



DEVELOPMENT FINANCE IN CHALLENGING TIMES

**edited by
Nicola Bilotta and Fabrizio Botti**



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Lorenzo Kamel

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List of Abbreviations

ADB	Asian Development Bank
ADF	Asian Development Fund
AITF	Afghanistan Infrastructure Trust Fund
APS	Available Public Support
AS	Advisory and Support
CAREC	Central Asia Regional Economic Cooperation
CBI	Confederation of Business Industry
CEB	Council of Europe Development Bank
CF	Cash Flow
CF	Climate Finance
CPIA	Country Policy and Institutional Assessment
DFI	Development Financial Institution
DMC	Developing Member Country
DSP	Desired Public Support
EBRD	European Bank for Reconstruction and Development
EIB	European Investment Bank
EMDE	Emerging Market and Developing Economy
ENEF	Enterprise Expansion Fund
ENIF	Enterprise Innovation Fund
EU	European Union
FCAS	Fragile and Conflict-Affected Situation
FCV	Fragility, Conflict and Violence

FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GF	Guarantee Facility
GHG	Greenhouse-Gas
HIPC	Highly-Indebted Poor Country
IDA	International Development Association
IDFC	International Development Finance Club
IFI	International Financial Institution
IMF	International Monetary Fund
IPA	Instrument for Pre-Accession
IPCC	Intergovernmental Panel on Climate Change
KfW	Kreditanstalt für Wiederaufbau
LIC	Low-Income Country
LPG	Liquefied Petroleum Gas
MDB	Multilateral Development Bank
MDRI	Multilateral Debt Relief Initiative
MFF	Multiannual Financial Framework
MIC	Middle-Income Country
MIS	Management Information System
mPS	Minimum Public Support
MPS	Maximum Public Support
MW	Megawatt
NC	Normal Cost
NGFS	Network for Greening the Financial System
ODA	Official Development Assistance
REH	Rational Expectations Hypothesis
SBS	Small Business Support
SDG	Sustainable Development Goal

LIST OF ABBREVIATIONS

SME	Small and Medium-Sized Enterprise
TAPI	Turkmenistan–Afghanistan–Pakistan–India
TCFD	Task Force on Climate-related Financial Disclosures
TEG	Technical Expert Group
UN	United Nations
UNESCO	UN Educational, Scientific and Cultural Organization
US	United States
USc/kWh	US cents per kilowatt hour
WB	World Bank
WB EDIF	Western Balkans Enterprise and Innovation Facility
WBIF	Western Balkans Investment Framework

Foreword

Lorenzo Kamel

Five years on from the launch of the 2030 Agenda, the multilateral development system is under stress, perhaps as never before. The COVID-19 crisis has brought renewed attention to the crucial role multilateral organisations have to play in addressing the triple crisis looming in developing countries: health, economic and humanitarian. The global scale of the virus has highlighted the interdependence of nations and people around the world, demonstrating that the need for international co-operation and solidarity is greater than ever. Yet, the crisis has also exposed some limitations of the multilateral development system that need to be tackled to ensure international organisations can best contribute to the recovery.

This book collects contributions from international leading experts from academia and multilateral development actors on the opportunities and challenges for development finance in a post-pandemic world. Key issues raised by the authors remarkably enrich the current debate on the development of a global development architecture equipped to cope with the impact of global challenges, such as climate change, digital transformation and inequality.

At the threshold of the “decade of action” (2020–2030), the multilateral development system has hardly ever been so solicited, with a highly ambitious global development agenda, and a simultaneous need to cope with the impact of global challenges – such as climate change and the COVID-19 pandemic – that could undo years of hard-won development progress.

Despite multilateralism reached its low point in 2020 with increasing tensions between major global powers, nationalism and deglobalisation trends, the global scale of the coronavirus outbreak uncovered the deep interdependence between countries and made clear the intrinsically transnational nature of all the major global challenges, from climate change to digital transformation and economic recovery.

Introduction

Nicola Bilotta and Fabrizio Botti

The European Union (EU) is currently engaged in a major effort to strengthen its institutional architecture for development finance. Over the past decade, both the number of actors involved in this process and the financial and non-financial tools deployed for development have been continuously growing. The EU is now the largest contributor worldwide to Official Development Assistance (ODA) and a major source of foreign direct investment (FDI). There is, however, a widespread belief that its visibility and influence in this international arena are not commensurate with the measures actually put in place.

In March 2019, the Council of the EU established the “High-level Group of Wise Persons on the European financial architecture for development” (the Wise Persons Group) to provide an independent view on how to improve Europe’s financial architecture for development. The European Commission is also expected to reform the EU’s development-finance architecture in the context of current negotiations on the Multiannual Financial Framework (MFF) 2021–7.

Regardless of the European institutional framework’s future shape, key issues in development policies and practices need to be addressed in order to better orient the EU’s future development efforts. In the following sections, we explore the challenges and opportunities facing European development actors in three potential key areas of intervention that we expect to become increasingly crucial over the coming years:

1. infrastructure finance and private-sector contribution to the

- achievement of the SDGs (the United Nations' Sustainable Development Goals);
- 2. climate finance and energy;
- 3. prospects and policies for low-income countries (LICs) and fragile states.

1. INFRASTRUCTURE FINANCE AND PRIVATE-SECTOR CONTRIBUTION TO THE ACHIEVEMENT OF THE SDGs

Infrastructure appears as an explicit goal of the SDGs' agenda,¹ along with being an implicit means by which to implement other Goals – placing infrastructure firmly at the centre of SDG achievements. An estimated 57 trillion US dollars would be needed by 2030 (3.4 trillion per year) for infrastructure investment. There is, however, a finance gap in meeting this demand of around 500 billion US dollars per year.

Infrastructure investments are largely funded by governments, which face debt and deficit limitations. Only a relatively small share is funded through project-finance markets – in the form of non-recourse loans and bonds that are paid from cash flow from the project rather than from investor balance sheets.

The recent regulations – in particular, Basel III and Solvency II – impose tighter capital requirements on private financial institutions and insurance companies, potentially undermining the funds that they might have available for these kinds of projects. This regulatory environment indeed impacts on private investment policies. This is why several private financial institutions are demanding the reform of some regulatory constraints – such as risk-weighted assets calculation, liquidity indicators impact and market risk rules. The risk, otherwise, is of a crowding-out of private capital from infrastructure investments.

In addition, to unleash investment potential, governments need to remove many bottlenecks that prevent private investments: the chal-

¹SDG 9: Build resilient infrastructure, promote inclusive and sustainable industrialization and foster innovation—is the most direct call for increased investment in sustainable infrastructure.

lenge is to make infrastructure projects “bankable”. There is therefore an increasing search for mechanisms to “crowd-in” private finance and improve the effectiveness of infrastructure projects. Blended-finance investment solutions are mechanisms that capitalise on partnerships between diverse actors – including international organisations, development co-operation agencies and private enterprises – in order to mobilise capital. The aim of these instruments is, first, to leverage capital by reducing risk and guaranteeing investments or supplementing private investments. Secondly, they try to increase returns by helping to improve the investment climate in risky markets.

For example, guarantee instruments unlock investments as they mitigate risks for investors. Instruments such as political risk insurance, export credit guarantees or partial risk guarantees, if issued by international bodies, reduce the uncertainty regarding political, policy and regulatory risks – thereby improving private capital flows. Similarly, there are currency-mitigation instruments that facilitate transactions in which revenues and loan payments are paid in different currencies – the former in local currency and the latter in hard currency. To meet the demand of infrastructure finance and to promote an agenda of sustainable infrastructure, there is a need to rethink the financial system in order to deliver the scale and quality of investment needed.

2. CLIMATE FINANCE AND ENERGY

The broad expression “climate finance” (CF) refers to all investments, public and privately funded, which aim both at mitigating the effects of climate change and at adapting people’s lives to the effects of future climate conditions. According to a recent Intergovernmental Panel on Climate Change (IPCC) report, it is estimated that around 2.4 trillion US dollars per year (equivalent to 2.5 per cent of world GDP [gross domestic product]) of investments in the energy system are required to keep global warming below the agreed 1.5-degree threshold. However, “green” investments worldwide amounted to just 455 billion US dollars in 2016 and 472 billion in 2015, according to the latest figures available.

In more than three-quarters of green investments, the nationalities

of the CF investor and the final recipient coincide. The resulting lack of interstate CF flows shows the absence of a solid and cohesive shared response between developed and developing countries. As a consequence, the need to increase green financial flows from developed to developing countries has emerged from discussions and it has resulted in the transcription of Article 9(1) of the Paris Agreements, which states, “Developed country Parties shall provide financial resources to assist developing country Parties with respect to both mitigation and adaptation in continuation of their existing obligations under the Convention”.

Within this context, the multilateral development banks (MDBs) have a crucial role in increasing and facilitating green financial flows from developed to developing countries. Even though the last “2018 Joint Report on Multilateral Development Banks’ Climate Finance” estimated that the six major MDBs’ climate-finance investments reached a peak of 43.1 billion US dollars (a 59 per cent increase since 2011), it is evident that without the intervention of the private sector the absolute amount will never be enough to cover the funds required.

A full range of actions could be implemented in order to crowd-in private investments. In addition to de-risking green investments in developing countries with measures such as the creation of policy insurance to cover investors in case of policy change, enhancing private expertise in the design of national and international green policies would be a way to increase private participation.

Finally, in order to enhance the coherency of the CF architecture there is a need to implement a common framework on tracking CF investments. The absence of such a common understanding of the criteria for defining green investment hampers even measures to create common statistics on CF numbers or to calculate the general annual achievements with respect to climate adaptation and mitigation. Efforts to construct a common framework to track climate mitigation and adaptation investment started in 2015, when the MDBs and the International Development Finance Club (IDFC) agreed on a set of Common Principles. However, after four years these still do not constitute a robust accounting framework, leaving space for each country to pursue different tracking methods. Nonetheless, the announcement by the MDBs and IDFC, at the COP24 United Nations Climate Change Conference in December 2018, of

their intention to strengthen these principles shows that efforts of this type are on the agenda.

3. PROSPECTS AND POLICIES FOR LOW-INCOME COUNTRIES (LICs) AND FRAGILE STATES

The number of low-income countries (LICs) almost halved between 2001 and 2019 (from 64 to 34), with those verging on middle-income (MIC) status showing an average yearly economic growth rate of 5.8 per cent during 2001–18 (about 50 per cent faster growth than that of emerging market and developing economies – EMDEs – that are not LICs). Rapid economic growth in LICs contributed heavily to the 20-percentage-point decline in the global poverty headcount between 2001 and 2015. Nevertheless, such trends in poverty reduction hide persistent poverty headcounts among countries that have remained or became LICs.

Several cyclical and structural factors contributed to the substantial economic growth in Class-of-2001 LICs – namely:

1. the commodity-price boom of 2001–11;
2. the cyclical rebound experienced by nine LICs transitioning from centrally planned to market-based economies;
3. easing conflicts in five countries during the 2000s;
4. a total of thirty-five 2001 LICs receiving debt relief in the context of the Multilateral Debt Relief Initiative (MDRI) and the Highly-Indebted Poor Country (HIPC) initiative;
5. greater trade integration from entering into free-trade agreements;
6. investments in infrastructure and human capital; and
7. an improved business and rule-of-law climate in more than half of the 2001 LICs.

The progress of today's LICs towards MIC-level per capita incomes is threatened to some extent by more severe and challenging cyclical and contextual factors than in 2001. Their starting position compared with 2001 LICs that became MICs is weaker in terms of per capita income and other development indicators (e.g. public spending relative to GDP, financial inclusion and electricity access). More than half of the Class-of-2019

LICs are countries affected by fragility, conflict and violence (FCV), and accordingly face governance and institutional weaknesses, dependence on foreign aid and probable output contraction. More than half of them suffer very limited access to trade, mainly due to geographical position (being landlocked and clustered with other LICs), high trade costs and barriers. Most of today's LICs are highly dependent on agriculture (the sector accounts for more than one-quarter of their economies) and are thus exposed to increasingly severe climate-change-related challenges. In the long term, China's slowing growth and shifting demand to less-resource-intensive sectors presages weaker prospects for commodity demand for those LICs relying on recent resource discovery. Since 2013, today's LICs' external debt has shown an increasing trend, with a potential impact on poverty-reducing public expenditure.

Since today's LICs account for about 40 per cent of the global poor, challenging prospects for their economic growth seriously jeopardise the achievement of the SDGs. In order to reach the target of reducing global extreme poverty to 3 per cent of the population, GDP per capita would need to grow by six percentage points per year up to 2030 (and such a growth rate was not even attained during the global economic expansion of the early 2000s).

Ambitious targets in the context of such severe challenges demand appropriate and coordinated multilateral policy responses in order to trigger both domestic (investment in human and physical capital, de-escalating conflicts and fostering financial inclusion, amongst other targets) and external (trade integration and FDI attraction) drivers of economic growth in today's LICs.

1.

Development Finance Must Tackle Climate Change and Support a Just Transition

Mattia Romani, Russell Bishop and Francesca Foglia

Climate change, both in terms of mitigating associated risks and adapting to the inevitable changes that we are already observing, remains one of the most severe global risks facing the world. It hits the poorest and the least-developed countries first and foremost. The COVID-19 pandemic serves as an “alarm bell” alerting us to the complexities of dealing with a global crisis. The next decade will be crucial in setting us on an emissions path that reduces the most extreme risks of climate change.

The necessary structural changes, however, do come with intricate political-economy consequences. Given the speed and scale of change required, the risk of “losers” blocking or slowing down the transition will be high. The only way forward is finding “just” solutions from a social, economic and environmental perspective. Two particular groups of challenges stand out: finding new sources of income and livelihood for workers, countries and regions reliant on fossil fuels; and managing the distributional effects of implementing policies that tackle climate change.

Focus needs to be first on creating mechanisms to protect vulnerable groups of individuals and regions – and to equip them, where possible, with the necessary skills and access to new opportunities. Second, there is a need to share equitably the benefits of innovation and technology, and leapfrog towards a low-carbon economy. International organizations like the European Bank for Reconstruction and Development

(EBRD) will need to play a fundamental role in building just transition considerations into investments and policy frameworks, supporting the private sector and an environmentally sustainable recovery of economies hit by the COVID-19 pandemic.

1. TACKLING CLIMATE CHANGE IN A JUST WAY

1.1 The next decade will be critical for climate action

Addressing climate change is crucial if we want to manage and be prepared for what is inevitably an enormous global risk. The risks posed by climate change, while inherently uncertain, are likely to have extreme consequences on ecological systems and human welfare in the next decade and beyond – be it through impacts linked to altered rainfall patterns, food production or human health.¹ The coronavirus pandemic has shown the need for preparation for extreme events – and set against the context of the disruption caused by the virus, climate change is an urgent threat and one less easy to manage. That is why climate change and environmental protection are indeed at the heart of the United Nations’ Sustainable Development Goals (SDGs), which are to be achieved by the end of 2030: 14 of the 17 SDGs are linked with reducing pollution, with climate issues or with environmental sustainability.²

In order to manage climate-related uncertainties, the Paris Agreement has already set long-term objectives to limit risk. Central to the agreement is a commitment to limit the increase of global mean temperatures to well below 2°C, and as close as possible to 1.5°C, above preindustrial levels. To achieve this, global greenhouse-gas (GHG) emissions (the set of gases released into the atmosphere because of activities that

¹ Intergovernmental Panel on Climate Change (IPCC), *Climate Change 2014: Synthesis Report*, Contribution of Working Groups I, II and III to the Fifth Assessment Report of the Intergovernmental Panel on Climate Change, Geneva, IPCC, 2015, <https://www.ipcc.ch/report/ar5/syr>.

² Mark Elder and Simon Høiberg Olsen, “The Design of Environmental Priorities in the SDGs”, in *Global Policy*, Vol. 10, No. 51 (January 2019), p. 70-82, <https://doi.org/10.1111/1758-5899.12596>.

involve burning fossil fuels and land-use change) need to reach “net zero” around mid-century. Unfortunately, the time available in which to manage the risks posed by climate change is running out. We are told that action is not being delivered at the pace required: warming of approximately 1.0°C is already observable, and the 1.5°C target may by now be out of reach. In addition, adding up “nationally determined contributions” submitted so far – the national commitments presented voluntarily by countries to reduce their GHGs – world emissions will remain too high. Even if they are successfully implemented, the world is likely to see an increase in temperatures of 3°C by 2100 – likely to cause significant damage.³

Achieving the Paris Agreement objectives require an urgent structural shift in the way in which economies operate. As gross domestic product (GDP) rises through economic activity, there will need to be a decoupling from GHG emissions. To achieve this decoupling, a simultaneous reduction in carbon intensity (emissions per unit of energy) and energy intensity (energy use per unit of GDP) will be needed at a faster rate than any observable in recent history. The COVID-19 crisis and recovery, if seen as a broader crisis of sustainability, could offer useful momentum towards this goal. However, if it is instead seen as a competing issue to that of climate change it may just become the convenient alibi under cover of which to continue “business as usual” and irreversibly distance us from it.

While each country is different and will require different decarbonization strategies, all will generally require the rapid deployment of renewable energy for electricity generation, the electrification of sectors such as heat and transport, and significant improvements in energy efficiency.⁴ For non-energy-related GHGs, decoupling will depend crucially on more sustainable land-use practices and food systems, as well as revised industrial processes and some adjustments in demand.

³ United Nations Environment Programme (UNEP), *Emissions Gap Report 2019*, Nairobi, UNEP, November 2019, <https://www.unenvironment.org/resources/emissions-gap-report-2019>.

⁴ International Energy Agency (IEA), *World Energy Outlook 2019*, Paris, IEA, November 2019, <https://www.iea.org/reports/world-energy-outlook-2019>.

Some decoupling between GHG emissions and output has begun to be observed in some richer nations, particularly in Europe, but not yet in emerging markets.⁵ Energy and CO₂ intensity in the EBRD regions – which span across central Europe and the Baltic states, southeastern Europe, eastern Europe and the Caucasus, the western Balkans, Turkey, the southeastern Mediterranean and Central Asia – remain, in fact, on average over three times higher than in the European Union (EU).⁶

The choices made in the coming years, particularly in fast-growing emerging countries, will either result in the continued lock-in of high-carbon assets for decades ahead, making climate ambitions ever more challenging to achieve, or put the world on a more sustainable path.

By the end of 2030, around 90 trillion US dollars will have been spent on infrastructure (more than the value of the total current stock of infrastructure), primarily in emerging countries. A large part of those infrastructure decisions will determine what our cities will look like – with around 1 billion more people moving to urban areas over the next decade, mostly in developing countries. And these are not only choices that will impact on the lives of generations to come, as taking action on climate change through technologies and choices that also reduce local pollutants would have the potential to avoid the loss of 700,000 premature deaths from local air pollution.⁷

Development financial institutions (DFIs) like the EBRD will have an important role in supporting the aims of the SDGs and the Paris Agreement – not least by ensuring that all financing is more systematically

⁵ Gail Cohen et al. “The Long-Run Decoupling of Emissions and Output: Evidence from the Largest Emitters”, in *IMF Working Papers*, No. 18/56 (March 2019), p. 29, <http://dx.doi.org/10.5089/9781484345283.001>.

⁶ European Bank for Reconstruction and Development (EBRD), *MDB Climate Action: The EBRD Perspective. Input Document for the G20 Climate Sustainability Working Group*, Japan, February 2019, <https://www.mofa.go.jp/files/000498434.pdf>.

⁷ Global Commission on the Economy and Climate, *Unlocking the Inclusive Growth Story of the 21st Century: Accelerating Climate Action in Urgent Times*, Washington, New Climate Economy, August 2018, <https://newclimateeconomy.report/2018>; UN Department of Economic and Social Affairs (UNDESA), Population Division, *World Urbanization Prospects: The 2018 Revision* (ST/ESA/SER.A/420), New York, United Nations, 2019, <https://population.un.org/wup/Publications>.

aligned with these goals, maximizing the use of public funds by unlocking and leveraging private-sector financing.

1.2 Ensuring a “just” transition

The structural changes that will be necessary in order to take action quickly do, however, come with intricate political-economy challenges attached.

