38 experiments in 14 developing countries estimated an average net present value of consumption over the first 3 years as \$1.44 per dollar transferred (without discounting).<sup>23</sup> In Uganda, a transfer explicitly intended for investment produced an cumulative gain in earnings from self-employment over nine years estimated at roughly 1.8 times the size of the grant.<sup>24</sup> The impact on consumption was

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<sup>19</sup> Fried, S and D Lagakos (2020), "Electricity and firm productivity: a general equilibrium approach", NBER Working Paper No. 27081

<sup>20</sup> Hussam et al., (2021). The Psychosocial Value of Employment. NBER Working Paper No. w28924.

<sup>21</sup> Cavallo et al., (2021). Product Variety, the Cost of Living and Welfare Across Countries. NBER Working Paper No. w28711.

<sup>22</sup> Some activities classified as government consumption, such as health and education, might be more properly considered investment. Evidence on the impact of aid financed health and education expenditure is mixed, with some large beneficial effects on infant mortality and via vaccination.

<sup>23</sup> Kondylis, Florence, and John Loeser. "Intervention Size and Persistence." (2021). World Bank Policy Research Working Paper 9769

<sup>24</sup> Blattman et al., (2020). The Long-Term Impacts of Grants on Poverty: Nine-Year Evidence from Uganda's Youth Opportunities Program. American Economic Review: Insights.

much smaller, presumably because some earnings are spent on inputs to production or are saved.

When thinking about how aid is allocated between DFIs and other uses, we should be careful not to compare the most effective examples of grant aid against the average DFI investment, any more than we should compare the best DFI investments to the average aid program. But we take a high-end range for the impact of cash transfers and assume £1 raises the recipient's consumption over time by something like £2, or if we look at the multipliers that increase economy-wide consumption by 2-2.5 times, and re-do our sums, then we are looking for a 14-18 percent return on DFI investments.

## Poverty traps

Cash transfers are a sensible and demanding benchmark aid spending, but most excitement in anti-poverty programming is focused on graduation programmes, as pioneered by the Bangladeshi NGO BRAC, which provide a bundle of asset transfers and training, designed to lift people out of extreme poverty for good. The evidence from randomised control trials is very encouraging.<sup>25</sup> Recently, some researchers have found evidence for the existence of poverty traps, in which people will fall back into poverty if given a small amount of money (or assets) but if the transfer is large enough they will escape extreme poverty for good (on average).<sup>26</sup> Once households receive a large enough transfer, over time their consumption starts to diverge from those left behind, because they acquire more land and livestock, work longer hours and shift into more productive forms of employment.

What does this tell us? One lesson is that cash transfers might need to be substantially larger than is often the case, to enable recipients to recycle returns into further positive-return investments.<sup>27</sup> It complicates the simple comparison being attempted in this paper, because the return on the dollar depends on how close recipients are to escaping the poverty trap. Some very high returns for ambitious “ultra-poor graduation programmes” have been found—for instance \$4.33 of long-term benefits for every \$1, in India.<sup>28</sup>

We should not be surprised were we to find that DFIs are not as cost-effective at lifting people out of extreme poverty as the best graduation program that is targeted precisely at that objective. This brings us to a crucial question:

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<sup>25</sup> Banerjee et al., (2016). The long-term impacts of a “Graduation” program: Evidence from West Bengal. MIT Working Paper.

<sup>26</sup> Balboni et al., (2021). Why Do People Stay Poor? LSE Working Paper.

<sup>27</sup> This conclusion is contested by Kondylis and Loeser who argue that smaller transfers have more impact per dollar, when compared to larger transfers and holding total expenditure constant, because they reach more people who are close to the poverty trap inflection point.

<sup>28</sup> <https://www.poverty-action.org/impact/ultra-poor-graduation-model>

## Who benefits?

Of every complication waved aside so far for the sake of simplicity, the most important omission is the question of who benefits from higher consumption as a result of DFI investments.

In line with the standard assumption that a dollar of consumption makes more of a difference to the lives of poorer people, DFIs regard the impact of investments as higher when those that benefit from them are poorer. But whilst there are some opportunities for investments that directly reach people living in extreme poverty, formal firms do not so often hire the very poorest people or sell things to them. If you are willing to accept the correlation in the data between changes in private investment and changes in the \$1.90 PPP per day extreme poverty rate as suggestive of a causal relationship, then there is roughly a private investment-extreme poverty elasticity of 2.<sup>29</sup> If so, we may expect an average private sector investment to have some indirect impact on the poorest people, even if it does not directly reach them.

