

Strengthening Demand:

A Framework for Financing Sustainable Development

Prepared by the Ring of Sustainable Development Institutions
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1. Introduction

This document has been prepared on behalf of the Ring of sustainable development institutions, an international network of policy research institutions that work on various aspects of sustainable development, including natural resource conservation, pollution abatement, poverty eradication, and quality of life improvement. While these institutions undertake policy advocacy at global as well as national levels, their primary emphasis is on the experiences and perspectives that stem from the local level.

The purpose of this paper is to examine the issue of financing for sustainable development from the above perspective. The key insight in this paper relies on a distinction between what we call the traditional "supply side" approach, preoccupied with the mobilization of concessional resources, and an alternative "demand side" approach that focuses instead on creating capacity, especially of smaller- and medium-scale entities to access and deploy financial resources on commercial terms. While the conventional approach is concerned directly with identifying new sources of funds, shoring up existing ones, and encouraging the redirection of others, the alternative proposed here seeks to accomplish all this by increasing the legitimacy of the process and reducing the risk of alternative scale investment.

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

2. Crisis in development finance

There is a crisis in development finance. Steady erosion in official development assistance (ODA) and declining effectiveness and legitimacy of domestic revenue-raising efforts have sharply reduced support for programs of capacity building, poverty eradication, and environmental conservation. While non-concessional financial flows – commercial credit and direct investment – are growing, their focus is on large-scale industry and infrastructure projects, which are inadequate vehicles for the pursuit of sustainable development. The small and medium-scale sectors, which hold the potential to create large numbers of sustainable livelihoods, are generally not reached by this large and growing segment of development finance.

In a number of the wealthiest countries, ODA has sunk to 50-year low levels, coinciding with states' shifting priorities, shrinking autonomy and increased obligations to emerging crises – changes that suggest to many that the era of aid as a force in development is nearing its end. Similarly, domestic tax collection, which has historically yielded funds for poverty and development programs, is in crisis in many developing countries, swamped by rising deficits and increasing questions of transparency and legitimacy. Commercial creditors typically find small-scale development finance too costly a resource to provide. Finally, while the shining example of micro-credit provides grounds for optimism, it has worked effectively in only a handful of countries and caters only to a small (though significant) niche.

As the tenth anniversary of the Earth Summit approaches, these trends reflect poorly on the global commitment to the goals of Agenda 21. A renewed commitment would involve a three-pronged international agenda.

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

We argue below that progress on all three fronts would be rendered more robust and sustainable if the problem were treated not merely as supply enhancement, but as that of building effective demand. An attribute that is common to many successful examples of capital mobilization for sustainable development – whether micro-credit, franchising, partnering – is that they increase the capacity of individuals and organizations to access and use finance, and strengthen the ability of institutions to serve as intermediaries. Widespread replication of this outcome – one in which both the risk of commercial lending is reduced and the legitimacy of charitable aid is increased – is needed to stabilize and foster sustainable development efforts.

2. Background

According to the textbook definition, financial intermediation performs two distinct functions. First, it channels resources from surplus economic units (i.e. net savers) to deficit units (i.e. net dissavers or investors); and second, it distributes risks according to risk preference of savers as well as investors. By performing two specific functions – channeling money and distributing risks – the intermediary mechanism makes the movement of finance from the surplus units simple and rewarding, and makes the movement of finance to the deficit units possible.

The risks that such systems encounter, regardless of scale, can be divided into two categories: objective risks (e.g. business failure) and moral hazard (i.e. deliberate failure to avoid reimbursement). Both types of risks can be reduced with appropriate corrective actions. Investing in the managerial and planning capacity of borrowing organizations can reduce objective risks; and better monitoring of the outcomes can help reduce moral hazard.

The term 'development finance' covers a broad terrain, ranging from official development assistance (grants, concessional loans by governments and multilateral financial institutions) to commercial loans by multilateral financial institutions and private banks, foreign direct investment, to domestic credit, investment and government transfers. The surplus and deficit units in the different examples could be governments, corporations or individual households. The activities undertaken by these households also span a broad range: high-tech start-up projects, industrial investment, public infrastructure, and small-scale human development projects. While all of these can be described as "developmental" activities, only a small subset can be termed to be *sustainable*. These are often in small packages,

many are led by entities with less established track records, and most cater to social as well as individual gain. The result is that they are viewed as entailing greater risk and greater administrative effort by lenders relative to the volume of resources.