It is clear that rapid transition to a low-carbon economy will, inevitably, displace jobs and strand capital. We will see significant “creative destruction” in the global economy. As in all such transitions, the risk of “losers” blocking or slowing down the transition will be very high – particularly where the ones set to lose out in the transition to a low-carbon economy can exercise pressure on political systems.

This implies that the only way forward lies in finding “just” solutions from a social, economic and environmental perspective – solutions that are fair to the firms and individuals within countries that are particularly at risk of displacement. The Paris Agreement itself acknowledges, “the imperatives of a just transition of the workforce and the creation of decent work and quality jobs in accordance with nationally defined development priorities”.

Managing a just transition is not an excuse for inaction or delay but rather something that must be at the forefront of policy design. As countries reorientate their economies towards low GHGs and high resilience to the effects of climate change, there will be significant opportunities – presenting a better alternative than a more conventional, polluting development model.⁸

Our efforts need to focus first and foremost on sharing the substantial benefits of innovation and technology, and on leapfrogging towards a low-carbon economy while also creating mechanisms to protect the most vulnerable. This will be especially crucial in the aftermath of the COVID-19 pandemic, which could cause long-lasting changes in the eco-

⁸ Organisation for Economic Co-operation and Development (OECD), *Investing in Growth, Investing in Climate*, Paris, OECD, 2017 (revised version June 2019), <http://dx.doi.org/10.1787/9789264273528-en>.

nomic and industrial structures underpinning the world's prosperity and development. But identifying new opportunities will not be possible in all geographies and contexts; we will inevitably face situations in which the only solution will be compensation, and we should be prepared for that.

There is mounting consensus for action to be taken in this direction on Europe's development "architecture". Inside the EU, as part of the European Green Deal, a "Just Transition Mechanism" is set to channel around 150 billion euro towards its most carbon-intensive territories.⁹ Outside the Union, the 2019 report of the High-Level Group of Wise Persons on the European Development Finance Architecture urged DFIs to address climate change as the world's biggest development challenge.

Two particular groups of challenges stand out: finding new sources of income and livelihood for workers, countries and regions reliant on fossil fuels; and managing the distributional effects of implementing policies that tackle climate change. Across these groups, DFIs can play a role, by integrating just transition considerations alongside their investments in support of the SDGs.

1.3 Supporting countries, regions and workers reliant on fossil fuels

Many countries rely heavily on fossil fuels for economic growth and fiscal income, due to either their large fossil-fuel reserves or their reliance on energy-intensive industries. A shift away from fossil fuels will have substantial implications for these countries' fiscal revenues – and hence, for their fiscal position. The "macro relevance" of this situation as well as the political-economy relevance are well recognized.¹⁰

Take the example of Kazakhstan – a country in which oil accounts

⁹ European Commission, *Proposal for a Regulation Establishing the Just Transition Fund* (COM/2020/22), 14 January 2020, <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52020PC0022>.

¹⁰ Signe Krogstrup and William Oman, "Macroeconomic and Financial Policies for Climate Change Mitigation: A Review of the Literature", in *IMF Working Papers*, No. 19/185 (September 2019), p. 58, <http://dx.doi.org/10.5089/9781513511955.001>.

for roughly 50 per cent of exports and is a major source of government revenue. The period to 2040, in a scenario in which there is worldwide adoption of greener energy practices in line with the SDGs and the Paris Agreement, could see an overall drop of around 40 per cent in Kazakhstan's fiscal revenues, relative to a "business as usual" scenario. While a transition of this kind may present significant fiscal risks, the good news is the country has time to adapt before such impact is felt. Indeed, its government has already prioritized many of the actions required to deal with these risks – including supporting economic diversification, improving fiscal management and supporting Kazakhstan's own transition to a green economy.¹¹

These shifts will ultimately have a link to jobs and livelihoods. The country's most vulnerable sectors are in petroleum refining and jobs related to coal (i.e. mining and at coal-fired power plants). The International Labour Organization has shown that by 2030, in a scenario with significant climate action (before the COVID-19 pandemic hit), 25 million jobs will be created and nearly 7 million lost globally. Of the holders of those 7 million jobs, 5 million will be able to find positions in the same occupation but in a different industry within the same country. Around 2 million workers will, however, be in jobs that cease to exist; for them, finding alternative employment will be challenging.¹²

Training is clearly part of the response, to ensure that people have the requisite skills to take advantage of new opportunities. On the one hand, training enables alternative employment opportunities for the most vulnerable; on the other, it ensures that a workforce more generally has the skills that will be demanded by the market. The importance of human capital must therefore be acknowledged alongside countries' national climate commitments. It is thus concerning that less than 40 per cent of

¹¹ EBRD, *The Fiscal Implications for Kazakhstan of Worldwide Transition to a Greener Global Economy*, London, EBRD, 22 November 2018, <https://www.ebrd.com/news/publications/special-reports/the-fiscal-implications-for-kazakhstan-of-worldwide-transition-to-a-greener-global-economy.html>.

¹² International Labour Organization (ILO), *Skills for a Greener Future: A Global View Based on 32 Country Studies*, Geneva, 12 December 2019, p. 22, https://www.ilo.org/skills/pubs/WCMS_732214/lang--en.

countries' climate pledges in their nationally determined contributions include any plans for skills training to support their implementation, and 20 per cent do not plan any human-capital-related activities at all.¹³

While the overall negative employment impact will be small relative to the total size of the labour market, it will be concentrated in vulnerable geographical regions.

In the EBRD region, in fact, these assets generate significant employment: around 1.1 million jobs are directly or indirectly linked to coal-related activities in power plants and mines. Of these, around 640,000 are direct jobs – with mining, which is more labour-intensive than power generation, making up around 75 per cent of the total. But it has also been estimated that these activities support around 500,000 indirect jobs in the associated coal supply chain and through employment generated in the local economy.¹⁴

Within the EU, where the ambition is that the European Green Deal will lead to the phasing out of coal, it is estimated that approximately 80 per cent of coal-fired electricity capacity in the eight EBRD countries of operation that use coal will need to be closed by 2030 to meet EU targets. This would lead to potentially 90,000 job losses (of which over 80 per cent will be in the supply chain and surrounding economy). As set out in Figure 1, any job losses will primarily impact on the specific regions where the assets are located – including in the Śląskie and Małopolskie regions in Poland (around 45,000 direct jobs at risk), Sud-Vest Oltenia and Vest in Romania (around 15,000) and Yugoiztochen in Bulgaria (around 10,000 jobs at risk).¹⁵

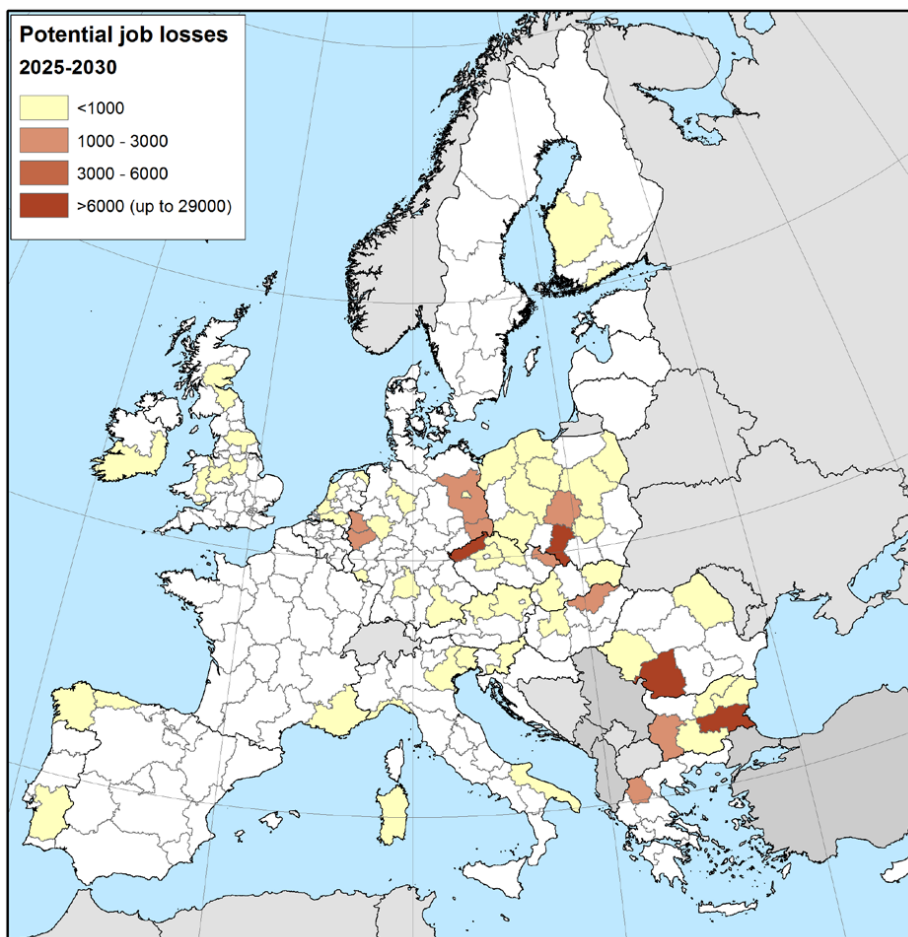
This means that responses need to be focused and local, acknowledging different starting points and the capacity needed to facilitate such shifts. A promising example, which also takes into account the importance of environmental restoration and of a “circular economy”, is that of the Futur-e project (see Box 1).

¹³ Ibid., p. 21-22.

¹⁴ EBRD, *The EBRD Just Transition Initiative*, London, EBRD, June 2020, <https://www.ebrd.com/just-transition>.

¹⁵ Patricia Alves Dias et al., “EU Coal Regions: Opportunities and Challenges Ahead”, in *JRC Science for Policy Reports*, 2018, <http://dx.doi.org/10.2760/064809>.

Figure 1 | Potential job losses in EU coal regions between 2025 and 2030



Source: Patricia Alves Dias et al., “EU Coal Regions”, cit., p. 58.

Box 1 | Transforming decommissioning into a local opportunity: the case of Enel’s Futur-e project

A worldwide, leading best-practice case of public-private cooperation is presented by the Futur-e project launched by Enel, an Italian multinational electricity-utility company, which aims to decommission 23 of its former thermal power plants. The project plans to find a new purpose for them instead of dismantling them, to keep materials and resources in use as long as possible in line with the objectives of a circular economy.

The first instance was completed on 14 March 2019, and entailed the reconversion of a thermal power plant in a small fraction of Italy’s Emilia-Romagna region into a new logistics hub. It was realized by reusing

3,700 tonnes of metallic materials, in addition to copper and aluminium, and 7,000 tonnes of concrete available from the dismantling of the old premises. The hub itself is now operational thanks to sustainable solutions, such as LED lightening and the collection of rainfall for irrigation of the nearby fields.

There is currently more in the works, such as the reconversion of a power-plant site on the River Po Delta that used to provide about 10 per cent of Italy's total energy-generation capacity. As of 2023, the site – which is part of UNESCO's (the United Nations Educational, Scientific and Cultural Organization's) biosphere reserves – is expected to become an innovative tourist “pole” to be named Delta Farm and be managed by Human Company. Human Company is expected to invest 60 million euro, while Enel will fund the demolition works. With a capacity of 8,000 visitors, the pole will be dedicated to open-air activities and will contribute to relaunching in a sustainable way the economic activity of this region and its agribusiness and craftsmanship excellence. The pole is expected to directly create 400 jobs.

Source: Enel website: *Future-e*, <https://corporate.enel.it/en/futur-e>.

1.4 Managing distributional effects and policies to tackle climate change

Just transition considerations must go beyond the impact on vulnerable sectors and geographies: the distributional effects of climate policies must also be assessed carefully. The impact will depend on the policy tool, the sector targeted, the design of the policy and the initial socio-economic conditions in the country concerned.¹⁶ The *gilets jaunes* movement in France, which was initiated by the introduction of a carbon tax on fuels, is an important reminder that policies need to be designed with distributional consequences in mind.

One of the most complex issues that needs to be addressed in climate-related policy-making is the abolition of fossil-fuel subsidies. According to the International Monetary Fund (IMF), fossil-fuel sub-

¹⁶ Georg Zachmann, Gustav Fredriksson and Grégory Claeys, “The Distributional Effects of Climate Policies”, in *Bruegel Blueprints*, No. 28 (November 2018), <https://www.bruegel.org/?p=28291>.

sides accounted for around 6.5 per cent of global GDP in 2017. Overall, 85 per cent of these subsidies are focused on coal and petroleum.¹⁷ Subsidies make fossil fuels (and electricity generated from them) cheaper for households and firms, incentivizing wasteful and inefficient behaviour. Reforming these subsidies would ensure that energy prices reflect full market prices, and their externalities too.

However, it is evidently not politically straightforward to raise energy prices, bearing in mind the fact that poorer households would potentially be the hardest hit – as energy spending absorbs a larger proportion of their disposable income. This is particularly relevant in countries that do not have adequate social-safety mechanisms to protect the energy-poor (the definition of this term varies; here, we refer to those who are obliged to spend at least 10 per cent of their income on energy).

Emerging evidence, however, suggests that it is possible to design subsidy reform in politically “smart” ways.

Elements include, among others (see Figure 2), building public acceptance for reform, ensuring adequate social protections for the poorest, gradual removal of the subsidy and building in adequate mechanisms to stop rapid price rises.¹⁸

Importantly, one of the lessons from EBRD’s experience in the energy sector is that moving to competitive procurement for renewables is key to delivering lower prices and transparent price discovery. EBRD financed the first photovoltaic solar plant in Jordan in 2014 while also starting to work with Jordanian authorities in order to develop a competitive system. At the time, the feed-in tariff was 16.9 US cents per kilowatt hour (USc/kWh). By 2016, EBRD had financed a project with a tariff of just 6.1 USc/kWh – and in 2018, when Jordan opened its second auction, the winner offered under 2.5 USc/kWh. In only four years, introducing competition has delivered an 85 per cent price reduction that makes renewables a complement and, associated with adequate demand management

¹⁷David Coady et al., “Global Fossil Fuel Subsidies Remain Large: An Update Based on Country-Level Estimates”, in *IMF Working Papers*, No. 19/89 (May 2019), p. 39, <http://dx.doi.org/10.5089/9781484393178.001>.

¹⁸Jun Rentschler, *Fossil Fuel Subsidy Reforms. A Guide to Economic and Political Complexity*, London/New York, Routledge, 2018.

and storage, a competitor to gas.¹⁹ These costs continue to fall, and the world's lowest price for solar electricity was agreed in April 2020 in the 1.5 gigawatt solar tender of the Emirates Water and Electricity Company at 1.35 USc/kWh.²⁰

Figure 2 | Elements of a comprehensive fossil-fuel subsidy-reform package

Assessment of subsidies & pricing mechanisms	Building public acceptance	Social protection & compensation	Revenue redistribution & reinvestment	Complementary measures	Timing & price smoothing
Definition	Communication strategies	Compensate vulnerable households (e.g. cash transfers)	Infrastructure investments	Support for energy/material efficiency & innovation	Sequencing reforms for different fuels
Identification			Public spending (e.g. health, education)	Infrastructure investments	Gradual subsidy reductions
Measurement & estimation	Mapping of interest groups	Support firms (energy access & efficiency programs)	Institutional reforms	Training & capacity building	Phase out ad-hoc pricing
Assess social costs, incl. illicit activities		Social safety nets	Tax cuts (e.g. labour taxes)	Reform market structures	
Assess potential reform impacts	Stakeholder identification & engagement	Anti-inflationary policies	Direct transfers ("resource dividend")	Complementary fiscal reforms	Automatic fuel pricing & price smoothing mechanisms

Source: Jun Erik Rentschler, "Fossil Fuel Subsidy Reforms: We Know Why, the Question Is How", in *Sustainable Energy for All*, 1 June 2018, <https://blogs.worldbank.org/energy/fossil-fuel-subsidy-reforms-we-know-why-question-how>.

2. THE ROLE OF DFIs IN SCALING UP CLIMATE ACTION AND SUPPORTING A JUST TRANSITION

To achieve climate neutrality will be crucial unleash the private-sector dynamism to provide solutions and support the repurposing of capital, be it financial or human.

This is going to require cooperation between the public and private

¹⁹ Nandita Parshad "Renewable Energy Auctions: Bidding Our Way to a Greener Future", in *Financial Times*, 9 October 2018, <https://www.ft.com/content/25130264-cb15-11e8-9fe5-24ad351828ab>.

²⁰ Emiliano Bellini, "Abu Dhabi's 1.5 GW Tender Draws World Record Low Solar Bid of \$0.0135/kWh", in *PV Magazine*, 28 April 2020, <https://www.pv-magazine.com/2020/04/28/abu-dhabis-2-gw-tender-draws-world-record-solar-bid-of-0-0135-kwh>.

sectors, and DFIs can play an important bridging role – maximizing the impact of public funds and leveraging the private sector as much as possible, and backing first movers in deploying and sharing the substantial benefits of innovation and technology in developing economies. Four specific areas stand out, as detailed below.

2.1 Working on policy frameworks that set a clear sense of commitment to addressing climate change

Credible commitments on long-term climate-change ambition can guide and incentivize the private sector to act.

It is therefore critical to enshrine climate targets into law, as pledges alone are less credible. What has been shown to be effective is a combination of long-term targets consistent with the Paris temperature goals and a set of nearer-term targets. As reflected in the approach taken in the EU, the combination of a legislated long-term target alongside intermediate milestones seems to offer a basis for strong action.

These targets should also be backed with predictable and credible policy in order to send clear signals and shift private-sector incentives. The role of DFIs in working with governments to create such policies and regulatory frameworks – which promote bankable investments that use new technologies in areas such as green buildings, renewable energy and green-cities planning – will therefore continue to be of the utmost importance.

It would simultaneously make investment in fossil fuels less attractive but also offer the incentives for innovative practices to deliver what is required. This should take the form of a combination of getting prices to reflect their true cost to society (i.e. a price on carbon, the removal of fossil-fuel subsidies) and other policies and targeted regulations (e.g. energy-efficiency standards for buildings).

Evidence shows that DFIs can be actively involved not only in designing reforms but also in ensuring that the process for delivering them (i.e. implementation) adheres to good practice. DFIs can actively support in the preparation of these long-term ambitions with the countries involved, work on dedicated policy frameworks to deliver them and mobilize the required investments.

The use of “mission-oriented” policies to both catalyse a new sector and to ensure that new technologies are fully diffused and deployed, as

happened with the IT revolution, could be useful for the green-tech sector.²¹ The low-carbon roadmap recently developed under the leadership of the EBRD for Egypt's cement industry is one such example (see Box 2).

Box 2 | Low-carbon roadmap for the Egyptian cement industry

Until 2014, the Egyptian cement industry, one of the most energy-intensive businesses in the country, had primarily used state-subsidized natural gas and heavy fuel oil to fire its kilns. However, following a gradual phasing out of the energy subsidies, Egyptian cement companies have switched to using CO₂-intensive fuels such as coal and petroleum coke ("petcoke").

In an effort to support technology and innovation in hard-to-abate industrial sectors, the EBRD, the Egyptian Environmental Affairs Agency and the Chamber of Building Materials Industries/Cement Industry Division – in collaboration with the Egypt Ministry of Trade and Industry and the Cement Sustainability Initiative of the World Business Council for Sustainable Development – joined forces to develop the "Low-Carbon Roadmap for the Egyptian Cement Industry".

The roadmap suggests that in order to reduce CO₂ emissions, the industry should reduce the clinker content in cement, increase the use of alternative fuels to coal and petcoke, improve electrical energy efficiency and use more renewable sources of energy. Under one of the most ambitious scenarios, by phasing out the use of coal and making the switch to lower-carbon alternatives, by 2030, 2.2 million tonnes of coal per year will no longer have to be imported, saving about 200 million US dollars. Furthermore, this outcome would lead to a reduction in CO₂ emissions to about 2 per cent below the historic level prior to the fuel switch.

In parallel and in support of the general policy objectives, the EBRD has been in discussions with a number of cement companies in Egypt to finance energy-efficiency projects, including the use of alternative fuels and industrial energy-efficiency investments as well as improved environmental and health and safety measures. The roadmap recommendations have indeed been included in projects financed by the EBRD for cement companies in Egypt such as Arabian Cement.