Nonetheless, it is probably a reasonable assumption that the benefits of DFI investments are more often felt by those living above \$1.90. Around 80 percent of the people in Africa and South Asia live on less than \$5.50 per day. These people are poor by any reasonable standard, but aid donors may regard them as less of a priority than the extreme poor. How much less is a question without a definitive answer. The [Global Innovation Fund](#) has adopted an approach that values all percentage changes in income equally—meaning, for example, that a dollar increase in consumption for someone initially living on \$2 per day has twice the impact on welfare as dollar for someone initially living on \$4 per day. That weighting implies that for each doubling of a beneficiary’s initial income, we should require the return on investment (the resulting increase in consumption) to be twice as high. How does the median beneficiary of DFIs investments differ from the median beneficiary of grant-funded aid?

Grant aid may offer greater potential for targeting the extreme poor, but the overall distributional impact of existing grant funded aid programs is not much clearer than it is for DFIs.<sup>30</sup> The question of whether DFIs get too much or too little money really needs conditioning on whether you are taking the nature of grant-funded aid as given, or are able to change it.

The question of which instruments are better at reaching the poorest naturally interacts with how much aid you wish to allocate to the poorest. If you only care about the extreme poor—an approach Lant Pritchett and Charles Kenny have [characterised as kinky](#)

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<sup>29</sup> Carter P and Thwaites G (2021) “Investment and poverty reduction” CDC Group Impact Study 18. An elasticity of 2 means, for example, that if investment rises by 5 percent from 20 percent to 21 percent of GDP, then the annual rate of extreme poverty rate reduction might increase by 10 percent from 0.5 percentage points to 0.55pp.

<sup>30</sup> The evidence suggest that aid is usually allocated to [better-off regions within countries](#), but also that some [“pro-poor” categories of aid reduce inequality](#).

development—then it makes sense only to use the instrument that is better at that.<sup>31</sup> But if you want to do something for the moderately poor it would be perverse to complain that DFIs are not very good at reaching the poorest if that is not what you are using them for. There are also arguments that it is inappropriate to give grants to better-off countries.<sup>32</sup>

## What kind of benefits?

The argument so far has concerned whether investments and grants might be equally as efficient at achieving the same objective: raising consumption, with a weight on doing so for poorer people. And there is a reasonable case that investments can compare favourably to grants, on efficiency grounds. But there is another way to look at the problem: diversification.

To simplify again, we might say that aid can do two things: first, it can help people escape poverty given the economic environment that they find themselves in; second, it can change the economic environment that people find themselves in.

The graduation programs that help households escape a poverty trap are an excellent example of the former, but they are probably not going to change South Sudan into South Korea.<sup>33</sup> The households that ‘graduate’ from extreme poverty are still smallholder farmers with no better employment opportunities than the local labour market has to offer. That’s a massive improvement on living in penury, and a terrific thing to spend aid on, but it’s not everything we might want aid to do. If you also want aid to help raise productivity and modernise economies so that they can provide people with much higher real incomes and sustainably support a better standard of living for all, then investments in larger formal sector firms are one of the things you need for that (another is public investment).

Of course, the basic distinction between a transfer to fund consumption and an investment is that only the latter increases future income. But there are different types of investment, and aid allocation decisions should account for the benefits of diversification across these. Grants can fund investments by individuals and DFIs can fund investments by firms. The former might be a great way for individuals to escape poverty into a somewhat higher standard of living, but without changing the underlying economic environment, that might only take people so far.<sup>34</sup>

So part of what should inform allocation decision between grant programs and DFIs is the relative importance we place on the immediate impact of helping people escape poverty, into a somewhat higher standard of living, as opposed to helping countries move towards middle-income and then high-income status, with much higher standards of living for (almost) all. The long-run objective might boil down to the same thing (raising consumption)

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<sup>31</sup> Pritchett, L and Kenny C (2013) Promoting Millennium Development Ideals: The Risks of Defining Development Down. CGD Working Paper 338

<sup>32</sup> The UK decided to stop giving grant aid to India, for example.

<sup>33</sup> DFIs are not going to singlehandedly transform economies, any more than aid-funded cash transfers are going to singlehandedly eradicate extreme poverty, but the role of DFIs is to accelerate the process of economic transformation.

<sup>34</sup> Grant funded public investments can also change the underlying economic environment.

but if there is some uncertainty about which is the best route to that goal, there is value in diversifying.

