What is innovative financing?

'Innovative financing' is a term used to describe financing approaches and models addressing development challenges that remain insufficiently addressed by traditional aid flows and which may try to leverage additional financing – often from the private sector – and/or attempt to provide financing more quickly, efficiently and with more reliable and greater impact. Innovative financing includes a range of models or approaches such as social enterprise, impact investment, transaction taxes and levies on goods and services. The Leading Group for Innovative Financing estimates that innovative financing approaches have raised USD6 billion for development since 2006.¹

Examples

Development impact bonds (DIBs). Modelled on social impact bonds developed in the UK since 2010, DIBs are a type of impact investment that bring investment capital from private sources (philanthropic and for-profit investors) to development problems with the promise of a return on the investment if the intervention achieves pre-agreed outcomes. A not-for-profit service provider typically agrees to deliver the service or programme with payment assured by the private investor. In the event of successful delivery against agreed outcomes, ‘outcome funders’, who may be governments and/or donors, may be offered to deliver the service or programme with payment assured by the private investor. In the event of successful delivery against agreed outcomes, ‘outcome funders’, who may be governments and/or donors, repay the investor along with their agreed share of profits. DIBs therefore leverage private sector investment to ease liquidity constraints for interventions that may require substantial initial start-up investment as well as assuming the financial risk if the project fails. In addition, linking the financial return to delivery of measurable results promotes innovation and flexibility in programme delivery.

Currently the Center for Global Development and Social Finance are working to research and develop DIBs notably in health, nutrition and education.

Advance market commitments (AMCs). There is a strong case for front-loading investments in vaccination programmes that deliver greater social impact from an early ‘big bang’ investment to achieve high levels of coverage and prevention of morbidity and mortality. In an AMC, governments borrow against future official development assistance (ODA) packaging and selling on multi-year ODA commitments as bonds to raise larger volumes of funds up-front with which they can negotiate advantageous terms with pharmaceutical companies. For example, price guarantees may be offered for vaccines yet to be developed encouraging the development of vaccines that might not otherwise attract investment but which may have substantial social advantages for developing countries. Front-loading may also provide a stronger position from which to negotiate cost reductions. Supporting social goods may also be an attractive ‘return’ for potential investors.

Key concepts

Innovative financing usually refers to financial solutions to development challenges that remain insufficiently addressed by traditional aid flows. There are two sub-categories of innovative financing: 1) innovative sources that help generate new financial flows for sustainable development that may come from various economic sectors; 2) innovative mechanisms that help maximise the efficiency, impact and leverage of existing resources (Leading Group for Innovative Financing).

Social enterprise development usually refers to the process of creating and nurturing micro, small and medium-sized businesses that aim for positive social or environmental outcomes while generating financial returns. (UN Global Compact)

Impact investment is the placement of capital (into social enterprises and other structures) with the intention of creating benefits beyond financial return. (UN Global Compact)
The International Finance Facility for Immunisation (IFFIm) has sold vaccine bonds, with administrative support from the World Bank, on international capital markets to raise large volumes of funds for early investment in vaccine development and support to Gavi’s immunisation programmes.2

Taxes and levies.3 Taxes on financial transactions (including the purchase of shares, bonds, traded funds and derivatives) and currency exchange have been mooted since the 1970s as a mechanism to redistribute finance from private sources towards social and global goods. The political feasibility, costs and benefits of a financial transaction tax are still the subject of much debate, though some European countries have agreed to begin to implement a version of a transaction tax.4 In the meantime however, a successful ‘levy’ initiated by the governments of Brazil, Chile, France, Norway and the United Kingdom in 2006 has successfully leveraged substantial new funds for development.

An air tax levy is paid by passengers at the point of purchase in nine countries – Cameroon, Chile, the Republic of Congo, France, Madagascar, Mali, Mauritius, Niger and the Republic of Korea. This provides 70% of UNITAID funding and some additional funding to IFFIm. Taxes are calibrated according to the type of flight and country context (i.e. income level). The air tax has generated more than EUR2.5 billion since its inception.

Considerations

Access to new sources of finance. Taxes and levies may be of particular appeal to the humanitarian community as newly attracted funds are additional and stay within the system. This is in contrast to investment approaches, where the ultimate cost (including additional cost of providing profit returns) are typically borne with existing sources of development finance. The appetite for an expansion of taxes and levies for humanitarian purposes may be worthy of further investigation.

Front-loading investments. The ability to front-load investments – as is the case with DIBs and vaccine bonds – may be particularly relevant for humanitarian programmes where early investment has the greatest impact such as is the case with risk management and resilience-building investments and, indeed, early action to arrest deteriorating humanitarian situations such as food security crises.

Innovation and flexibility. Social enterprise initiatives typically focus on developing technological solutions and efficiency gains that are likely to benefit humanitarian action indirectly through more cost effective and/or improved relief inputs. Impact investments such as DIBs may promote and enable experimentation, innovation and flexibility.

Focus on results. By tying investor returns to achievement of agreed upon social outcomes – not inputs – impact investment models create incentives to put in place necessary feedback loops, data collection, performance management systems to ensure that the desired results are achieved and in the process producing a more accountable, client-centred and generally more effective, innovative and flexible approach. However, the risks inherent in working in politically unstable contexts in particular as well as limited baseline data and challenges measuring results may seriously challenge models which link payment to results.

Additional costs. Mechanisms that allow for profits to accrue to the private sector come at a greater cost than traditional grant funding. If they can guarantee better results, provide liquidity and foster innovation that has benefits beyond the individual intervention, the additional costs may be worth it. But without these gains, and particularly where traditional approaches have been tried and tested with more or less predictable positive outcomes, traditional grant funding may still be a logical and cheaper option. In general,
returns on investments in crisis-affected contexts may be much more difficult to reliably ensure and may therefore not be feasible or may demand a higher-return on investments to compensate for higher levels of risk.

1 See: <www.leadinggroup.org/rubrique327.html>
4 The OECD (2014) notes that “Eleven countries (Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, the Slovak Republic, Slovenia and Spain) have decided to implement – through enhanced co-operation – a European directive on the taxation of financial transactions. A recent meeting of the Economic and Financial Affairs Council (May 2014) reached agreement on the modalities of the future tax, which will exclude derivative products. However, there is no consensus yet on the allocation of the future revenues of the tax (Council of the European Union, 2014).”