Source: Bruno Vanderborght et al., *Low-Carbon Roadmap for the Egyptian Cement Industry*, London, EBRD, October 2016, <https://www.ebrd.com/documents/climate-finance/egypt-roadmap-cement.pdf>.

²¹ Mariana Mazzucato and Gregor Semieniuk, "Public Financing of Innovation: New Questions", in *Oxford Review of Economic Policy*, Vol. 33, No. 1 (January 2017), p. 24-48, <https://doi.org/10.1093/oxrep/grw036>.

2.2 Supporting the private sector in order to help it to understand and manage risks

Private-sector firms are recognizing that climate action can be a driver of competitive advantage and innovation, and that it should therefore be embedded in good risk-management practices. Firms face the twin risks of declining profitability of high-carbon sectors (transition risks) and potential damage from climate change (physical risks). The financial “value at risk” from climate change has been estimated at between 2 and 17 per cent of the total value of financial assets worldwide today.²² The better these risks are managed, the better for firms in exposed sectors and their workforces.

As a result, financial markets need to internalize these risks more explicitly in companies’ valuations, firms need to improve their understanding of how to manage them and regulators need to understand the implications for financial stability if they materialize. There is increasing momentum through various initiatives to provide guidance on how to better manage climate risks and opportunities – and disclose them to investors. Prominent examples include the Financial Stability Board’s Task Force on Climate-related Financial Disclosures (TCFD), the Central Bank-led Network for Greening the Financial System (NGFS) and the European Commission’s Technical Expert Group on sustainable finance (TEG).

As companies and financial institutions are at an early stage of identifying, managing and disclosing their financial risks from climate change, DFIs can play an important role. They can work with their clients directly in order to incorporate climate risks into their decision-making and prepare for change well in advance.

2.3 Supporting the sustainable recovery of economies following the COVID-19 pandemic

On top of these structural challenges, the shift to low-carbon, green

²² Simon Dietz et al., “Climate Value at Risk of Global Financial Assets”, in *Nature Climate Change*, Vol. 6, No. 7 (July 2016), p. 676-679.

and just economies will be affected by the consequences of the COVID-19 pandemic.

Several linkages are already being drawn between the global response to this pandemic and that required to tackle climate change. Because the sharp decline in CO₂ emissions²³ and GHG during the lockdown of entire countries has shown the dependence of economic and human activities on high-carbon businesses and fossil fuels,²⁴ a debate is ongoing about whether or not environmental considerations will make their way into businesses planning and policy-making in the recovery phase.

Importantly, this is not a new debate. In the aftermath of the 2008 global financial crisis, several experts²⁵ had already seen a danger that the challenge of climate change might be put aside if meeting it appeared to conflict with short-term political and economic objectives. They therefore asked whether, in the light of the slowdown in economic growth, it might be better to delay climate action until the world economy recovered. Their answer at the time was “no”; so is the EBRD’s today: efforts to counteract the COVID-19 pandemic create an opportunity to “tilt to green” the large-scale recovery spending being pledged, making it a key accelerator towards a low-carbon economy²⁶. The global financial crisis resulted in a fiscal stimulus in advanced economies of around about 3 per cent of GDP²⁷ – and while a larger stimulus is likely to be required to counteract the consequences COVID-19 it offers an immense opportunity.

²³ “Daily carbon dioxide emissions have fallen almost 60 per cent across the EU” as of mid-April 2020. See Victor Mallet, “EU Carbon Emissions Tumble During Lockdowns”, in *Financial Times*, 8 April 2020, <https://www.ft.com/content/4c59fd16-6020-4798-b8f1-5df686bbd97a>.

²⁴ Jason Bordoff, “Sorry, but the Virus Shows Why There Won’t Be Global Action on Climate Change”, in *Foreign Policy*, 27 March 2020, <https://foreignpolicy.com/2020/03/27/coronavirus-pandemic-shows-why-no-global-progress-on-climate-change>.

²⁵ Alex Bowen et al., “An Outline of the Case for a ‘Green’ Stimulus”, in *Grantham Research Institute Policy Briefs*, February 2009, <https://www.lse.ac.uk/granthaminstitute/publication/an-outline-of-the-case-for-a-green-stimulus>.

²⁶ EBRD, “COVID-19: from Shock to Recovery”, in *Regional Economic Prospects*, April 2020, <https://www.ebrd.com/cs/Satellite?c=Content&cid=1395289845931&d=&pagename=EBRD%2FContent%2FDownloadDocument>.

²⁷ European Commission-International Institute for Labour, “A Review of Global Fiscal Stimulus”, in *EC-IILS Joint Discussion Paper Series*, No. 5 (November 2011).

But developing these green co-benefits in the COVID-19 stimulus, without diverting it from its main purpose, will require governments to take careful policy action.

Despite evidence that green-economy investments declined in the aftermath of the 2008 financial crisis,²⁸ we believe that there are important reasons why the economic recovery from the consequences of the COVID-19 pandemic can – and should – be compatible with an ambitious climate agenda and the objectives of the Paris Agreement.

First, the pandemic exposed the lack of preparedness and the complexities of dealing with a global crisis, even when its trigger – an infectious disease²⁹ – featured prominently among global risks rankings. Thus, political, but also global business, leaders cannot afford to be caught off-guard when it comes to climate-change risks, which are very well known, underpinned by scientific evidence and possibly even larger than a pandemic by many orders of magnitude.

Second, the effectiveness of the global response to the COVID-19 pandemic relies on collective action and there is a potential intergenerational trade-off given the observed increases public debt. Public spending in the recovery should thus be tilt towards providing for investments that cater for younger generations and manage future risks, such as managing the impact of climate change. The drastic lockdown measures that most governments around the world have decided to take – which led many countries into economic recession – were the result of a compromise, in the short term, between protecting citizens' health and their livelihoods. In the long run, the detrimental impact of climate

²⁸ “Then, as now, global greenhouse gas emissions initially dropped. But they quickly rebounded in 2010 and have been rising steadily since, partly because the chance was missed to use the vast amounts of public money to set the world on a green path. Environmental standards and law enforcement have been deprioritised, clean energy investments deferred and infrastructure and resource development poorly planned.” EBRD, “COVID-19: from Shock to Recovery”, cit., p. 17.

²⁹ Infectious diseases and/or pandemics featured in the WEF Global Risks reports since 2007. In addition, the WEF Global Risks Report 2020 ranks infectious diseases among the top-ten global risks by likelihood and impact over the next 10 years. World Economic Forum (WEF), *Global Risks Report 2020*, 15 January 2020 <https://www.weforum.org/reports/the-global-risks-report-2020>.

change on health is well known. Deforestation, biodiversity loss and climate change actually make pandemics more likely, and global warming will most likely accelerate the emergence of new viruses.³⁰ Therefore, if a fiscal stimulus in the recovery phase accelerates a just transition to a low-carbon economy, both people's livelihoods and their long-term health will be better off.

Third, balancing a quick economic recovery against its sustainability will be the "low-hanging fruit" in geopolitically shaping the world's post-pandemic future. The probable loss of millions of jobs will emphasize the need for a new social contract.³¹ In their efforts to rebuild citizens' confidence, global powers will also be assessed through the lens of how sustainable their social, economic and health-care systems are. Thus, funding a recovery that has equality at its core, including a just transition in the world's most carbon-intensive territories, represents a chance to emerge from this crisis as true leaders. The European Union – empowered by the welfare systems of its member states, and the extraordinary fiscal and monetary measures already taken in response to the outbreak – can quickly find itself on the right path.

CONCLUSIONS

Climate change, both in terms of mitigating its risks and adapting to the inevitable changes to the climate that we are already observing, remains the most severe global risk facing the world. The COVID-19 crisis serves as an "alarm bell" of the complexities of dealing with a global crisis.

Climate change hits the poorest and least-developed countries first and foremost, as they are both more likely to witness the effects of severe changes in climate sooner than others and because of their weaker infrastructure and emergency preparedness. We also know that we need to take action quickly. The next decade will be crucial in laying the foundations

³⁰ EBRD, "COVID-19: from Shock to Recovery", cit.

³¹ International Trade Union Confederation, *ITUC Global COVID-19 Survey: 30 March–2 April 2020. Key Findings*, 7 April 2020, https://www.ituc-csi.org/IMG/pdf/200407_ituc_covid-19_globalsurveyreport_en.pdf.

for a low-carbon economic model that can set us on an emissions path that reduces the risk of more extreme climate-change outcomes.

However, the structural changes that will be necessary in order to take such action come with intricate political-economy consequences. Rapid transition to a low-carbon economy will, inevitably, displace jobs and strand capital; it will also create new jobs and generate new investments. We will see significant “creative destruction” in the economy. As in all transitions, the risk of “losers” blocking or slowing things down will be very high – and we have already seen this in, for example, the coal sector in a number of European countries.

This implies that the only way forward is finding “just” social, economic and environmental solutions. If we do not strive to take vulnerable groups along with us in this transition, we are unlikely to succeed at all.

Focus needs to be first on creating mechanisms to protect vulnerable groups of individuals and regions, and to equip them – where possible – with the requisite skills and access to new opportunities. It needs to be, secondly, on sharing the substantial benefits of innovation and technology, and on leapfrogging towards a low-carbon economy. International organizations like the EBRD will need to play a fundamental role in supporting the development of solid, just transition plans, and then using their financing arms as well as their policy experience to implement such plans effectively and quickly. In the aftermath of the COVID-19 pandemic, international organizations will also have the opportunity – and responsibility – to help governments “tilt to green” their economic plans, supporting the private sector and fostering a recovery that, while focused on quickly coming out of the crisis, lays the foundations for a low-carbon economy that can help to avoid the even larger risks of climate change further “down the line”.

Climate change is proving to be not only the biggest environmental and economic challenge that the world faces, but the biggest social and political one as well.

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2.

Defining and Implementing Policy Targets Together: Two Concrete Examples (WBIF and SDGs)

Massimo Cingolani¹

This text develops the intuitive idea that sharing objectives is a precondition for, and can be a way to achieve, coordination between different stakeholders in realizing international-development cooperation in a context in which uncertainty is likely to be pervasive. Section 1 discusses uncertainty as a possible cause of both market and government failure in international policy cooperation for development – particularly in fragile contexts, in which it is more likely that stakeholders have heterogeneous views on how to achieve development goals. The discussion is developed from the viewpoint of collective decision-making and makes use of the concept of *expectational market failure*. In Sections 2 and 3, two concrete examples are presented that give insights from actual or foreseen international-development-cooperation situations. These examples are those of the cooperation developed within the *Western Balkans Investment Framework* and that developing for defining common criteria for concessionality in support of private-sector projects that pursue the

¹Opinions expressed are personal. The author is grateful to Romualdo Massa Bernucci for continuous support and encouragement over the years and to Roger Guesnerie and Michel Delau for several discussions on related issues. A warm thank to Alessia Isopi for her comments on the first draft as well as to the reviewer. The usual disclaimer applies.

United Nations' *Sustainable Development Goals*. Based on these examples, it is argued that agreement on setting common objectives mitigates the pervasive effects of uncertainty on collective decision-making, and is an important precondition for successful international-development cooperation.

INTRODUCTION

When development policy is pursued through the cooperation of different stakeholders, this cooperation implies collective decisions that take time and resources, and which condition the speed and type of development results obtained.

The difficulties in collective decision-making have been emphasized already by Nicolas de Condorcet² in his famous paradox, popularized by Kenneth Arrow.³ In its original formulation, the Condorcet paradox states that when decisions are to be taken between mutually exclusive alternatives on the basis of the majority rule, as long as there are more than two choices the majority rule may fail to produce a rational ordering of collective preferences.⁴ Georges-Théodule Guilbaud illustrated the

² Jean-Antoine-Nicolas de Caritat Marquis de Condorcet, *Essai sur l'application de l'analyse à la probabilité des décisions rendues à la pluralité des voix*, Paris, Imprimerie Royale, 1785, <https://gallica.bnf.fr/ark:/12148/bpt6k417181.image>.

³ Kenneth J. Arrow, *Social Choice and Individual Values*, New York/London, John Wiley & Sons/Chapman & Hall, 1951, <https://cowles.yale.edu/sites/default/files/files/pub/mon/m12-all.pdf>. After a period of oblivion and dismissal, Condorcet's paradox gained worldwide recognition with the celebrated second edition of Arrow's thesis. It was Guilbaud who gave Arrow Condorcet's reference after Arrow presented the first version of his seminal contribution in Paris.

⁴ When there are three possible choices A, B and C, Condorcet compares them two by two and shows that, depending on the distribution of preferences of individual voters, under the majority rule it is possible that A is preferred to B and that B is preferred to C but that C is preferred to A. In the words of Guilbaud, the maximum of collective satisfaction does not coincide with the minimum of dissatisfaction when there are three options (or more), contrary to happens with binary choices. See Georges-Théodule Guilbaud, "Les théories de l'intérêt général et le problème logique de l'agrégation", in *Revue économique*, Vol. 63, No. 4 [1952] (2012), p. 664, <https://www.cairn.info/revue-economique-2012-4-page-659.htm>.

general and pervasive nature of Condorcet's paradox, from which even the Bergson–Samuelson ordinal social-welfare function is not exempt.⁵ In his analysis, if we reject cardinal utility only “dictatorial” or “unanimity” decision rules would preserve collective decision-making from the inconsistencies that Condorcet brought to light for the majority rule.⁶

Intuitively, we can expect that Condorcet's paradoxical results may arise more frequently when opinions are very diversified or, worse, conflicting. On the contrary, in the extreme case in which everybody shares the same opinion, whichever way preferences are aggregated, the collective decision-rule coincides with unanimity. More generally, if we take, for instance, the subjective approach to probability as a reference, however individual probabilities are defined, if opinions are very divergent, subjective probabilities (*prévisions*) can never converge to objective probability, defined as the frequency of favourable outcomes when several trials of “exchangeable events” are repeated.⁷ In such cases, the very notion of “price of risk” needs to be reinterpreted,⁸ or completely abandoned⁹ – a point that severely limits the practical relevance of the *efficient market hypothesis*¹⁰ and would suggest prudence in proposing “market solutions” to development problems, especially in fragile contexts.

As developed in the first section below, the argument holds a fortiori if, instead of the rationality assumption implicit in the expected utility hypothesis, other less rational approaches to risk and uncertainty are considered – such as those retained by prospect theory or others that

⁵ Ibid., p. 712-718.

⁶ “Les deux seuls extrêmes sont cohérents : le concert ou la servitude”. Ibid, p. 719.

⁷ Bruno de Finetti, “La notion de ‘distribution d’opinions’ comme base d’un essai d’interprétation de la statistique”, in *Les annales de l’ISUP*, Vol. 1, No. 2 (1952), p. 1-19.

⁸ Elyès Jouini, “Tarifer un risque dont l’intensité est diversement perçue”, in *Revue d’économie financière*, No. 133 (2019), p. 21-43.

⁹ Simone Enrico Casellina and Giuseppe Pandolfo, “Probability (of Default) Does Not Exist”, in *Global & Local Economic Review*, Vol. 22, No. 2 (2018), p. 133-160, http://www.gler.it/archivio/ISSUE/gler_22_2.pdf.

¹⁰ Massimo Cingolani, “What Economic Modelling Hypotheses Should Underlie Regulation & Policy Advice? Towards a Probabilistic Approach”, in *Forum for Social Economics*, 5 August 2020, <https://doi.org/10.1080/07360932.2020.1725589>.

behavioural finance has shown to be relevant in describing actual individual choices in the face of uncertainty.¹¹

In the first section, below, some aspects of the impacts of uncertainty on international policy cooperation are discussed from a collective viewpoint with the help of the concept of *expectational market failure*, which is likely to arise when the effects of uncertainty are pervasive.

In the following sections, two practical examples are examined in which it is argued that coordination in setting common objectives may reduce the negative impact of uncertainty: the policy cooperation developed within the Western Balkans Investment Framework (WBIF)¹² and that of concessionality in support of private-sector projects that pursue the Sustainable Development Goals. The final section draws some conclusions.

1. INTERNATIONAL COORDINATION IN UNCERTAIN POLICY ENVIRONMENTS

In the absence of a world government that could play the role of a single decision centre and, as a matter of principle, impose decisions that would respect the properties of individual rational decision-making,¹³ a way must be found to decide on the scope and means of international-development cooperation – and it is likely that differences of opinions or even conflicts may arise between the various parties involved. It is

¹¹ See Richard H. Thaler, *Misbehaving. The Making of Behavioral Economics*, New York/London, WW Norton, 2015; Daniel Kahneman and Amos Tversky, "Prospect Theory: An Analysis of Decision Under Risk", in *Econometrica*, Vol. 47, No. 2 (1979), p. 263-291; Amos Tversky and Daniel Kahneman, "Advances in Prospect Theory: Cumulative Representation of Uncertainty", in *Journal of Risk and Uncertainty*, Vol. 5, No. 4 (1992), p. 297-323. For a critique of prospect theory see Michael Nwogugu, "A Further Critique of Cumulative Prospect Theory and Related Approaches", in *Applied Mathematics and Computation*, Vol. 179, No. 2 (2006), p. 451-465.

¹² See, in particular, the latest annual reports of the Western Balkans Investment Framework (<https://www.wbif.eu>) and the Western Balkans Enterprise and Innovation Facility (<http://www.wbedif.eu>).

¹³ These are reflexivity, symmetry, transitivity, etc. A classic reference is Amartya K. Sen, *Collective Choice and Social Welfare*, Expanded ed., Cambridge, Harvard University Press, [1970] 2017, p. 53.

argued in this contribution that defining common objectives and specific goals may help in reducing this “decisional uncertainty” and can thus foster development cooperation, being moreover a necessary precondition for achieving concrete impact results that can also be measured and evaluated *ex ante* and *ex post*.¹⁴

Whereas in the 19th century, classical Political Economy developed around the discussion of major policy issues, nowadays economists tend to dodge policy debates by assuming the existence of a social-welfare function that summarizes the preferences of policymakers and on the basis of which policy targets can be quantified. Following Jan Tinbergen, the best use of policy instruments to achieve these targets is then determined on purely technical grounds.¹⁵ Despite Arrow’s negative result,¹⁶ a large literature developed on social choice and welfare that was not always con-

¹⁴ The perspective in this section is that of a committee in which different stakeholders coordinate their development action in view of financing a project or an action that will exert its effects in the future. It is assumed that opinions on the content of the action and its possible financing are diverse, independently from the way in which they are formed. One stakeholder may derive his opinion from the optimization of discounted worldwide utility for the next 100 years, another from an evaluation of his chances to get promoted by his national hierarchy, a third one by a minimization of the time spent before he may be able to come back home. The starting point is thus one of heterogeneity of opinions: the way in which these are defined is not discussed.

¹⁵ Jan Tinbergen, *On the Theory of Economic Policy*, 2nd ed., Amsterdam, North Holland, 1955.

¹⁶ Kenneth J. Arrow, *Social Choice and Individual Values*, cit. Arrow’s celebrated impossibility theorem asserts that it is not possible to find a rule aggregating individual preferences (some say “a constitution”), that respects all possible preference orderings and is symmetric, transitive and not dictatorial. While partisans of welfare economics such as Samuelson asserted that this did not prevent to assume an ordinal social welfare function of the type introduced by Bergson and Samuelson himself (see Kotaro Suzumura, “An Interview with Paul Samuelson: Welfare Economics, ‘Old’ and ‘New’, and Social Choice Theory”, in *Social Choice and Welfare*, Vol. 25, No. 2-3, 2005, p. 327-356), and as mentioned above, Guilbaud asserted that this is only possible with a cardinal welfare function, little attention was given to the rather obvious fact that, in the abstract mathematical setup of Arrow, a dictator is someone whose preferences coincide in all aspects with the preferences of society. But since in this setup there is no social interaction other than voting, the dictator could simply be a “happy idiot”, hence the pessimistic interpretation of Arrow’s result for democratic decision-making is not the only one possible.

clusive – for instance, in the debate between ordinal and cardinal welfare functions. Moreover, this literature was essentially static and did not discuss in a sequential framework the risk implicit in environments in which opinions diverge and agents interact, adapting their behaviour to circumstances¹⁷ – which are also those environments in which Condorcet’s paradoxes have more chances to arise.