## **Additionality**

Finally, we don't know whether every £1 of DFI investments translates into £1 more investment in a country. Uncertainty about additionality is usually framed as a negative - if DFIs substitute for other investors, every £1 of DFI investment will translate into a less than £1 increase of investment in the economy. But there is also uncertainty in the other direction. If DFI investments are transformational, in the sense of inducing investment by others, £1 of DFI investment could translate into more than £1 increase of investment in an economy. There is plenty of evidence that investments can cause further investments. Perhaps some DFI investments crowd-out, and others crowd-in.

We should remember that DFIs can sometimes have additionality, in the sense of having an impact, when they displace private investors but also influence a business to have a larger development impact than it would have done with commercial investors. Although grant-funded aid may sometimes crowd-out things that the local government might have done, the additionality of grant aid is usually thought to be much clearer than it is for DFIs.<sup>35</sup>

## **The answer**

I am not about to pull a rabbit out of a hat and reveal the optimal allocation between grant aid and DFIs. According to Eurodad, private sector instruments account for 2.2 percent of global aid.<sup>36</sup> With variation across countries and over time, we are looking at a low single digit percentage of aid going to DFIs.

Of course, it would help if we had more evidence about the impact return on DFI investments, and also on the impact per dollar of grant-funded aid programmes, which may also be more, or less, cost-effective than cash transfers. And we should consider other objectives than material poverty reduction. The fact we don't have good evidence for how cost-effective alternative uses of ODA are reflects, I think, how hard it is to obtain. As a result, aid allocation decision must be made in its absence, and thinking through what sort of social return we might expect from DFI investments, relative to a benchmark like cash transfers, is a potentially useful approach.

But when taking decisions in the presence of uncertainty, both about which objectives are more important and which instruments are more effective, a good rule is not to put all your eggs in one basket and choose a set of policies that would perform reasonably well under different possible eventualities. One implication is that aid donors should split their efforts between different potential paths to poverty reduction, including the more immediate route

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<sup>35</sup> Deserranno et al, (2021) The unintended consequences of NGO-provided aid on government services in Uganda. NBER WP 26928

<sup>36</sup> Craviotto N and Caio N (2021) "Time for action: How private sector instruments are undermining aid budgets"

of cash in hand, and the more indirect path of public and private investment for job creation and economic growth.

Charles Kenny, Scott Morris and Vijaya Ramachandran made the case for a major shake-up to development finance in their blog [Time for a New—or Old—Development Finance Model](#) based on the observation that DFIs have not turned billions into trillions, and their investments are only a small share of recipient GDPs, which doesn't even add up to much in absolute terms in smaller poorer countries. They conclude that if a radical change in the role of DFIs cannot be achieved, then we should return to a model where DFIs focus on projects mostly in richer middle-income countries, and self-fund (and pay dividends).<sup>37</sup>

I would argue that instead what matters is whether the social return on those investments in poorer countries exceeds the opportunity cost of other uses of aid forgone. If they do then DFIs should not withdraw from poorer countries. Cost-benefit analysis of the sort outlined here should be the foundation of how we think about that question, but there is also a diversification argument about placing some chips on different routes to ending poverty.

The relative cost-effectiveness of grant aid versus money given to DFIs depends on questions that are hard to answer, both positive—such as who benefits from grant aid and DFI investments—and normative—such as what weights donors should place on who benefits, and how they should value the future against the present. But if the back-of-an-envelope calculations performed here, to adjust for how investments are recycled and generate a flow of benefits over time, are in the right ballpark, then there is every reason to think that DFIs may benchmark well against cash transfers.

Finally, we are not completely in the dark about the impact of what DFIs do. There is plenty of high-quality empirical evidence about the social returns of expanding financial services, of reliable electricity, of improved internet connectivity, of cheaper medicines and from modernising agriculture, and so on. If we consider the priority that [Africans place on jobs and economic growth](#), or the importance of investment in [historical examples](#) of rapid poverty reduction, we may regard it as prudent to allocate a single-digit share of the aid budget to an attempt to accelerate private investment in poorer countries.<sup>38</sup>

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<sup>37</sup> The argument is based on the IFC taking money away from traditional aid (IDA) to enable more investment in low and lower-middle income countries. The argument could be generalised to other DFIs that are taking money from an aid budget.

<sup>38</sup> Afrobarometer (2018) “Taking stock: Survey findings track citizens’ priorities, Sustainable Development Goals, and government performance in Africa”; Yuen Yuen Ang (2019) Missing the Big Picture on Poverty Reduction. Project Syndicate.