When collective decisions must be taken by a negotiated consensus that is unpredictable in its timing, scope and content and when, as is the case almost surely in extreme poverty and/or conflict areas, these actions are deployed in an environment that is itself highly uncertain, the partial ignorance of decision-makers on the future consequences of their actions can delay agreeing on a common course of action – and thus reduce the efficiency of collective decision-making. This contribution suggests that such ignorance should be addressed rationally – i.e. with the help of probability.¹⁸

The first and most obvious element of uncertainty that affects collective decision-making in the context of development policy is the uncertainty on the future environment in which policy must be implemented. Depending on the future scenario on which one bets, the effect of a certain policy action can be different and sometimes of opposite sign. This type of uncertainty is likely to generate what Roger Guesnerie called an “expectational market failure”,¹⁹ a concept that he traces back its origin

¹⁷ Serge-Christophe Kolm, *Reciprocity. An Economics of Social Relations*, Cambridge, Cambridge University Press, 2008. Kolm adopts a sequential approach but does not discuss the expectational market failure.

¹⁸ “La théorie des probabilités n’est, au fond, que le bon sens réduit au calcul”, see Pierre-Simon Marquis de Laplace, *Théorie analytique des probabilités*, Paris, Mme Ve. Courcier, 1812; “[...] la concezione della teoria della probabilità come un ramo della logica, [...] nel senso intuitivo e totalitario di ‘logica del modo di ragionare sui giudizi di probabilità, di plausibilità, di verosimiglianza’”, see Bruno de Finetti, “Probabilisti di Cambridge”, in *La logica dell’incerto*, edited by Marco Mondadori, Milano, Il Saggiatore, [1938] 1989, p. 203-222.

¹⁹ Roger Guesnerie, “The Government and Market Expectations”, in *Journal of Institutional and Theoretical Economics*, Vol. 157, No. 1 (2001), p. 116-126; Roger Guesnerie, “Expectational Coordination Failures and Market Volatility”, in Roman Frydman and Edmund S. Phelps (eds), *Rethinking Expectations. The Way Forward in Macroeconomics*, Princeton, Princeton University Press, 2013, p. 49-67.

in the work of Pierre Massé.²⁰ Expectational market failures are defined with reference to a comparison between the static intertemporal general equilibrium, as extended to uncertainty by Arrow²¹ and Gerard Debreu,²² and a sequential temporary equilibrium such as that presented by Roy Radner.²³ Radner showed that a sequential equilibrium of plans, prices and price expectations achieves the same efficiency conditions of the Arrow–Debreu static intertemporal framework when “price expectations are correct in the sense of being market clearing prices” and when expected prices are the prices prevailing when future markets are open.²⁴ These assumptions boil down to retaining the *rational expectations hypothesis* (REH), which in fact “provides the missing link between a sequential world *à la* [Léon] Walras and the static intertemporal Arrow–Debreu world”.²⁵ Under temporary equilibrium, in the absence of the “focal point” provided by rational expectations, economic

²⁰ Pierre Massé, *Le plan ou l'anti-hasard*, Paris, Gallimard, 1965.

²¹ Kenneth J. Arrow, “The Role of Securities in the Optimal Allocation of Risk-bearing”, in *The Review of Economic Studies*, Vol. 31, No. 2 (1964), p. 91-96.

²² Gerard Debreu, *Theory of Value. An Axiomatic Analysis of Economic Equilibrium*, New Haven/London, Yale University Press, 1959.

²³ Roy Radner, “Existence of Equilibrium of Plans, Prices, and Price Expectations in a Sequence of Markets”, in *Econometrica*, Vol. 40, No. 2 (1972), p. 289-303. These notions correspond respectively to Hicks’s concepts of “futures” and “spot” economies, which are associated respectively to intertemporal and temporary equilibria (see John R. Hicks, *Value and Capital. An Inquiry into Some Fundamental Principles of Economic Theory*, Oxford, Clarendon Press, 1939, p. 136-140). Already in Hicks, the two coincide under “perfect foresight”.

²⁴ Jacques H. Drèze and Jean-Jacques Herings, “Sequentially Complete Markets Remain Incomplete”, in *Economics Letters*, Vol. 100, No. 3 (2008), p. 445.

²⁵ Roger Guesnerie, “The Government and Market Expectations”, cit., p. 118. In this quoted paragraph, Guesnerie associates Walras to a notion of temporary equilibrium. Authors such as Petri associate Walras to a notion of “classical equilibrium” (long-term dynamic equilibrium of reproduction), which could, under stationary conditions, be seen as logically equivalent to the neo-classical intertemporal equilibrium (see Fabio Petri, “Walras on Capital: Interpretative Insights from a Review by Bortkiewicz”, in *Contributions to Political Economy*, Vol. 35, No. 1, 2016, p. 23-38). To the best of the author’s understanding, both interpretations find confirmation in Walras’ writings. See Massimo Cingolani, “Augusto Graziani’s Equilibrio generale ed equilibrio macroeconomico: A Key Milestone in a Long Journey Out of the Neoclassical Mainstream” in *Review of Keynesian Economics*, Vol. 4, No. 3 (2016), p. 295.

agents cannot anchor their expectations to a common view of the future on which they can draw individual plans with reasonable comfort that they have a chance of succeeding. In this literature, which originates in the French indicative-planning approach,²⁶ a key role for economic policy is that of reducing this type of uncertainty, which can be labelled “uncertainty on the future scenario”.

A second and less obvious source of “decisional uncertainty”²⁷ may be the lack of consensus (or collective ignorance) on the causal relationship to be expected between means and goals. For stakeholders to agree on a development policy, it is not sufficient to have a reasonably convergent view of the future, it is also necessary to share a common understanding of the causal relations between policy instruments and targets. A typical example is that of the relationship between public expenditure and employment, wherein many argue that more public expenditures decrease private employment while others assert the contrary.²⁸ In the absence of an agreement on which level of public expenditures should accompany a certain employment policy, discussions can be difficult. De facto, in actual policy negotiations, consensus is reached only by boredom and exhaustion of the energies of the negotiating parties. Cooperation in setting common goals may be a way to reduce decisional uncertainty, as it helps identify a common view of the future and forces stakeholders to be explicit about possible causal relationships between means and ends. A geometrical illustration may clarify this point.²⁹

The basic idea is that today there are several possible futures depend-

²⁶ For a comparison between the French and Dutch approaches to indicative planning, see Alain Desrosières, “La commission et l’équation: une comparaison des Plans français et néerlandais entre 1945 et 1980”, in *Genèses*, Vol. 34 (1999), p. 28-52, https://www.persee.fr/doc/genes_1155-3219_1999_num_34_1_1550.

²⁷ Instead of “decisional uncertainty”, one may also talk less neutrally about “administrative” or “bureaucratic” uncertainty. The modern literature of behavioural economics has identified many other sources of uncertainty that cause “non-rational” or “sub-optimal” behaviours, but these two appear more relevant in the context of the decisions of a committee and are sufficient to illustrate the point.

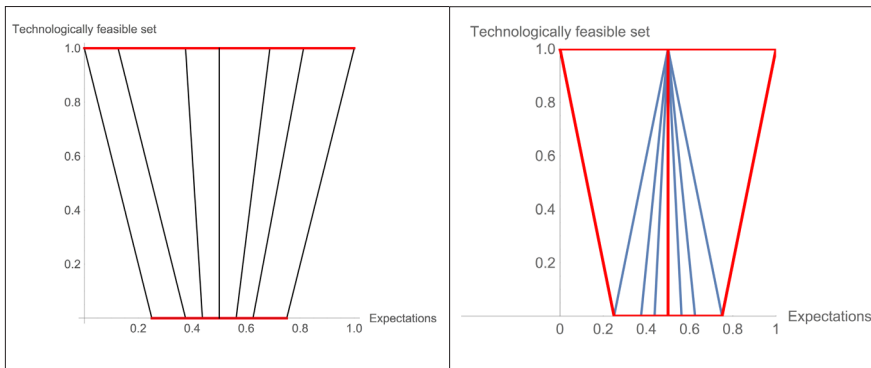
²⁸ Massimo Cingolani, “What Economic Modelling Hypotheses Should Underlie Regulation & Policy Advice?”, cit.

²⁹ This hypothetical example is reproduced from a presentation given at a meeting of the Western Balkans Investment Framework.

ing on many circumstances but tomorrow there will be only one present, which will be the (“equilibrium”) outcome of the plans undertaken today by all involved stakeholders.³⁰

Let us assume that there is a spectrum of ex ante expectations that is depicted in the lower, red segment of the charts in Figure 1 below. Each point on this segment represents a view on the future. Against this spectrum of ex ante expectations, there is a range of possible outcomes defined by technology. Assume that technology allows reaching all possible outcomes comprised between 0 and 1 (higher red segment in the charts below). Let us draw a line joining the set of initial expectations to the range of possible outcomes. This is a feasible plan ex ante, and its length could be thought to be proportional to the production period.³¹ Considering all lines joining the range of possible outcomes to the segment of expectations defines the population of all possible plans on the future respecting technological constraints that could thus in principle be undertaken, showing also that all futures contained between 0 and 1 are technologically possible. These plans are included in the “glass shape” area meshed diagonally in the left chart in Figure 1.

Figure 1 | Ex ante and ex post feasible plans



Source: Elaborations of the author.

³⁰ Implicitly the word “equilibrium” is used here in the sense of “solution of a mathematical system” as suggested by Patrick Artus, Michel Deleau and Pierre Malgrange, *Modélisation macroéconomique*, Paris, Economica, 1986, p. 120-122.

³¹ The line can also be seen as an individual steady state whose growth rate is given by its slope.

However, we should exclude from this set all plans that are not consistent between each other, which are those that do not intersect “after one production period”. Only the plans represented by lines located on the inverted triangle in the chart on the right, which start from the point of intersection with the segment of feasible outcomes above and join the expectation segment below, are feasible plans that will be realised and will produce positive net revenues (the triangle meshed diagonally on the rightmost chart).³²

But the plans included in that triangle are only a fraction of all the plans that could potentially be undertaken without policy coordination. All ex ante plans contained in the “glass-shaped” area depicted in the chart on the left are in fact possible, and could in principle be undertaken. Part of them (the part not included in the triangle on the right) will, however, fail.

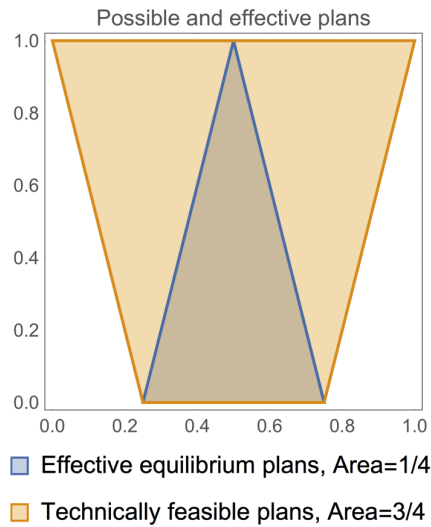
In Figure 2 below, the two areas (the glass and the triangle) are overlaid, showing that the area of the triangle outlined in blue is $\frac{1}{4}$, whereas that of the yellow “glass” is $\frac{3}{4}$ – hence, a difference of $\frac{1}{2}$. The more uncertainty there is (the larger the base of the cone and the glass) the larger also the difference between the two areas – and hence, the magnitude of the “expectational market failure”.

Given that the units in this example are such that the overall square has an area of 1, these areas can be interpreted as probabilities. In this simple and purely illustrative example, just because of the differences of opinions, there is thus a 25 per cent chance of undertaking a successful project, a 50 per cent chance of undertaking an unsuccessful one and a 25 per cent chance that no investment will be done at all. Hence, in the example there are sizeable potential gains that can be realized through policy coordination, of a magnitude of 200 per cent. This coordination can also be seen as a coordination on policy goals if it concerns the definition of the apex of the triangle and of the ways in which to reach it.³³

³² There is no particular reason why the intersection point should be in the middle of the upper segment, other than it simplify the calculation of the areas of the various triangles presented below.

³³ Kanie Norichika and Frank Biermann (eds), *Governing Through Goals. Sustainable Development Goals as Governance Innovation*, Cambridge, MIT Press, 2017. Norichika

**Figure 2 | Possible and effective plans:
Illustration of the expectational market failure**



Source: Elaborations of the author.

2. THE WESTERN BALKANS INVESTMENT FRAMEWORK: A REGIONAL INSTRUMENT BLENDING LOANS AND GRANTS FROM DIFFERENT DONORS

2.1 Background

The former Yugoslavia was the object of a tragic war in the 1990s, which broke up the country into several states, some of which – such as Slovenia and Croatia – have since entered the European Union (EU). Even before the fall of the Berlin Wall, international financial institutions were active in the country, which, at the time, was the leader of the non-aligned world. With the breakup of ex-Yugoslavia, what were before regions became countries and – together with Albania

and Biermann argued that setting common goals at an international level is a way to foster the attainment of SDGs.

– were confronted with the double challenge of reconstruction from the war and transition from a command to a market economy. Each of them had to deal separately with the various national and international organizations active in their territory, having to address their specific procedures and conditionalities. For this reason, a request coming initially from Croatia around 2006 went through the European Council in 2008 under the Slovenian EU presidency and led to the establishment of the Western Balkans Investment Framework (WBIF).³⁴ The WBIF was thereafter launched in December 2009 as a EU led instrument,³⁵ blending grants and loans from different bilateral and multilateral donors, implementing the initial idea of a “single stop and single shop” but also that of a “single pot”, in which grant money from different donors would be pooled before being blended with international financial institutions (IFI) loans.

2.2 Features

Although similar to other regional blending mandates outside the EU,³⁶ the WBIF also differs from them – in particular, because 1) it joins together a larger number of bilateral and multilateral donors committed by cash contributions; 2) it takes decisions that have a stronger element

³⁴ At its meeting of 14 May 2008, the Economic and Financial Affairs Council welcomed the initiative of the Commission to establish a comprehensive WBIF “to enhance harmonisation and cooperation in investments for socio-economic development in the region”. Council of the European Union, *Economic and Financial Affairs 2866th Council Meeting*, Brussels, 14 May 2008, https://ec.europa.eu/commission/presscorner/detail/en/PRES_08_113.

³⁵ Besides the European Commission, the three “European International Financing Institutions” (namely the Council of Europe Development Bank – CEB, the European Bank for Reconstruction and Development – EBRD, and the European Investment Bank – EIB) were the partner IFIs. Later KfW, World Bank and AFD joined what are now, together with the Commission, the partner institutions of the WBIF. Initially the WBIF covered also Croatia, now it covers the six Western Balkans countries still in the process of EU accession (WB6): Albania, Bosnia Herzegovina, Kosovo (as per UN resolution 1244), Montenegro, North Macedonia and Serbia.

³⁶ Such as the Neighbourhood Investment Facility (NIF), now Neighbourhood Investment Platform (NIP, part of EFSD+); the EU-Africa Infrastructure Trust Fund (EU-AITF) and others that were developed at the same time or later.

of commonality than those of other similar instruments; and 3) it foresees an active role for the beneficiary countries that is absent from other instruments of this kind.

Typically, WBIF stakeholders decide together on the common use of the pooled inputs and are jointly committed to the WBIF's output. This output is the shared "pipeline" of priority investment projects on which WBIF grant and loan resources are blended.³⁷ This investment coordination is embedded into the policy framework of the EU accession process, defined notably by the IPA (Instrument for Pre-Accession) regulations, which also set the financial resources that the European Commission budget devotes to the WBIF. The IPA grant resources made available to the WBIF increased from roughly 350 million euro in the 2007–13 period to more than 1 billion euro in the 2014–20 period,³⁸ and are expected to further increase in 2021–27 financial period.

Although apparently similar to that of other EU blending facilities, the output of the WBIF is – given the commonality of its decisions – also

³⁷ In arguing in favour of his proposal for an investment board, Keynes wrote: "But a wise public policy to promote investment needs, as I have said, long preparation. Now is the time to appoint a board of public investment to prepare sound schemes against the time that they are needed. If we wait until the crisis is upon us we shall, of course, be too late. We ought to set up immediately an authority whose business it is not to launch anything at present, but to make sure that detailed plans are prepared. The railway companies, the port and river authorities, the water, gas, and electricity undertakings, the building contractors, the local authorities, above all, perhaps, the London County Council and the other great Corporations with congested population, should be asked to investigate what projects could be usefully undertaken if capital were available at certain rates of interest – 3.5 per cent, 3 per cent, 21 per cent, 2 per cent. The question of the general advisability of the schemes and their order of preference should be examined next. What is required at once are acts of constructive imagination by our administrators, engineers, and architects, to be followed by financial criticism, sifting, and more detailed designing; so that some large and useful projects, at least, can be launched at a few months' notice." John M. Keynes, "How to Avoid a Slump", in *The Times*, 12 January 1937, p. 72.

³⁸ In the 2007–2013 period, WBIF benefitted from circa 70 million euro of Commission grants per year from 2009 to 2013, in the 2014–2020 period, the budget allocated exceeds 150 million euro per year, hence at least 1 billion euro is available for grants (mainly investment) over the 2014–2020 period.

different because of the number of stakeholders involved³⁹ and the magnitude of its created “consensus”.⁴⁰

The following principles of the WBIF are characteristic features of the framework, and illustrate a high level of sharing and commonality in its decisions:

- The principle of ownership of the beneficiary by the beneficiary making the grant request.
- The pooling of technical and financial expertise of donors in a *single stop, single shop and single pot*. Each stakeholder, but particularly the IFIs, puts its specific expertise at the disposal of the instrument for the screening (the Commission) and evaluation (the lead IFIs) of the proposals, based on the “four eyes principle”; the donors pool their grant resources into the European Western Balkans Joint Fund (*single pot*). Lead IFIs contribute to the common pot, and can access funds to be blended with their loans. The General Conditions of the joint fund are at the centre of an original co-delegation legal structure signed by all IFIs and donors.
- Decisions are taken by consensus.
- In principle, financial resources are not earmarked ex ante by sector or by country.
- A common management information system (MIS) helps beneficiaries to submit their grant requests, and the Commission and IFIs to transparently give their expert opinions before the decision is taken together by all donors.

³⁹ As of end 2019, 20 bilateral donors have brought 98.7 million euro to the EWBIF, excluding a contribution of about 5 million euro from the EIB.

⁴⁰ In the WBIF, decisions are taken by consensus, which is different from unanimity. The logic of the consensus approach is justified if it can reach a “general interest” that goes beyond and is higher than the sum of the individual “best interests” of each stakeholder. De Finetti showed that aggregating the solutions of a maximisation of individual objective functions that consider as given the decisions taken by others does not yield the same result as maximising all individual objective functions simultaneously (see Bruno de Finetti, “Problemi di ‘Optimum’”, in *Un matematico e l’economia*, Milano, Giuffrè, [1969] 2005, p. 50-53; Bruno de Finetti, “Problemi di ‘optimum’ vincolato”, *ibid.*, p. 54-66; Bruno de Finetti (ed.), *Requisiti per un sistema economico accettabile in relazione alle esigenze della collettività*, Milano, Franco Angeli, 1973).

- Any proposal should be part of investment priorities agreed in the context of EU accession at sectoral level (single pipelines), which link to the EU accession programming framework (economic reform programmes).

2.3 The WBIF project pipeline of investment projects

The following results were achieved over the first ten years of the WBIF's existence, and testify to the fact that the rather complex type of cooperation that it established worked reasonably well in creating consensus on a common project pipeline of investment projects.⁴¹ In infrastructure, from 2009 to 2019, no less than 226 projects were supported by the grants of the WBIF, for a total investment cost of 22.5 billion euro, through 360 grants of a cumulated amount close to 1.3 billion euro.

Table 1 | Financing the WBIF project pipeline: IFI blending of WBIF grants and loans, 2009–19 (million euro)

Investment cost		Financing source		Instrument by IFI			
Monitoring IFI		Source	Total	Grants by IFI	Loans by IFI	of which signed	of which to be signed
CEB	612	Other sources	2,986	32	588	515	73
EBRD	7,816	External grant	1,087	637	6,093	1,891	4,202
EIB	11,845	WBIF loans	13,390	354	5,136	3,290	1,846
KfW	2,006	WBIF grants	1,262	256	1,154	557	597

⁴¹ The focus on the financial results presented here is justified, because ex ante it is not straightforward that so many stakeholders agree on such a broad range of investment projects that are all in line with EU policy. The figures should thus be interpreted first as indicators of "consensus performance". If one accepts further that consensus should lead to better projects (also thanks to the 4 eyes principle) these output figures can also be seen as indicators of expected actual impact at macro level. This does not mean that the impact at microeconomic level of each of these projects should not be examined at a later stage, when they will be finished. Nor does it mean that the mobilization of investment is sufficient for the needs of accelerating the growth of the Western Balkans. A back of the envelope calculation shows that the WBIF pipeline, which had an investment cost of 19.7 billion euro as of end 2018, represented that year some 5.6 per cent of the capital stock of the WB6 countries. Hence the pipeline will replace some 6 per cent of the present value of the WB6's capital stock once fully implemented and this could be seen as insufficient for the development needs of the region.

WB	217	External loans	377	12	419	348	71
Other	15	Own contributions	2,986	3	377	110	267
Total	22,511		22,511	1,295	13,766	6,711	7,055

CEB: Council of Europe Development Bank

EBRD: European Bank for Reconstruction and Development

EIB: European Investment Bank

KfW: Kreditanstalt für Wiederaufbau (the main German state-owned development bank)

WB: World Bank

Source: Elaborations of the author on data extracted from the WBIF-MIS.

These grants – mainly coming from the European Commission, but also from 20 bilateral donors – leveraged 321 IFI loans of a total value of 13.8 billion euro. Of these, 146 have already been signed for a total value of 6.7 billion euro and another 122 have been identified for a value of 7.1 billion euro and will be signed in the future. The level of blending achieved is thus quite substantial, as also shown in Table 1 above.

In terms of infrastructure, the WBIF covered a broad range of sectors. Energy, transport and environment account for roughly the same number of projects (respectively 64, 61, 60), followed by the social sector (32). As shown in Table 2 below, in monetary terms the most capital intensive sectors of transport and energy concentrate most of the WBIF financial resources.

Table 2 | WBIF project pipeline by sector, 2009–19, 2009–19 (million euro)

Investment cost		Financing source		WBIF grants	WBIF loans		
Sector		WBIF loans & grants	Others		Total loans	signed	to be signed
Digital	252	201	51	6	172	4	168
Energy	5,884	4,040	1,844	249	3,835	970	2,865
Environment	2,795	1,952	844	143	1,700	932	769
Social	3,250	2,044	1,206	50	1,941	-	-
Transport	10,034	6,240	3,794	838	6,118	1,177	764
Private sector development	297	-	297	9	-	3,628	2,490
Total	22,511	14,477	8,035	1,295	13,766	6,711	7,055

Source: Elaborations of the author on data extracted from the WBIF-MIS.

In addition to infrastructure, the Western Balkans Enterprise and Innovation Facility (WB EDIF) was created in 2011 to provide a platform for SMEs (small and medium-sized enterprises) for the WB6 region – i.e. the area comprising the half-dozen Western Balkan countries still in the process of EU accession: Albania, Bosnia Herzegovina, Kosovo, Montenegro, North Macedonia and Serbia. From the beginning, the platform included two equity pillars (Enterprise Innovation Fund or ENIF and Enterprise Expansion Fund or ENEF), one guarantee pillar (Guarantee Facility or GF) and one Advisory and Support Services pillar (AS). A competitiveness pillar was added later. Today, most of the WB EDIF pillars are operational and as of end 2019 the facility has committed 760 million euro in funding, financing 500 projects involving 5,390 SMEs, which supported 112,705 jobs.⁴² In 2018, a European Youth Employment and Training Initiative of 10 million euro was proposed by the European Investment Bank (EIB) Group. The EU contribution was approved in 2019, and it is becoming operational in 2020. Also in 2019, a 20 million euro grant was approved for the European Bank for Reconstruction and Development (EBRD) Small Business Support TA programme (SBS) and for the World Bank's EU REPARIS programme.

Finally, two platforms proposed by EBRD were established in the context of the WBIF that focus on energy efficiency in the private sector. They blend European Commission grants with EBRD and KfW (German Credit Institute for Reconstruction) loans, also providing support in the form of technical assistance. Overall, these two energy-efficiency facilities have a budget of 393 million euro – of which 47.7 are investment grants, 28 are technical assistance grants and 317 are loans, mainly from the EBRD.

2.4 Judgement

In general, the cooperation achieved between donors and beneficiaries in the WBIF is recognized as a value added of the instrument per se, and is acknowledged to work well. This was not straightforward ex ante,

⁴² Western Balkans Enterprise Development and Innovation Facility (WB EDIF), *Annual Report 2019*, 31 December 2019, p. 5, <http://www.wbedif.eu/?p=3126>.

considering that there are 20 bilateral donors, 6 recipient countries and several international and bilateral financing institutions who take decisions by consensus. Certainly, the fact that this cooperation was developed for a specific region where there was a rather natural consensus on the needs of reconstruction, transition to a market economy and preparation for EU accession helped to strengthen the process. Cooperation also benefited from some cultural homogeneity in the area on the beneficiaries' side, despite the well-known religious divisions that were so much exploited by destabilizing forces during the war and that are still today a potential threat to its stability.

In thinking about the scalability of the WBIF, the main message seems to be that this type of consensus cooperation can be made to work in geographically defined areas where a broad policy consensus on priorities exists or can be naturally built up, the instruments themselves contributing to this built-up. For the WBIF there was an initial agreement on a few high-level objectives such as reconstruction, transition and EU accession. Starting from shared broad objectives, it is possible to define lower-scale targets that ultimately translate into concrete cooperation at project level in a way that is then part of a general strategy – defined in this case in the context of European Commission accession policy. This requires an institutional framework that is as lean as possible and allows sequential interactions. This institutional framework is needed because important background policy work is required. In the absence of dedicated institutions able to lead it (such as the European Commission in the case of WBIF), the framework should at least be compensated by the adherence of the interested stakeholders to concrete goals and targets, as discussed in the next section.

3. COORDINATION IN PURSUING SDGs: CONCESSIONALITY FOR CLIMATE PROJECTS IN THE PRIVATE SECTOR

3.1 Background

Kanie Norichika and Frank Biermann claim that developing the Sustainable Development Goals (SDGs) is a means to foster international coop-

eration that will, in the end, enhance their realization.⁴³ However, since there is no central government able to enforce SDGs at world level, their realization is left to the decentralized *voluntary cooperation* of individuals, as well as local and central governments and their financing institutions (bilateral or multilateral).

In this section, the argument is developed that for private-sector projects the logic of defining common SDGs (with their intermediate targets and evaluation indicators) should be extended to the coordination of the main parameters necessary to define public support at project level⁴⁴ – and, notably, the shadow (or accounting) prices to be used to determine such support. This would reduce the decisional uncertainty referred to in the first section and render practical cooperation possible at project level, thus increasing the likelihood that the SDGs are effectively realized at the required scale.⁴⁵ A formal framework for discussing the main parameters to be considered in order to determine public support at project level is introduced below, and is presented in more detail in the Appendix.

3.2 Indicative project parameters

Let us assume that there is a project that enhances the realization of the SDGs – say, a project that will remove X units of pollutants over the course of its economic life. Let us further assume that the shadow (or accounting) discounted value of the removal of one unit of pollutant is PS , however this is calculated.⁴⁶ The social value of this project is then shown by $VS = PS \cdot X$. If PM is the discounted price at which one unit of pollutant can be sold on the market (PM can be negative), the project has market value, which is a cash flow (revenue) for its owner of $VM = PM \cdot X$ in present value terms.

⁴³ Kanie Norichika and Frank Biermann (eds), *Governing Through Goals*, cit.

⁴⁴ It is assumed that the project is sufficiently mature to determine these parameters.

⁴⁵ It is of course always possible for a few donors to agree on the main parameters for support to a single project, but this microeconomic voluntary cooperation is unlikely to address systematically an investment challenge of the size of a few points of world GDP per year.

⁴⁶ Massimo Florio, *Applied Welfare Economics. Cost-Benefit Analysis of Projects and Policies*, New York/London, Routledge, 2014, chapter 3.

If c_u is the discounted unit cost of the project before earnings and financing (inclusive of investment cost and entrepreneur's remuneration) and r is the average per centage cost of obtaining financing for the project on the market (a "real" interest rate), what could be called the "natural profit", labelled π , is that profit that covers the project costs inclusive of investment. Accordingly, we can distinguish the following three components of the cost of production of X :

- 1) the cost before financing and profit $CBFP = c_u * X$ (cost incurred to pay the factors of production and the raw materials);
- 2) the cost of obtaining financing for the project: $CF = r * CBFP$ ⁴⁷; and
- 3) the "natural" earnings for the owner of the project: $\pi * (CF + CBFP)$.⁴⁸

The "natural cost" of the project that would prevail under maximum efficiency is then:

$CN = (1 + \pi) * (CF + CBFP)$. This cost is generally unobservable. What can be observed is the cost C , which includes what can be called the target profit rate of the investor π^* ,⁴⁹ which could potentially converge towards the "natural" competitive profit rate under free entry – a condition unlikely to be

⁴⁷ In classical economics there is no distinction between the rate of profit and the rate of interest. In neo-classical economics $\pi=r$ under the golden rule of the steady state, which is also the one that maximises efficiency. For Post-Keynesians, the Cambridge equations states that the rate of profit is equal to the growth rate divided by the savings rate of the capitalists, while the former should also be equal to the rate of interest (see Massimo Cingolani, "Interest, Growth, and Income Distribution: What Ought to Be the Objectives of EU Macroeconomic Policy Coordination?", in *International Journal of Political Economy*, Vol. 40, No. 4 (2011-12), p. 31-61. If risk is introduced, as it was done more systematically in the neo-classical tradition, most economists working under this paradigm would argue that $\pi > r$, which implies that the risk is transferred to the consumer. *De facto*, one observes that generally the financial rate of profit exceeds by far the rate of interest.

⁴⁸ The profit rate is defined here over all invested capital: circulating and fixed.

⁴⁹ To simplify, it is assumed that, if any, financial rents are included in π^* and r is a competitive rate. It is clear that the latter assumption can only be provisional and that conditions should be expected to be non-competitive in a development context, i.e. characterized by the lack of convergence of rates of return to a single value. In such cases, one can assume both the minimum profit rate and the range of sectoral rates of return as given; see: Paolo Sylos Labini, "L'utilizzo del contributo di Sraffa nell'analisi dello sviluppo", in *Convegno internazionale Piero Sraffa*, Roma, Accademia nazionale dei Lincei, 2004, p. 335-346.

fulfilled in a development context. The target profit rate exceeds the natural rate by an amount that could be called a rent: $\pi^* = \pi + \text{Rent}\%$. Therefore, the actual cost of the project observable on the market is:

$$C = (1 + \pi^*) \cdot (CF + CBFP) = (1 + \pi) \cdot (CF + CBFP) + \text{Rent}.$$

Following the logic of Arthur Pigou, the maximum public support that can be given to this project is: $MPS = VS - VM = (PS - PM) \cdot X$.⁵⁰ For a project complying with SDGs, it is reasonable to assume that its social value exceeds its market value ($VS > VM$) and that therefore $MPS > 0$. We should also not be too surprised to see a market value below the total cost of the project, otherwise it would not be so difficult to achieve the SDGs. The net market cash flow of the project, $NMV = VM - C < 0$, would thus be negative for a typical SDG project.

Without public support the private sector would be unwilling to undertake the project because its return would be below the target rate of profit. For the project to be undertaken, the available public-sector support for the project, APS , would therefore have to be higher than the minimum public support, $mPS = -NMV$. The latter would probably be higher than the desired or preferred level of support from the public sector, which is $DSP = mPS - \text{Rent}$ but is unknown. In any case, any level of available public support above mPS would allow the project to be undertaken by the private sector:

$$APS \geq mPS$$

⁵⁰ Arthur Cecil Pigou, *The Economics of Welfare*, 4th ed., London, Macmillan, 1932. This is for instance the principle that DG REGIO's applied to calculate the *Funding Gap* in EU regional projects (see Andrea Mairate and Francesco Angelini, "Cost-Benefit Analysis and EU Cohesion Policy", in Massimo Florio (ed.), *Cost-Benefit Analysis and Incentives in Evaluation. The Structural Funds of the European Union*, Cheltenham/Northampton, Edward Elgar, 2007, p. 49-64), which went beyond Pigou. It is noteworthy that, strictly speaking, Pigou's analysis assumes that resources are fully used and income is equally distributed (see Richard F. Kahn, "Some Notes on Ideal Output", in *The Economic Journal*, Vol. 45, No. 177, March 1935, p. 2).

As noted above, the total value relation for the project being , the maximum public support that the public sector would accept for the project is MPS:

$$MPS = V_S - V_M.$$

Above MPS, the public sector would stop supporting the project because its costs to society would exceed the social benefits. Hence, in the end the range for which APS makes the project feasible is bounded by mPS and MPS:

$$mPS \leq APS \leq MPS$$

Within these boundaries, the specific distribution of APS will determine the probability that the project occurs, which will be zero outside of this range. The length of this “project feasibility interval” is: . As detailed in the Appendix below, taking as given (or observable) the market price PM, the unit investment costs cu and the interest rate r, the main unknown or exogenous parameter influencing mPS is shown to be the target rate of profit of the private sector π^* , whereas the main unknown exogenous parameter influencing MPS is the shadow price of the output PS. The bounds mPS and MPS thus depend on parameters that are generally non-observable, and on which there can be differences of opinions between stakeholders: PS for MPS, which depends on the specific social-welfare function of each donor, and π^* for mPS, which includes the Rent parameter known to the investor but not to the donors.

3.3 Advantages of cooperation in setting common targets

Now, assume several donors i ($i = 1, \dots, n$) pool their grant support for a project, trying to reach an aggregate amount of public support as close as possible to mPS (to eliminate unknown rents). Each donor will have their independent opinion on the highest and lowest (unitary) levels of support that they consider adequate for this particular project. If these opinions are independent and distributed normally, aggregating the various MPSi and mPSi defines the range of available public support (APS) for the project from these donors, which would be given by the interval: . Under the assumptions retained, this interval will be distributed following a normal distribution with a mean equal to the difference between the sum of the means of the maximum and mini-

mum supports and with variance equal to the sum of the individual variances. For instance, with two donors labelled 1 and 2, if we have:

$$\begin{aligned} MPS_1 &= N[\mu_{MPS1}; \sigma_{MPS1}]; mPS_1 = N[\mu_{mPS1}; \sigma_{mPS1}] \\ MPS_2 &= N[\mu_{MPS2}; \sigma_{MPS2}]; mPS_2 = N[\mu_{mPS2}; \sigma_{mPS2}] \end{aligned}$$

where N indicates the normal distribution, μ its mean and σ its standard error, the distribution of the range for the aggregate supports will be given by:

$$\begin{aligned} MPS_2 - mPS_1 - mPS_2 \\ = N \left[\mu_{MPS1} + \mu_{MPS2} - \mu_{mPS1} - \mu_{mPS2}; \sqrt{\sigma_{MPS1}^2 + \sigma_{mPS1}^2 + \sigma_{MPS2}^2 + \sigma_{mPS2}^2} \right] \end{aligned}$$

Then agreeing ex ante on the value of the shadow prices to be used for valuing the project's output will reduce the uncertainty attached to the distribution of the maximum public support aggregated for the two donors, which would obviously have a lower standard error when σ_{MPS1} and σ_{MPS2} are zero ($MPS1$ and $MPS2$ will then be known with certainty). The same is true if an agreement is reached on a higher bound for the parameter π^* , which determines the aggregated minimum public support mPS . Other things being equal, agreement on these two factors of exogenous uncertainty will reduce the time needed to find an agreement on the public support to be given to the project, facilitate the collective decision-making on the project's financing and increase the probability that the level of public support is not defined outside the range of justified project feasibility (i.e. lower than mPS or higher than MPS).

CONCLUSION

The experience of the WBIF confirms that consensus decision-making may help in building support for shared objectives on concrete projects. Blending allows grants to focus on projects that have a better chance of having an impact because they are linked to IFI loans, while grants integrate the required policy dimension sometimes absent from the IFIs' quasi-commercial loans. The principles of the WBIF seem sound:

- Ownership of final beneficiaries seems a logical prerequisite for development.
- The holistic policy approach – including infrastructure, SMEs, energy efficiency, climate change and the private sector – is also a less obvious prerequisite for development.
- The fact that the WBIF is embedded in the EU pre-accession policies is consistent with the conclusions of the Wieser Report.⁵¹
- The pooling of expertise and funding between IFIs leverages scarce grants.
- The “four eyes” principle fosters effectiveness.
- The common pipeline of priority projects implies a joint commitment of all stakeholders for the future – and hence, the coordination of expectations (and the reduction of uncertainty).

Experience shows that over the years in which these principles were applied by several donors in six recipient countries of the Western Balkans, they allowed support to be given to a broad range of sectors with sizeable amounts of grants and loans.

Similarly, given that SDGs assume decentralized planning procedures in which there is no umbrella coordination by any structure other than that of voluntary cooperation, to make them successful it is advisable to foster cooperation further and to set common objectives at project level for the accounting prices and maximum allowable target profit rate of the private sector. These are important parameters, on the basis of which suitable levels of project concessionality can be calculated. It can be suggested that the appropriate concessionality levels for climate projects in the private sector should consider:

1. The economic and social return of the project: a synthetic measure of the economic and financial flows generated by the project evaluated from a policy perspective (i.e. including

⁵¹ Thomas Wieser (chair), *Europe in the World. The Future of the European Financial Architecture for Development*, An Independent Report by the High-Level Group of Wise Persons on the European Financial Architecture for Development, Brussels, Council of the European Union, October 2019, https://www.consilium.europa.eu/media/40967/efad-report_final.pdf.

externalities), which depends on the shadow price of the project output.

2. The financial return of the project before financing and earning: a synthetic measure of the stream of cash flows generated by the project.
3. The cost of funding to the borrower or investor: a synthetic measure of the cost (if any) at which a borrower can finance their project on the market.
4. The target rate of return of the investor: the minimum return that the investor expects from the project's financial cash flows in order for them to undertake the project.
5. The price at which any blended finance is provided for the project inclusive of concessionality, which can be assessed in terms of pure grant equivalent. The latter should be comprised between the bounds of minimum and maximum public support discussed in Section 3 and in the Appendix below.

Taking the above parameters into account, a possible decision principle to refer to could be: provided that (4) remains reasonable, it is only for projects for which (1) exceeds (2) that (5) could and should be lower than (3) and part of the difference between the IFI conditions and (4) could be covered by public funding.

Following this rule should facilitate decentralized collective decision-making on SDG projects and increase the probability that the relevant projects are realized – and, thus, that their impact is achieved.

APPENDIX: MODEL USED IN SECTION 3.2

Assuming as given a “normal profit rate” above the exogenous rate of interest, a formalization of the problem discussed in Section 3.2 is provided by the following system, made of 18 variables linked by 11 equations.

$$\left\{ \begin{array}{l} V_S = P_S X \\ V_M = P_M X \\ C_{BFP} = c_u X \\ C_{FIN} = r C_{BFP} \\ CF = VM - C_{BFP} - C_{FIN}; \\ NC = (1 + \pi)(C_{BFP} + C_{FIN}) \\ Rent = (\pi^* - \pi)(C_{BFP} + C_{FIN}) \\ C = (1 + \pi^*)(C_{BFP} + C_{FIN}) \\ mPS = C - V_M \\ MPS = V_S - V_M \\ DPS = mPS - Rent \end{array} \right. \quad (I).$$

The acronyms are defined by

X	Cumulated output of the project
C	Total cost of the project
c_u	Discounted unit cost of the project before earnings and financing (*)
C_{BFP}	Cost of the project before earnings and financing (*)
C_{FIN}	Financing costs (real)
NC	Normal cost
CF	Cash flow
P_M	Market price of output
P_S	Shadow price of output
V_M	Market value of output
V_S	Social value of output
R	Percentage financing cost
π	Normal profits (percentage)
π^*	Target profits (percentage)
$Rent$	Rent
mPS	Minimum public support
MPS	Maximum public support
DSP	Publicly desired public support

(*) Inclusive of investment cost

The exogenous variables are: c_u , P_M , P_S , π^* , r and X . Solving the nine equations for the endogenous variables gives the final form of the model,⁵² which is given by the system II:

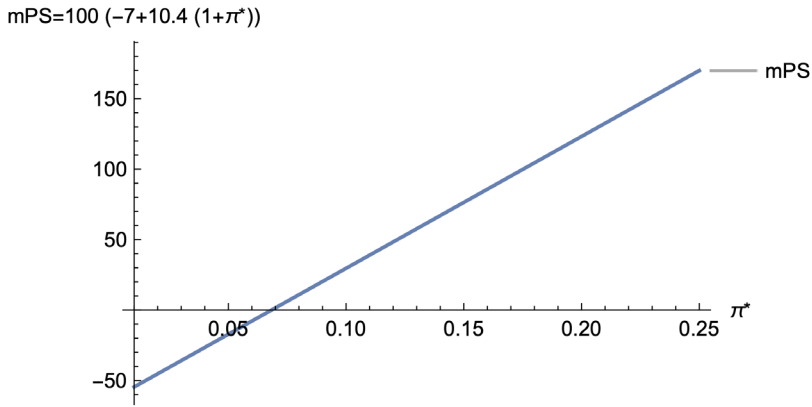
⁵² Patrick Artus, Michel Deleau and Pierre Malgrange, *Modélisation macroéconomi-*

$$\left\{ \begin{array}{l} V_S = P_S X \\ V_M = P_M X \\ C_{BFP} = c_u X \\ C_{FIN} = r c_u X \\ CF = [P_M - (1 + r)c_u]X \\ NC = (1 + \pi)(1 + r)c_u X \\ C = (1 + \pi^*)(1 + r)c_u X \\ Rent = (\pi^* - \pi)(1 + r)c_u X \\ mPS = [(1 + \pi^*)(1 + r)c_u - P_M]X \\ MPS = (P_S - P_M)X \\ DPS = [(1 + \pi)(1 + r)c_u - P_M]X \end{array} \right. \quad (II).$$

The solution (II) implies, for instance, that if we take the values of 100 for output X , 10 for its market price P_M , 9 for the unit cost c_u , 4 per cent for the interest rate or financing cost r , 20 for the shadow price of output P_S , 8 per cent for the normal profit rate and 25 per cent for the target profit rate of the investor π^* , then the result for the endogenous variables is: ($V_S = 2,000$; $V_M = 1000$; $CBFP = 900$; $CFIN = 36$; $C = 1,170$; $CF = 64$; $Rent = 159$; $mPS = 170$; $MPS = 1,000$; $DPS = 10.88$).

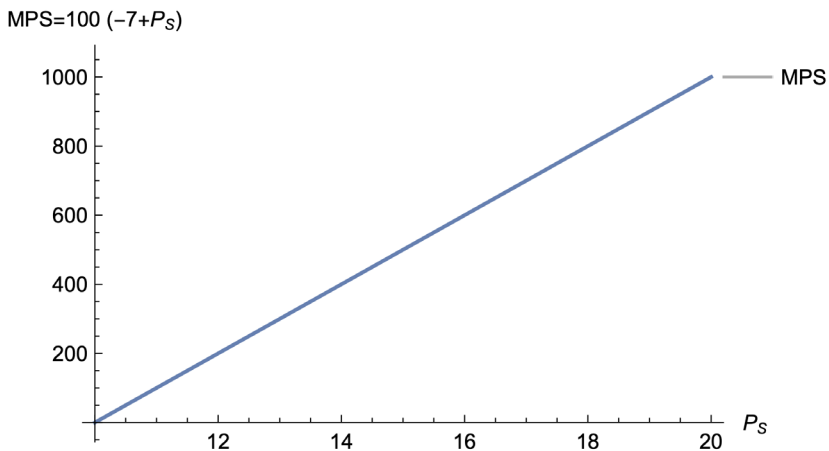
Keeping the other parameters fixed at the value in the above example, Figure 3 below shows the sensitivity of the minimum public support mPS to changes in the target profit rate of the private sector π^* , showing that when the latter changes from 0 per cent to 25 per cent, the minimum possible subsidy varies between 0 and 170, which could be compared with a total “natural” project cost (cost before profit) remaining constant at 1,011 while total cost varies between 936 and 1,170:

que, cit., p. 120-124.

Figure 3 | Sensitivity of the minimum public support to the target profit rate

Source: Own calculations.

Similarly, Figure 4 below shows that for a shadow price varying between 0 and 20, the maximum public support (MPS) would vary in principle between 0 and 1,000. Beyond that level of support, the public sector would not finance the project.

Figure 4 | Sensitivity of maximum possible support to the shadow price of output

Source: Own calculations.

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3.

Development Fund in Fragile States: The Role of Institutions

Alessia Isopi

According to the last OECD report, by 2030 some 80 per cent of the world's poor will live in *fragile contexts*. In this chapter, we discuss the role of the local private sector in those contexts and how the multilateral agencies such as the European Union should engage in this process. The most recent Economic literature has highlighted the role played by the institutions that rule a country for its development and long term growth. What happens in a country where institutions have been severely undermined by a recent conflict? Fragile settings are well known for stretching the limits of multilateral organisation in many ways: security concerns, limited access to partner government and high staff turnover make the interaction with the local institutions particularly difficult. If in other contexts both bilateral and multilateral aid agencies have traditionally seen sovereign governments as their natural partners and/or arenas of action in fragile contexts states are often weak or predatory. One recent response to those difficulties it has been to turn to the private sector for help. The scope of this analysis is to identify if and when the private sector can represent the ideal partner (or "institution") with which the European Union needs to interact in those environments.

INTRODUCTION

In the last decade the number of countries classified as *fragile states* has increased considerably. In 2020, 76.5 per cent of people who live in conditions of extreme poverty live in the 57 countries on the unstable states

list.¹ According to the latest OECD report, by 2030 some 80 per cent of the world's poor will live in *fragile contexts*. Partly, it is because the weakness of public services in these societies exposes them to health shocks that can spread across borders. The largest proportion happens to be in Sub-Saharan Africa, followed by Middle East, Nord Africa and Asia. Despite the fact that fragile states are situated in almost every continent of the World, they all share some negative records such as a low life expectancy and having authoritarian regimes; on top of that, out for the 13 countries considered extremely fragile, 10 countries were in active conflict in 2019. For these reasons, fragile states can be considered the future of aid: poor countries that are politically stable are increasingly gaining access to capital markets and therefore they are less likely to rely on this type of support.

Fragility is not a simple phenomenon because requires the understanding of many informal aspects of the society such as social norms and capital, culture and underlying social network activities. All these elements represent the foundations of the institutions to which we delegate the power of improving citizens' lives. As has been documented by the work of Acemoglu, Johnson and Robinson in order to understand the ultimate causes of underdevelopment, not only it is necessary to explore why certain institutions prevail with respect to others but also what are the economic implications of certain institutional systems.² Fragile states, by definition, are countries where this original system has been either severely compromised by the conflict or is considered extremely

¹ Organisation for Economic Co-operation and Development (OECD), *States of Fragility 2020*, Paris, OECD, 2020.

² See Daron Acemoglu, Simon Johnson and James A. Robinson, "The Colonial Origins of Comparative Development: An Empirical Investigation", in *The American Economic Review*, Vol. 91, No. 5 (December 2001), p. 1369-1401, <https://doi.org/10.1257/aer.91.5.1369>; Daron Acemoglu, Simon Johnson and James A. Robinson, "Reversal of Fortune: Geography and Institutions in the Making of the Modern World Income Distribution", in *The Quarterly Journal of Economics*, Vol. 117, No. 4 (November 2002), p. 1231-1294, <https://economics.mit.edu/files/4127>; Daron Acemoglu, Simon Johnson and James A. Robinson, "The Rise of Europe: Atlantic Trade, Institutional Change and Economic Growth", in *American Economic Review*, Vol. 95, No. 3 (June 2005), p. 546-579, <https://economics.mit.edu/files/4466>.

unstable. This poses an extreme challenge to the international community that plans an intervention in those areas because, compared to other developing countries, in fragile states it is not always easy to identify the right partner to initiate a discussion regarding the implementation of a particular development program. Recently the international development community has identified in the local private sector the right temporary partner to reconstruct the institutional system in fragile states. If on one side it is true that the private sector is the first one to be hit by a conflict and that therefore tends to disappear first, it is also true that it is the one that has the higher marginal rate of growth once peace is again restored.

The aim of this contribution is to discuss the importance of the private sector as an institutional partner in contexts where the official institutional partners are not there or are in an embryonal stage. The most recent literature has identified in the lack of a solid institutional system not only one of the main reason to explain current underdevelopment but also to predict the lack of growth in the long run. When countries cannot rely on their current governments, it becomes crucial for long term growth to establish the identity of the *second best* player.

The chapter is organized as follows. Section 1 discusses the recent theories that explain differences across countries in terms of growth and economic development. We then establish the characteristics of fragile states and the type of institutions (or lack of) that rule in those countries. We conclude by discussing the new role that the private sector can have in those contexts and what are the challenges that they might encounter by playing it. Last section concludes.

1. THE ROLE OF INSTITUTIONS FOR COUNTRIES' DEVELOPMENT

Since the series of papers by Acemoglu, Johnson and Robinson came out 20 years ago, the origins of development have been completely revised. In the previous decade, the literature considered the production function, the leading element for understanding how the growth process can develop within a country. First, it was the lack of capital the element that prevented countries from growing. Donor countries reacted

to that news by channelling foreign aid into developing countries focusing in particular on the ones with the highest poverty rates. But after decades, very limited evidence was provided that this was the best way forward. And so the focus shifted from lack of physical capital to the lack of skilled labour (human capital). In terms of policy implication that led to an increase in the investments of primary and secondary education and to support program that favoured school enrolment in developing countries. The rationale behind those interventions was that developing countries did not have a sufficient level of education to use the investment in capital in a productive way, so in terms of priority developing countries should have focussed in increasing the marginal productivity of the workers via increasing the average level of education. But again, even if is undeniable the positive effect that a country can receive from a more educated population, many developing countries are still severely underdeveloped.

In the early 2000, Acemoglu, Johnson and Robinson produced a series of papers that for the first time linked the differences of growth performance among countries to the way in which societies are organized, i.e. to their institutions. Douglas North had already identified in the institutions a key player for the economic performance of the society,³ Acemolu et al. went a step forward by isolating a source of exogenous differences in institutions to study how a number of otherwise-identical societies end up with different sets of institutions. The exogenous factor that the authors isolate is the European colonization. From the late fifteenth century, Europeans dominated and colonized much of the rest of the globe. Together with the European dominance came the imposition of very different institutions and social power structures in different parts of the world. Acemoglu, Johnson, and Robinson document that in a large number of colonies, especially those in Africa, Central America, the Caribbean, and South Asia, European powers set up “extractive states”.⁴

³ Douglass C. North, *Institutions, Institutional Change, and Economic Performance*, Cambridge/New York, Cambridge University Press, 1990.

⁴ Daron Acemoglu, Simon Johnson and James A. Robinson, “The Colonial Origins of Comparative Development”, cit.

These institutions (again broadly construed) did not introduce much protection for private property, nor did they provide checks and balances against the government. The explicit aim of the European in these colonies was extraction of resources, especially natural resources, in one form or another. This colonization strategy and the associated institutions contrast with the institutions Europeans set up in other colonies, especially in colonies where they settled in large numbers, for example, the United States, Canada, Australia, and New Zealand. In these colonies the emphasis was on the enforcement of property rights for a broad cross section of the society, especially smallholders, merchants, and entrepreneurs. The term “broad cross section” is emphasized here, since even in the societies with the worst institutions, the property rights of the elite are often secure, but the vast majority of the population enjoys no such rights and faces significant barriers preventing their participation in many economic activities. Although investments by the elite can generate economic growth for limited periods, for sustained long run growth property rights for a broad cross section seem to be crucial.⁵

A crucial determinant of whether Europeans chose the path of extractive institutions was whether they settled in large numbers. In colonies where Europeans settled, the institutions were being developed for their own future benefits. In colonies where Europeans did not settle, their objective was to set up a highly centralized state apparatus, and other associated institutions, to oppress the native population and facilitate the extraction of resources in the short run. Based on this idea, Acemoglu, Johnson, and Robinson suggest that in places where the disease environments made it easy for Europeans to settle, the path of institutional development should have been different from areas where Europeans faced high mortality rates.⁶ In practice, during the time of colonization, Europeans faced widely different mortality rates in colonies because of differences in the prevalence of malaria and yellow fever. These there-

⁵ Daron Acemoglu, *Introduction to Modern Economic Growth*, Princeton, Princeton University Press, 2009.

⁶ Daron Acemoglu, Simon Johnson and James A. Robinson, “The Colonial Origins of Comparative Development”, cit.

fore provide a possible candidate for a source of exogenous variation in institutions. These mortality rates should not influence output today directly, but by affecting the settlement patterns of Europeans, they may have had a first-order effect on institutional development. There are a number of channels through which potential settler mortality could influence current economic outcomes or may be correlated with other factors influencing these outcomes. Nevertheless, there are also good reasons for why, as a first approximation, these mortality rates should not have a direct effect. Malaria and yellow fever were fatal to Europeans who had no immunity, thus having a major effect on settlement patterns, but they had much more limited effects on natives who, over centuries, had developed various types of immunities. The data also show that there were major differences in the institutional development of the high-mortality and low-mortality colonies. Moreover, consistent with the key idea in Acemoglu, Johnson, and Robinson, various measures of broad institutions, for example, measures of protection against expropriation are highly correlated with the death rates Europeans faced more than 100 years ago and with early European settlement patterns.⁷ They also show that these institutional differences induced by mortality rates and European settlement patterns have a major (and robust) effect on income per capita. Acemoglu, Johnson, and Robinson focus on another important aspect, how densely different regions were settled before colonization.⁸ They document that in more densely settled areas, Europeans were more likely to introduce extractive institutions because it was more profitable for them to exploit the indigenous population, either by having them work in plantations and mines, or by maintaining the existing system and collecting taxes and tributes. This suggests another source of variation in institutions that may have persisted to the present, and Acemoglu, Johnson, and Robinson show similar large effects from this source of variation.⁹ Another example that illustrates the consequences of difference in institutions is the contrast between

⁷ Ibid.

⁸ Daron Acemoglu, Simon Johnson and James A. Robinson, "Reversal of Fortune", cit.

⁹ Ibid.

the Democratic People's Republic of Korea and the Republic of Korea.

The geopolitical balance between the Soviet Union and the United States following the World War II led to separation along the 38th parallel. The Democratic People's Republic of Korea, under the dictatorship of Kim Il Sung, adopted a very centralized command economy with little role for private property. In the meantime, the Republic of Korea relied on a capitalist organization of the economy, with private ownership of the means of production, and legal protection for a range of producers, especially those under the umbrella of the chaebols, the large family conglomerates that dominated the Republic of Korea's economy. Although not democratic during its early phases, the Republic of Korea's state was generally supportive of rapid development and is often credited with facilitating, or even encouraging, investment and rapid growth. Under these two highly contrasting regimes, the economies of the Democratic People's Republic of Korea and the Republic of Korea diverged. While the Republic of Korea has grown rapidly under capitalist institutions and policies, the Democratic People's Republic of Korea has experienced minimal growth since 1950, under communist institutions and policies. Overall, a variety of evidence paints a picture in which broad institutional differences across countries have had a major influence on their economic development. This evidence suggests that to understand why some countries are poor we should look at why their institutions are dysfunctional, which is the definition of a fragile state.

2. INSTITUTIONS (AND LACK OF) IN FRAGILE STATES

The OECD's definition of fragile state (or region) it is one having "weak capacity to carry out basic governance functions, and [which] lacks the ability to develop mutually constructive relations with society. Fragile states are also more vulnerable to internal and external shocks such as economic crises or natural disasters."¹⁰

¹⁰ OECD, *Fragile States 2013: Resource Flows and Trends in a Shifting World*, Paris, OECD, 2012, p. 15, <http://www.oecd.org/dac/conflict-fragility-resilience/docs/FragileStates2013.pdf>.

The World Bank formal definition, where state is deemed “fragile” considers if it is a low-income country or territory, IDA eligible (including those countries which may currently be in arrears), with a Country Policy and Institutional Assessment (CPIA) score of 3.2 or below, and has had a UN peacekeeping mission present at any time in the last three years.¹¹ Countries are considered “core” fragile states if their CPIA is below 3.0 or there is no data available; countries are considered “marginal” fragile states if their CPIA score is between 3.0 and 3.2. Such an approach yields a current list of 35 countries, which explicitly or implicitly, largely become the basis for determining fragility used by all the multi-lateral development banks and most donors. The CPIA score for each country at any particular moment is essentially determined by asking country experts for their views on sixteen governance issues (e.g., corruption, contract enforcement, etc.). As its very title suggests, however, the CPIA was not set up to determine state “fragility”, but became a default proxy measure for fragility when analysts discovered that the CPIA initially seemed to be strongly correlated with other (less comprehensive) indicators of fragility.

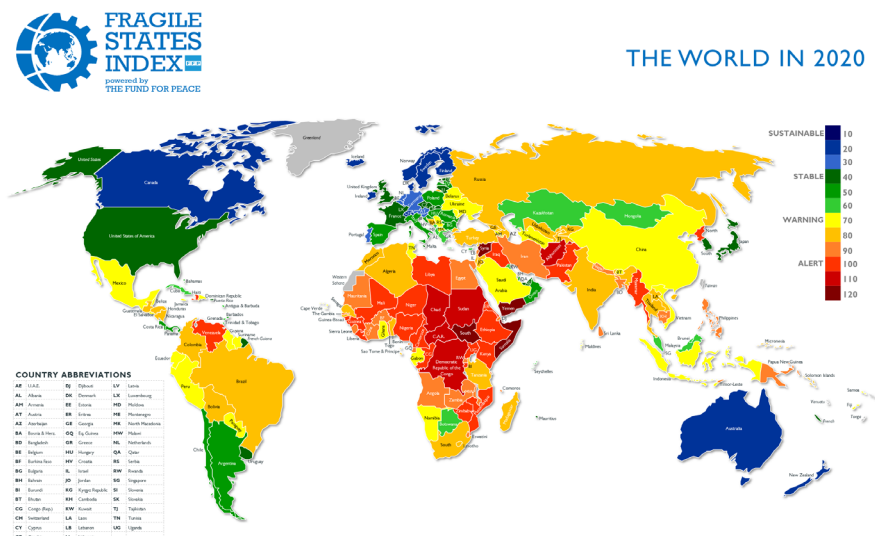
As anticipated in the introduction, fragile situations matter because they are home to an increasingly concentrated proportion of the world’s poor.¹² This is because conflict and fragility actively undermine development and the fight against poverty is slower in fragile states than elsewhere.

Specific lists of fragile states have been produced by national aid agencies, international organizations, and individual research teams. For example, consider the map of the world’ most fragile states illustrated in Figure 1. In this figure, countries are classified according to their decile in the distribution of fragility. Countries with the greatest fragility are coloured in red while those with least fragility are in blue.

¹¹ World Bank website: *Classification of Fragile and Conflict-Affected Situations*, last updated 9 July 2020, <https://www.worldbank.org/en/topic/fragilityconflictviolence/brief/harmonized-list-of-fragile-situations>.

¹² OECD, *Development Co-operation Report 2013. Ending Poverty*, Paris, OECD, 2013, <https://www.oecd.org/development/dcr2013.htm>.

Figure 1 | The world's most fragile states (120 = highest fragility)



Source: The Fund for Peace, 2020 *Fragile States Index Map*, <https://fragilestatesindex.org/analytics/fsi-heat-map>.

Intermediate deciles are coloured in shades of red and blue. According to this classification, the most fragile states are found in Sub-Saharan Africa and South Asia.

Helping fragile states escape from capability traps involves pursuing development interventions based on a very different set of principles from those characterizing current practice. The rationale beyond this approach is represented by the Paris Declaration which has changed the way in which donors do business.¹³ In this declaration key principles have been identified to improve the quality of aid and its impact on development.

These interventions should:

1) aim to solve particular problems in local contexts. The idea is that there should be a very detailed knowledge of the local context in which

¹³ OECD, *The Paris Declaration on Aid Effectiveness and the Accra Agenda for Action*, Paris, OECD, 2009, <https://www.oecd.org/dac/effectiveness/34428351.pdf>.

the intervention is happening. Inspired by the ownership principle of the Paris declaration this means that is the country that sets its own strategy and the approach should have a very specific focus to enhance accountability.

2) Adapting as much as possible the project design to the current circumstance. The context of a fragile state in which the international organizations operate is crucial and requires specifically designed measures rather than “one-size-fits-all” approach. Following the alignment principle this means that whatever support comes from outside must be in line with the local strategies and use the local system as much as possible.

3) Involving active, ongoing and experiential learning and the feedback of lessons into new solutions (as opposed to enduring long lag times in learning from ex post “evaluation”). The only way to progress is to learn from past experiences to not repeat the same mistakes again. This is the managing for results principle where every player involved in support programs should aim at producing and measuring the results obtained. Especially in fragile states context this should be done as much as possible at the same time of the project implementation compared to an ex post evaluation in order to be flexible and with the possibility of changing toolkit in due course rather than after.

4) Engaging broad sets of agents to ensure that reforms are viable and relevant – i.e., politically acceptable and practically possible. The wider is the local consensus the more likely the program will be a success. We go back here to the ownership principle that aims at having on board local authorities and players to make sure that they participate in choosing which project/reform to prioritize. To make this approach work, decision makers need to be given (or themselves create) a solid authorizing environment where to begin the process of articulating and implementing a different approach, one committed to building the capability of local teams to identify and prioritize problems, to assess the current nature and extent of these problems, to interrogate how positive change is being achieved, and to share this with others through a local community of practice.

Fragility matters because of the risk it poses to regional and global

stability.¹⁴ Thus, the rationale for international engagement in fragile states is driven both by a security and a development agenda. The growing importance of international support in tackling poverty and promoting stability is reflected by the level of aid flows to fragile states, with it being estimated that one third of all aid to developing countries goes to fragile states.¹⁵ However, the long trend of growth in Official Development Assistance (ODA) to fragile states is at serious risk given the current fiscal crunch in OECD countries.¹⁶ In terms of priority, this means that resources need to be better used in order to maximise their impact, designing more specific solutions to address the complexity of a post-conflict environment where multiple forms of support may be required, and where the coherence between these forms of support can have a critical impact on the effectiveness of any one of them.

And this is where the local private sector can come in acting in representation of the institutions, by selecting strategically small projects that do not need complex sets of implementation but that can provide good outcomes. The starting point should be quite realistic in terms of deliverables. Some examples of that come from Nigeria, where licensing the commercial rental of solar panels and liquefied petroleum gas (LPG) cylinders for off-grid light and cooking seems to be having great results.

3. PRIVATE SECTOR IN FRAGILE STATES

In the context of a fragile state, the private sector's role can go beyond the usual one of providing jobs and generating income through investments but can also provide basic and new services, introduce innovative approaches to development, and generate tax revenues for reconstruction efforts. Meeting these challenges without the support of a strong government is not easy. The local private sector we have in mind here can be mainly described by the network of private local firms that have

¹⁴ OECD, *Development Co-operation Report 2013*, cit.

¹⁵ OECD, *International Engagement in Fragile States: Can't We Do Better?*, Paris OECD, 2011, <https://www.oecd.org/countries/somalia/48697077.pdf>.

¹⁶ Ibid.

their registered office in the fragile state. A crucial role will be played by legal firms mainly because fragile states are characterized by weak business regulations and regulatory authorities the lack of which can fuel corruption and organized crime activities.¹⁷

There are many instances of the private sector playing a key role in building and sustaining peace after a period of conflict. Businesses can make strong strategic partners in peace building efforts, they can participate directly in peace negotiations or talks to prevent conflict, and they can engage indirectly by undertaking activities to influence the negotiations. The numbers of sector that can be part of this challenge are numerous but among those we consider the infrastructure one as probably the more representative. Calderón and Servén find a positive impact of infrastructure programmes on the stabilization of fragile states contexts is Sub-Saharan Africa.¹⁸ In South Africa for example, businesses helped the country transition from the apartheid days to a multiracial state. Consolidated Goldfields organized and financed meetings between the African National Congress and the Afrikaners leadership during the final years of the apartheid regime. This dialogue was widely credited with laying the groundwork for the eventual negotiations that brought end to apartheid. In Sri Lanka, a group of local trade associations sponsored a public campaign to mobilize citizens to speak out on the importance of peace in 2001. In Northern Ireland, the Confederation of Business Industry (CBI) advocated for the peace process, highlighting the benefits of a peace dividend. CBI and a number of other business associations formed the Group of Seven to encourage a settlement to the conflict by using media and public campaigns at critical points in the peace process. Throughout, they also interacted directly with all the parties to the conflict.

¹⁷ For a good review see Wade Channell, *Urgency and Legitimacy. Tensions in Rebuilding the Legal Structure for Businesses in Post-Conflict Countries*, Center for International Private Enterprise, May 2010, http://web.archive.org/web/20121118175128/http://bizclir.com/galleries/expert_opinion_files/Channell%20-%20Urgency%20and%20Legitimacy.pdf.

¹⁸ Cesar Calderón and Luis Servén, "Infrastructure, Growth, and Inequality. An Overview", in *World Bank Policy Research Working Papers*, No. 7034 (September 2014), <http://hdl.handle.net/10986/20365>.

The private sector and economic considerations more generally are rarely taken into account during the development of peace treaties. Although there is no single best way to engage the private sector in the peace process, the engagement itself – either by informal means or by means of a formal parallel track focused on private sector-led economic development – is critical. Without this, the private sector could become a deterrent to peace, rather than a key partner in the peace process. The private sector can also help address some of the key security issues in fragile and conflict-affected countries through the provision of jobs to unemployed youths and former combatants, either related to national disarmament, demobilization and resettlement initiatives or over the course of a normal business trajectory. But the relationship between security, justice, and the private sector is complicated. In the absence of basic security and legal transparency – for example, unclear property rights – businesses are reluctant to make the long-term investments that spur economic growth and generate the jobs so desperately needed in these challenging contexts. By generating jobs and income opportunities and filling gaps in delivering basic services, the private sector can help the state shift expectations in the country, because concrete dividends instil hope in people, and give them a reason to buy into peace.

And, over the long term, only the private sector is capable of growing new enterprises, opening investment opportunities, and providing employment and enduring economic security. By supporting the state's peace-building efforts, the private sector helps strengthen the state's legitimacy through registering and paying taxes, providing services on contract to the public sector, and others. Through the private sector's provision of essential services, a weak government in a fragile or conflict-affected context can strengthen its social contract and build credibility with its citizens.

Finally, the private sector cuts across all socioeconomic strata. So, it also plays a role in helping to mitigate the socio-economic exclusion that lies at the root of many conflicts. This is important because social exclusion can lead to significant economic and political grievances. Coupled with cultural affinities, such grievances can spur groups to challenge authority using violence. The private sector can help bridge these gaps. In Sri Lanka, for example, a group of members from regional chambers

of commerce from across the country promoted joint initiatives between Muslim, Sinhalese and Tamil businesses, as well as policy advocacy. The business was supported both by private partners and international organization to support reconciliation and the possibility to have business conducted among different ethnicities following the rationale of peace building. In the Philippines, La Frutera Inc. and Pglas Corporation established a banana plantation in a marginalized area, creating jobs for Christians and Muslims, including former fighters, thus helping to promote religious tolerance and facilitate reconciliation in the workplace.

While there are clear gains from developing a vibrant private sector in fragile states, the actual implementation can be a bumpy road. According to the World Bank's *Doing Business* database, fragile states represent the world's most challenging business environments, often with the most bureaucratic hurdles and the fewest property protections for entrepreneurs. The *Doing Business* indicators reveal that fragile states, on average, rank 144th out of 183 economies for ease of doing business. The average rank for non-fragile states is 78th. Among the bottom 25 economies in the *Doing Business* rankings, 20 are fragile states. Businesses operating in fragile states face numerous obstacles. While anecdotal evidence of the difficulties abound, the World Bank Group's Enterprise Surveys quantify these constraints to business operations. An examination of the survey data reveals that the number one environment constraint faced by firms working in conflict areas is lack of access to electricity. The second biggest challenge is obtaining access to finance. Other major issues cited by firm managers include political instability, practices of the informal sector, and corruption. Conditions in conflict-affected countries create additional dimensions of difficulty for businesses, beyond the standard barriers captured by the surveys and the *Doing Business* data. Indeed, just because the conflict has ended, it does not mean that the business operating environment has changed. So, businesses may continue to face many of the same difficulties they faced in the midst of the conflict. A country's ability to achieve sustained and permanent growth in the aftermath of a conflict has proven to be a particularly difficult and lengthy process.

As we discussed earlier on, the first main challenge faced by a fragile state is the poor quality of the institutions that survived the conflict. This

means that the local authority often suffers from distrust from local citizen. Sometime it is also hard to find a substantial number of officer and/or bureaucrats that can support the change. The lack of human capital due to the fact that many officers might have left the country also limit the amount of services that can be offered to the population and hence the country's governability. Because of the fragility that characterizes these states, it is unlikely to guarantee the complete rule of law such as for example basic security and a properly-functioning judicial system: not only property rights are unclear in a post-conflict context, but there may not be clear channels of dispute resolution. As documented by Datzberger and Denison when the macro context might not be suitable to support local business, a valuable substitute can be represented by the micro activities such as value chain projects.¹⁹ The value chain projects have the goal of upgrading poor individual activities to make them more suitable to compete in wider markets. Among the examples they list, coffee and econ-tourism and Shea butter programme in South Sudan. In these contexts, the private sector can set the objectives on how to upgrade the value chain and the international donors can come in and support the operation.

In the discussion that Acemoglu, Robinson and Johnson started in 2000 the key role played by the property rights emerges very clearly. The way in which countries organize the rule of law around the administration of property rights, according to the authors, has a huge impact on the long term growth of a country. The reason behind the choice of the variable *property rights* as a proxy for the level of institution in a country is driven by the fact that societies initiate their development being first of all agrarian economies. Therefore, the way in which land and crops are organized is crucial to provide incentive to those that either own it or work as a hired labour on it for long term investments.

Another consequence of a disrupted rule of law is the informal expropriation of property and disputes over rightful land ownership. The private sector

¹⁹ Simone Datzberger and Mike Denison, *Private Sector Development in Fragile States*, EPS Peaks, September 2013, <https://www.gov.uk/research-for-development-outputs/private-sector-development-in-fragile-states>.

suffers the direct effects of this impact, since individuals and firms will be unsure of their assets, limiting their opportunity to invest on them. With no security over land ownership and without institutions that can help recover, private citizens will not have any incentive to make long term investments on these plots with long term consequences on their productivity.

Setting the rule of the games is not easy and if rushed could actually have counterproductive consequences in the long run. Sometime new regulations in fragile states are urged to be implemented without a careful assessment of their long term effects or are designed with a heavy influence of external consultant without the full knowledge of the best way to adapt them to the local context. In other cases, regulations might be there but simply not implemented. This is why the local private sector must actively participate to their design providing inputs and suggesting solutions that can facilitate and regulate partnerships.

The macroeconomic scenario in the absence of a balanced and functioning system of regulations can be quite unstable, and uncertainty does not favour foreign direct investment and increases the risk associated to credit provision. MacSweeney's study describes, for example, the situation in which central and commercial banks do not operate normally during conflict and post-conflict environments.²⁰ Even when they do these banks are not equipped to serve the most vulnerable people, whereas extending their financial services to small entrepreneurs/business is essential to start economic activity in the immediate post-conflict period. Mills and Fan further explain that without a functioning banking and payment system, business transactions must rely on cash and cannot access formal credit.²¹ Businesses that need credit for working capital (for example, to purchase inputs or goods for on-selling) have to rely more than usual on informal financial services, which are more

²⁰ Naoise MacSweeney, *Private Sector Development in Conflict Affected Environments: A Review of Current Literature and Practice*, Donor Committee for Enterprise Development (DCED), 2008, https://www.enterprise-development.org/wp-content/uploads/PostConflict_PSD_EN.pdf.

²¹ Rob Mills and Qimiao Fan, "The Investment Climate in Post-conflict Situations", in *World Bank Policy Research Working Papers*, No. 4055 (October 2006), <http://hdl.handle.net/10986/9029>.

expensive, unregulated and limited in range.

The lack of these corollary public goods that allow a society to function properly can result in an increase of the informal activity already fuelled by the damages to the infrastructure (including basic transport and communications structure, as well as utilities such as electricity and water), that occurred because of the conflicts.

Another result of conflicts is a severely depleted national fiscal base, with a small number of enterprises remaining in the formal sector. A vicious cycle is created that feeds informality: as – economic activity declines and fewer firms remain in the formal sector, revenues from indirect taxes and VAT fall and governments become more dependent on import duties and other trade taxes. In many cases, the temptation has been to tax business activities too heavily, which strengthens the incentives for firms to remain in the informal sector.

There is no template for how these challenges are best addressed or for the best way to carry out private sector development in fragile and conflict-affected situations. Still, it is true that initiatives need to be grounded in a field-based understanding of a country's history, culture, resources and capacities. Probably, when thinking about the most effective ways to harness the power of the private sector to contribute to securing development, it is important to always consider the local context and to be pragmatic.

CONCLUSION

In this chapter, we have discussed what could potentially be the role of the local private sector, beside the standard one of boosting the labour market via the job posts creation, in environments where institutions have been severely compromised and have lost their authority as those characterizing fragile states. Recently the economics literature that looks at why some countries have a higher rates of growth than others has shifted focus from the amount of production factors that a country is endowed with to the way in which these factors are organized in the society. Because of that, local institutions and their formation has gained a key role in understanding the heterogeneity in the level of growth we observe across countries.

Countries that can be defined as *fragile states* usually cannot rely on their official institutions as a mean of growth. There is a transition period in the aftermath of the conflict where public trust needs to be re-established and where local authority needs to earn again respect from the society. In this environment, the local private sector could become an ideal *temporary* partner for the international community that wants to offer support for recovering from a conflict. Many are the challenges but the private sector can rely on a higher agility/flexibility respect to the public one and on higher incentives from which the entire society can benefit from.

Following the rationale proposed by the literature, we consider as a priority to establish land property rights and business regulations in order to provide land owners (or hired labour) with incentives to make long term investments that can lead to a higher productivity and, at the same time, new regulated markets where trading their yields. As a consequence, owners would be able to securitize the land to obtain credit and kick off a virtuous cycle that can affect the local financial sector first and, little by little, many other sectors of the economy.

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4.

ADB's Work in Fragile and Conflict-Affected Situations: Bringing Afghanistan Center Stage

Melanie Ullrich and Sayed Masood Alam

INTRODUCTION

Countries with fragile and conflict-affected situations (FCAS) are generally characterized by political instability, weak governance and institutional capacity, economic and social insecurity, and greater vulnerability to the effects of climate change. The Asian Development Bank (ADB) classifies ten of its Developing Member Countries (DMCs) as fragile countries, two of them are affected by conflict; Afghanistan and Myanmar.¹ ADB defines fragility as a multifaceted concept. It generally refers to the state's failure to perform its function effectively and provide basic social services, uphold the rule of law; and failure to provide sustainable sources of income for the population to get out of poverty. Five key dimensions translate from this definition: economic, political or state, justice, security and peace. ADB includes isolation, remoteness and environmental fragilities.

Fragility is a very dynamic process that has strong links with conflict. Countries can plunge into or exit from a fragile situation in a relatively short period of time for various reasons, contributing to the different

¹The remaining eight are Pacific Small Island Developing States (SIDS): Kiribati, the Marshall Islands, the Federated States of Micronesia, Nauru, Papua New Guinea, Solomon Islands, Timor-Leste and Tuvalu.

nature and complexity of fragility. Every aspect of an ADB project cycle in FCAS, from project design and preparation to project implementation is considerably more complex and challenging.

Afghanistan is beset by many issues and obstacles that complicate development efforts, starting with security challenges, political risks, and institutional capacity issues. One-third of its people are undernourished. Generally poor-quality infrastructure and connectivity remain a constraint to growth prospects as does limited energy supply. Only 63 per cent of the rural population lives within 2 km of an all-season road, more than 70 per cent of the interprovincial and inter-district roads are in a poor state, and just 31 per cent of the population is connected to the electric grid.²

Yet, grants from the Asian Development Fund (ADF) are helping to improve thousands of lives. ADF grants enable Afghans to start and grow businesses, a base for further economic development, creating jobs and socio-economic stability. Grants also contribute to ensure access to electricity. And ADF grants also help improving ever so needed infrastructure.

Another pillar for Afghanistan's future is regional integration. The country itself has a very limited internal market with low purchasing power. But geography matters and can take center stage in Afghanistan's development as it lies at the crossroads between Central Asia and South Asia, and beyond. Afghanistan is therefore a key member of the Central Asia Regional Economic Cooperation Program (CAREC), a partnership program of eleven countries, working together to promote development through cooperation.³ Addressing infrastructure gaps can improve opportunities for trade as well, and enhancing a stronger cross-border cooperation and integration would allow Afghanistan to build up its export base for products such as carpets and rugs, agriculture and animal products.

² Asian Development Bank (ADB), Asian Development Outlook 2019. Strengthening Disaster Resilience, April 2019, p. 218, <https://dx.doi.org/10.22617/FLS190070-3>.

³ CAREC members include Afghanistan, Azerbaijan, People's Republic of China, Georgia, Kazakhstan, Kyrgyz Republic, Mongolia, Pakistan, Tajikistan, Turkmenistan and Uzbekistan.

This chapter will elaborate how ADB works in FCAS with a special focus on Afghanistan in alignment with the framework of ADB's new corporate Strategy, Strategy 2030. Best practices will demonstrate the complexity of the work, its challenges as well as results and opportunities ahead. It will also demonstrate the value of regional economic cooperation and integration for development.

1. ADB'S WORK IN FCAS

Development agencies and policy makers need to rethink their approaches and be more innovative when working in fragile and conflict-affected countries. "Business as usual" does not work, because in FCAS, nothing is as usual. Over the past two decades, the global development community has sought to identify ways to ensure that development assistance in FCAS could and should be producing better impacts. These have been manifested in several declarations and agendas.⁴

ADB's work in FCAS is governed by the Operational Plan for Enhancing ADB's Effectiveness in FCAS (2013).⁵ ADB recognizes that fragility and conflict are complex and multifaceted and seeks to address five characteristics: (i) weak government, (ii) ineffective public administration and rule of law, (iii) prolonged civil unrest, (iv) exposure to interstate, national or subnational violent conflict, and (v) vulnerability to economic shocks and natural disasters as key drivers to fragility. To successfully operate in situations with these characteristics, ADB's approach follows the current international good practices and is based on ensuring:

1) Context sensitivity based on analysis of the specific circumstances of a country, including its political situation, economic condition and outlook, conflicts, ethnic and gender issues, and vulnerability to natural dis-

⁴ Paris Declaration on Aid Effectiveness (2005), Principles for Good International Engagement (2007), Accra Agenda for Action (2008), International Dialogue on Peacebuilding and Statebuilding, the establishment of g7+, and New Deal for Engagement in Fragile States (2011).

⁵ ADB, *Operational Plan for Enhancing ADB's Effectiveness in Fragile and Conflict-Affected Situations*, 2013, <https://www.adb.org/documents/operational-plan-enhancing-adb-effectiveness-fragile-and-conflict-affected-situations>.

asters, as well as understanding of the stakeholders. Context sensitivity needs to be done across the spectrum of activities, from project design, procurement, and implementation.

2) Doing no harm: Once ADB understands the context and the stakeholders, ADB must ensure that at the very least, its operations “do no harm”. And in fact, seek to significantly improve situations, whether it be the livelihood of the people, of the capacity to transition from FCAS to stability.

3) Increased capacity assistance and development: Based on the context, ADB operations need to ensure that ADB staff and counterparts have the capacity to undertake their roles and responsibilities in operations. If their capacity is lacking, resources must be made available in the form of advisors, training, outreach materials, to enable counterparts to undertake their responsibilities.

4) Enhanced monitoring for continuous improvement. Given the often-rapid changing context in FCAS, ADB operations need to build in a feedback loop on monitoring and continuous improvement to ensure that operations adjust to the changing contexts and remain relevant; and

5) Seeking progress on the fragility to stability continuum. ADB operations should seek to help progress from fragile or conflict situations to a transitional situation on its way to becoming resilient/stable country.

Fundamentally, an understanding of the interrelationship between vulnerability, resilience and fragility is key to act responsibly. ADB will coordinate efforts to address broader and interrelated vulnerabilities such as violence, forced migration, indigenous peoples and ethnic-based conflict, gender-based violence, climate change, natural disasters, food security, youth, etc.

All this includes increasing knowledge and understanding of the political economy context of each sector when designing development projects and programs. Looking into governance, institutional, political, and social issues, before intervening in infrastructure and technology, might also be necessary.

ADB’s Strategy 2020, approved in 2008,⁶ also recognized that greater

⁶ ADB, *Strategy 2020. The Long-Term Strategic Framework of the Asian Devel-*

regional economic and policy coordination, as well as improved governance in fragile situations, would facilitate regional stability and enable a wider range of intra- and inter-regional engagement, both private and public. The strategy stressed that in fragile situations, ADB must seek innovative means to strengthen the effectiveness of country-led models, provide longer commitment periods for institutional development, improved governance, and higher levels of transparency; including the possibility to work with nonstate actors.

2. ADB'S OPERATIONAL PRIORITIES IN FCAS

ADB's new long-term strategic plan, Strategy 2030,⁷ recognizes FCAS countries as needing special attention and advocates for a differentiated approach. Under this strategy, ADB will prioritize its support to FCAS by providing long-term financing and capacity-development assistance to support institutional development and governance reforms, to help build resilience, address causes of fragility or conflict and promote reconciliation and reconstruction. The differentiated approach under Strategy 2030 builds on ADB's long-standing support for development in FCAS, which emphasizes the importance of understanding the local context, making a long-term commitment to development, ensuring country ownership, and being flexible in responding to challenges.

Under the Afghanistan country partnership strategy 2017–2021,⁸ and the Afghanistan country operations business plan, 2020–2022, ADB

opment Bank 2008–2020, April 2008, <https://www.adb.org/documents/strategy-2020-working-asia-and-pacific-free-poverty>.

⁷ ADB, *Strategy 2030. Achieving a Prosperous, Inclusive, Resilient, and Sustainable Asia and the Pacific*, July 2018, <https://www.adb.org/sites/default/files/institutional-document/435391/strategy-2030-main-document.pdf>.

⁸ ADB, *Afghanistan Country Partnership Strategy, 2017–2021. Achieving Inclusive Growth in a Fragile and Conflict-Affected Situation*, October 2017, <https://www.adb.org/documents/afghanistan-country-partnership-strategy-2017-2021>. A country partnership strategy (CPS) is ADB's primary platform for designing operations to deliver development results at the country level. ADB works with each developing member country to map out a medium-term development strategy and a 3-year country operations business plan to implement it.

continues to focus on developing infrastructure, reducing poverty, and stimulating growth. The country partnership strategy will integrate various approaches to FCAS, and ADB will base its operations on three strategic pillars: (i) expanded access for women and men to economic opportunities, markets, and services; (ii) stronger institutions and human capacities; and (iii) increased environmental sustainability, climate change resilience, and disaster resilience.

ADB operations will continue focusing on its three priority sectors; energy, transport, and agriculture and natural resources, based on its comparative advantages in the country and the government's request for assistance in these areas.

3. ADB AND AFGHANISTAN: LAYING A FOUNDATION FOR FUTURE GROWTH

ADB was one of the first organizations to return to Afghanistan in 2002 when the country needed help. ADB's committed assistance to Afghanistan since 1966 totals 4,911.86 million US dollars. Cumulative lending totals 967.1 million US dollar loans and committed technical assistance totals 107.1 million US dollars.

The landlocked country has been suffering from conflict since the 1970s. It is one of the poorest and least developed countries in Asia, with a gross domestic product per capita of 520 US dollars in 2018.⁹ Of all Central Asian countries, it has with 54.5 per cent by far the biggest share of population below the national poverty line.¹⁰ Its economy grew at a relatively fast rate during 2002–2013, but this decreased substantially during 2014–2016, averaging less than 1.4 per cent annually, because of the withdrawal of international forces in 2014, political instability arising from the presidential election, as well as the deteriorating security situation. GDP growth though is expected to recover to 2.7 per cent in

⁹ World Bank Open Data.

¹⁰ ADB Data Library: *Afghanistan: By the numbers*, <https://data.adb.org/dashboard/afghanistan-numbers>.

2019 and 3.4 per cent in 2020.¹¹

Decades of conflict have left Afghan institutions and human capital devastated. The succession of changes in political regimes from the late 1970s to the end of the Taliban regime in late 2001 meant that there was practically no institutional memory and traditions left to build on in 2002. The country is also grappling with high numbers of internally displaced persons and the millions of refugees returning from neighboring countries, which place a greater strain on the already limited services and capabilities of the government.

Box 1. New road changes rural lives

Paktika province located in the eastern part of the country, is one of the conflict-affected provinces in the country. The province has one of the highest poverty rates in the country. The damage to physical infrastructure has been severe and extensive. In particular, the road network lies in a state of total disrepair due to prolonged neglect and underinvestment. For many years, people of Paktika province, faced many problems with accessing basic facilities and services due to unpaved and muddy road.

Change has already started, thanks to ADB for constructing a 50-kilometer all-weather road from Sharan to Angor Ada. The road project was part of the development projects initiated by the Ministry of Public Works with funding from ADB. The road project has greatly eased the transit and access.

The road connects the capital of Paktika province to the Pakistan border. The road facilitates access to basic social services, such as schools, hospitals, and local markets.

During construction of the road, many job opportunities were created for the local people.

The majority of population in Paktika province rely on agriculture as their main source of income. The new paved road enables the farmers to deliver their crops to market on time without damage and less crop loss. This used to be much more difficult and time consuming before.

In the decades of conflict, much of the country's already limited

¹¹ ADB, *Asian Development Outlook 2019 Update. Fostering Growth and Inclusion in Asia's Cities*, September 2019, <https://www.adb.org/publications/asian-development-outlook-2019-update>.

infrastructure had been destroyed and its transport and power systems were hit hard; an estimated 80 per cent of the country's roads were in disrepair and very little power being produced and delivered to the people. Since 2002, ADB has committed around 2.2 billion US dollars grant money for more than 20 key road projects to design, construct and upgrade over 2,000 kilometers of regional and national roads and railways across Afghanistan. Some of ADB's key support to Afghanistan include helping the government to develop a comprehensive Transport Sector Master Plan Update to prioritize transport infrastructure until 2036, supporting the feasibility study and detailed engineering design for a new Salang Tunnel, and supporting priority maintenance to several sections of Afghanistan's regional highway, from Kabul to Kandahar and from Kabul to Jalalabad. The support also includes capacity development at the Ministry of Transport to ensure a road asset management and maintenance system is designed, installed, and institutionalized to better manage the road infrastructure in the future. ADB has also funded the first rail line between Uzbekistan and Afghanistan.

In January 2020, ADB signed a 12 million US dollars grant agreement with the government of Afghanistan for a project readiness financing to finance preparatory activities for the Road Rehabilitation and Maintenance Program. The grant will help the government prepare feasibility studies, detailed engineering design and associated documents, and provide procurement and capacity building support for bridges and road rehabilitation of the Kabul–Kandahar road, one of the few viable land routes linking the capital of Kabul with the south and west part of the country, the North–South corridor and the East–West Corridor projects.

The project will help improve regional accessibility and enhance the road network, supporting the government's vision of achieving sustainable development, peace, and stability.

Another important component to support Afghanistan is the Afghanistan Infrastructure Trust Fund (AITF), which was established in 2010 to respond to the government's need for a dedicated financing mechanism to support infrastructure development. Administered by ADB, AITF is the only multi-donor platform for bilateral, multilateral, and individual contributors to invest in infrastructure development projects that foster the country's economic growth and improve

the livelihood of the Afghan people. Through AITF, development partners can provide harmonized on-budget grants financing for technical assistance and grants for eligible infrastructure investments. Sectors included are transport, energy, and agriculture as well as water management and irrigation. Development partners have committed a total of 744 million US dollars to AITF to date, almost 600 million US dollars of which has been allocated.

In the energy sectors, ADB has provided nearly 1.62 billion US dollars to support energy infrastructure, with an additional 436 million planned for 2020–2022. These projects include the construction of around 1,550 km of power transmission lines, 19 substations, 163,300 power distribution connections and resulted in more than 5 million people gaining access to electricity across the country. In addition, ADB has also provided assistance to rehabilitate 10 gas wells.

ADB has also supported the development of Afghanistan's first privately financed solar power plant by providing a loan to the private sector company 77 Group. The loan supports the development of a 15.1 MW solar power plant in Kandahar province to boost the country's renewable energy generation and supply. It is ADB's first loan to a power project in a FCAS country and remains the only project to-date that was competitively bid out by the Ministry of Energy and Water of Afghanistan and that was financed by an international development institution.

Despite all challenges, ADB brings substantial value addition to Afghanistan; it is Afghanistan's leading partner in large infrastructure and regional cooperation and has in-depth experience in delivering infrastructure projects during conflict and reconstruction. The holistic sector approach in the country partnership strategy, covering sector policy and regulatory development, planning, investments, capacity building, operation and maintenance, and other features, will help make results more sustainable.

ADB's support to Afghanistan has improved the lives of the people of Afghanistan and they are leading to significant economic growth. Travel by road and air has been made easier; electricity is more widely available; farm incomes are more secure; and there is greater accountability in the public sector.

As an example, ADB has helped rehabilitate and upgrade around

350,000 hectares of irrigated land, with work continuing on an additional 300,000 hectares. The completed projects have generated around 1.5 million short and long-term jobs and benefited more than 7 million people. The investments have also resulted in improved rural livelihoods, economic growth, and better water resources management.

3.1 The Asian Development Fund: Driver for change in Afghanistan

The Asian Development Fund (ADF) provides grants to ADB's low-income developing member countries. Established in 1974, the ADF initially provided loans on concessional terms. Grants were introduced in 2005, and beginning 2017, with ADB's concessional lending financed from its ordinary capital resources, the ADF has become a grant-only operation. Activities supported by the ADF promote poverty reduction and improvements in the quality of life in the poorer countries of the Asia and Pacific region.

Recognizing the unique and challenging operating environment in Afghanistan, ADB has developed the Enhanced Project Delivery Approach which identified specific measures in ADB's operations, such as increased international and national staff in the Afghanistan resident mission and additional assistance on procurement and project management to project counterparts to improve project performance. In addition, in 2019, ADB launched an FCAS toolkit that laid out specific steps to be taken in resource allocation, project design, procurement, implementation – especially on security measures and community involvement, and monitoring and evaluation that were designed specifically for the challenges in Afghanistan. For example, based on ADB's experience in seeing specific elements that address security concerns and enable successful project implementation, the FCAS tool kit calls for a social contract between the government, contractor, and local community that lays out the roles and responsibilities for each party. Specifically, it includes the types of security measures that are acceptable to a community and vice-versa, a commitment by allow the contractors to work safely. It also includes a grievance redress mechanism to ensure that all parties live-up to their end of the bargain. As such, with ADF resources supporting investments designed and implemented in a context-sensi-

tive approach, thousands of Afghans have received assistance to start or grow businesses and can now travel more quickly and cheaply on upgraded roads and enjoy reliable grid-supplied electricity.

Box 2. Power for a better life

Ask Afghans what their greatest need is after food and personal safety, and the answer is highly likely to be electricity. Decades of armed conflict laid waste to Afghanistan's energy infrastructure. Kabul, a focus of particular destruction, was sometimes described as the only dark capital in the world. Thanks in part to an ADF grant of 23.5 million US dollars, the lights are back on.

The Power Transmission and Distribution Project helped build more than 100 kilometers of the 420-km transmission line from Uzbekistan, Afghanistan's closest northern neighbor. The new line, which spans some of the most challenging terrain on earth, brings reliable power to Kabul and smaller towns in the northern and eastern provinces. "I remember the dark times only too well," says Mohammad Ismail, 32, who owns a private school in Paktia Province. "Our students couldn't study or do homework at night. When we used diesel-powered generators to give them some light it was unhealthy for everyone and expensive."

The project's improvements, including rehabilitation of low-voltage distribution substations, have almost halved transmission and distribution losses and reduced the price of grid electricity to 0.05 US dollar per kilowatt-hour, or about one-ninth of what it cost to generate the same amount of power with diesel fuel.

"The power used to stop and start all the time, and as a result, so would our production," says Samiullah Haidari, who is an investor in a PVC factory in the village of Shaikhan in Paktia Province. "Now that we can count on a steady supply, we've been able to scale up output, run two shifts, and hire more workers; we're looking at producing furniture as well."

With the need for wood-fired cooking reduced, and the respiratory problems it often causes avoided, a survey by a nongovernment organization has shown a 50 per cent improvement in household health in the project areas. Malaria cases are also down, with electric fans now usable in summer to blow both the heat and the mosquitoes away. "We had a little electricity before the project, 2 or 3 hours a day from a generator," says Hajib Shirkhan, a resident of Paktia's capital of Gardez, "but we still

had to wash clothes by hand, and it was impossible for our children to study at night.”

The 52-year-old community council member and his family now have electrical appliances, including a washing machine, and his children are happy to be able to study at a time of their choosing, even after dark. “Power has brought many positive changes to our lives.”

As ADB prepares for the ADF replenishment, grant assistance will continue to help Afghans to improve their lives. ADF grants will play a crucial role in supporting ADB’s Strategy 2030 and helping Afghanistan to meet the Sustainable Development Goals.

3.2 Afghanistan and CAREC. Integration is key

Afghanistan lies at the crossroads between Central Asia and South Asia and is therefore a key member of the CAREC Program. As the reintegration of the Eurasian continent gathers speed, the CAREC countries are poised to reap substantial benefits, but none of the region’s economies will be able to fully capture this opportunity in isolation.

Box 3. CAREC

The Central Asia Regional Economic Cooperation Program (CAREC) is a partnership of eleven countries and development partners working together to promote development through cooperation, leading to accelerated economic growth and poverty reduction. It is guided by the overarching vision of “Good Neighbors, Good Partners, and Good Prospects.”

The program is a proactive facilitator of practical, results-based regional projects, and policy initiatives critical to sustainable economic growth and shared prosperity in the region. Since its inception in 2001 and as of September 2019, CAREC has mobilized more than 34.5 billion US dollars investments that have helped establish multimodal transportation networks, increased energy trade and security, facilitated free movement of people and freight, and laid the groundwork for economic corridor development.

As of December 2018, the CAREC Program has invested more than 4.45 billion US dollars in 37 projects in Afghanistan, on the principle that better connections will be key to unlocking the region’s vast resources and human potential.

Afghanistan joined CAREC in 2005 and has since been working with

other member countries to forge links and partnerships that will restore the country to its traditional place as a crossroads of cultures and commerce.

With the rapid economic expansion of the People's Republic of China and Japan to the east, the Russian Federation to the north, and India and Pakistan to the south, there is a real and growing demand for improved connections between Europe and Asia. This momentum provides CAREC countries with an unprecedented opportunity to emerge as a center for trade and commerce, to achieve higher levels of economic growth, and to reduce poverty.

Afghanistan stands to benefit from closer cooperation with neighboring countries, and it will also make substantial contributions to economic integration across regions because of its location. Development of CAREC corridors will help Afghanistan to become a regional transit point; currently ADB is supporting the government of Afghanistan in preparing the CAREC Corridors 5 and 6 (Salang Corridors) Project. All these investments will also benefit the local communities by increasing access to new job opportunities along with education, health, and other social services.

Turning this potential into reality requires significant improvement in the region's physical infrastructure; in the way the region manages its shared resources to support efficient and rational use of energy and water; in progress toward harmonizing and modernizing its customs administrations, and streamlining the rules and procedures that govern countries' international trade relationships; and in efforts to promote and strengthen people-to-people contacts across borders.

ADB will continue to develop Afghanistan's potential as a cross-regional transit point for both transport and energy, with emphasis on the CAREC corridors and regional energy initiatives such as the Turkmenistan–Afghanistan–Pakistan–India (TAPI) gas pipeline and the Turkmenistan–Uzbekistan–Tajikistan–Afghanistan–Pakistan power interconnection project. Additionally, trade facilitation initiatives under CAREC will continue to increase regional trade and create greater opportunities for local businesses.

In 2020, ADB will support in organizing the CAREC Program under the chairmanship of Afghanistan, including hosting the 19th Ministerial Conference.

4. THE WAY FORWARD

Afghanistan's recent history has presented several daunting challenges to its development process. In 2016, foreign grants to Afghanistan were estimated to be about 48 per cent of its GDP (or 9 billion US dollars). Donor grants covered about 63 per cent of government expenditure. Over half of government expenditure goes toward security, leaving limited fiscal resources for development. Afghanistan will continue to require significant amounts of aid to cover both government operating costs and development costs. Government capacity is improving but needs further support to make development assistance more effective. ADB will continue this support through sector-level engagement with government counterparts and assistance to ministries and agencies in the preparation and implementation of action plans. Institutional strengthening and human capacity building will be centered around energy, transport, and agriculture and natural resources along with private sector development, to build a solid fundament for future development, to create an environment that creates jobs and attracts private sector investments.

In contrast to many other countries in the region, the private sector has not been the engine of growth in Afghanistan. One estimate is that the Afghan private sector contributes merely 10–12 per cent to GDP. This is the result of a poor business enabling environment and the distortions of foreign aid dependence. Factors such as a weak legal and regulatory framework, violence, slow pace of economic reforms, corruption, deficient infrastructure, limited access to land, and a nascent finance sector have created a poor business environment and limited private sector growth. The private sector is also not generating sufficient jobs for the estimated 400,000 entrants to the labor market each year. The government has made efforts to improve private sector conditions, such as passing the Public–Private Partnership Law in 2016, establishing the Executive Committee on Private Sector Development, and fostering cooperation between the government and the private sector on private sector reform priorities. But more is needed. ADB will strengthen its engagement with the private sector, following promising experiences in the telecommunication and energy sectors.

But over all these goals, the security remains as the crux of the problem. Based on experience, lessons learned and best practices, ADB will

continue to funding project security, however, its project will be more flexible in the design of these security measures will, and where appropriate, will use local police, the Afghan National Army, the Afghan Public Protection Force, and the local community, depending on what will work the best. Project ownership through participatory community-based approaches including employment for construction works will engage community elders to foster a common ownership and responsibility for projects. Benefits for the community will be explained in a locally adapted way.

Overall, ADB's assistance is aligned with the Afghanistan National Development Strategy. ADB has been a strong partner in Afghanistan's development over the last two decades. Major challenges, however, remain. In some aspects of health and education conditions may have improved since 2002, but gender disparity in Afghanistan remains among the highest in the world.

It is key for ADB to improve its understanding of the underlying fragility, conflict sensitivity, and local drivers of conflict to ensure appropriate security measures are implemented and that opportunities are taken up to promote peace and development through peace-building tools.

There is a lot of homework to do, both on Afghanistan's and ADB side. Afghanistan has to be in the driver's seat. ADB stands ready and willing to help. Together, the life of Afghans will be brighter in the future.

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This book collects contributions from international leading experts from academia and multilateral development banks on the opportunities and challenges for development finance in a post-pandemic world. Despite multilateralism reached its low point in 2020 with increasing tensions between major global powers and deglobalisation trends, the global scale of the coronavirus outbreak made clear the intrinsically transnational nature of all the major global challenges. In this context, the authors explore three potential key areas of development policies that are likely to become increasingly crucial over the coming years: the private-sector contribution to the achievement of the SDGs; climate finance; and prospects and policies for low-income countries and fragile states.

Book cover: The Paraisópolis Favela and the luxury buildings.



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