To give a well-known example, the World Bank not only channels commercial resources to developing countries it also redistributes the risk inherent in such transfers. Whereas commercial banks view most developing country borrowers as high risk and therefore offer relatively high rates, they consider the World Bank to be an inviolate borrower and thus lend to it at low rates. At the other end, the Bank considers developing countries to be good risks because they have never defaulted on Bank loans. The reason for this record is that the Bank's long-term relationship with the governments of borrowing countries would make it very costly for them to default. This relationship rests upon the extensive capacity of the Bank to monitor and influence economic conditions and policies. As a result, the Bank's opinion of economic conditions has a very strong influence on the overall creditworthiness of a country.

While it cannot be argued that the debtor countries borrow or spend the money wisely, and nor even that the Bank's influence has, on the whole, been a positive one, it is clear that the Bank has been able to create a growing niche for itself. It has been able to borrow ever-increasing amounts competitively, and can lend even more competitively with lower objective risk. The result is that it can borrow from commercial lenders at prime rates and, even after adding its premium, pass the loan on to developing countries at close to market rates or at least much below what the countries would be able to obtain in the market.

To give another well-known example, the system of 'micro-credit' (e.g. Grameen Bank) can be interpreted according to the same criteria. Grameen has established its creditworthiness as a borrower to be able to borrow at prime rates from commercial lenders. On the other hand, it has developed considerable capacity in working with poor villagers, and thus faces much lower risks and administrative costs in lending to them. It can, therefore lend to villagers and extremely small-scale borrowers at market rates.

The success of both these institutions derives from their capacity development, their relationships with borrowers, and the normative culture that they have been able to cultivate over time. Both institutions (by and large) lend at market rates rather than concessional rates. Both rely on the investment they have made in their own capacity and in the capacity of the borrowers to use the money effectively. Given this history, both are now constrained not by the supply of resources but by their effective demand. Both are sustainable efforts.

These two institutions operate at very different levels, the World Bank with national governments, and the Grameen Bank with small groups of poor villagers. However, the common lessons from their experience are relevant for other levels of operation as well—for example, to finance medium-scale export projects, or small-scale community development activities. These require the appropriate institutional framework whereby the borrowers become more creditworthy, and the lender goes through intermediate institutions that work closely with the borrowers. A number of methods have been developed for facilitating such finance. (Small credit systems have evolved over the past two decades to fill different niches in the rural and urban economy. The Indian experience with small credit systems is described in detail in Annex I.)

2.1 Current Trends in Development Finance

In the past decade, development finance has undergone a general downturn, its departure from the increasing trend of the eighties punctuated by a marked reduction in just the past three years. Flows

from nearly all sources have shrunk, as even the robust increase of foreign direct investment has stalled. The nineties witnessed an overall decline in official capital flows, with 1998/99 levels at two-thirds of their 1990 value, in real terms (World Bank, 1999). Between 1997 and 1998, total net long-term financial flows to developing countries dropped by nearly twenty percent, drawn down by a halving of the capital supply from international markets (World Bank, 1999). The table below outlines the components of this trend.

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Net long-term resource flows	100.8	123.1	152.3	220.2	223.6	254.9	308.1	338.1	275
Official flows	56.9	62.6	54	53.3	45.5	53.4	32.2	39.1	47.9
Private flows	43.9	60.5	98.3	167	178.1	201.5	275.9	299	227.1
From international capital markets	19.4	26.2	52.2	100	89.6	96.1	149.5	135.5	72.1
Private debt flows	15.7	18.6	38.1	49	54.4	60	100.3	105.3	58
<i>Commercial banks</i>	3.2	4.8	16.3	3.3	13.9	32.4	43.7	60.1	25.1
<i>Bonds</i>	1.2	10.8	11.1	37	36.7	26.6	53.5	42.6	30.2
<i>Others</i>	11.4	3	10.7	8.6	3.7	1	3	2.6	2.7
Portfolio equity flows	3.7	7.6	14.1	51	35.2	36.1	49.2	30.2	14.1
Foreign direct investment	24.5	34.4	46.1	67	88.5	105.4	126.4	163.4	155

The reasons for these shifts are manifold, but centered on a handful of factors. In the shorter term, the crisis of Asia, and later Russia (and most recently, Latin America), encouraged the global constriction of international capital market flows. If past history is any guide, the flows may revert to pre-crisis levels as these crises come to a close (World Bank, 1999). However, in the longer term, ODA (as shown in the table below) continues its decade-long slide, showing little prospect for reversal.

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Official development finance	56.9	62.6	54	53.3	45.5	53.4	32.2	39.1	47.9
Concessional finance	44.8	51	44	41.5	45.8	44.7	40.1	33.4	32.7
Grants	29.2	35.3	30.5	28.3	32.4	32.3	28.9	25.7	23
Loans	15.6	15.7	13.5	13.2	13.3	12.3	11.2	7.7	9.7
Bilateral	9.6	9.3	7	6.7	5.6	5.1	2.9	0.2	2.8
Multilateral	6	6.4	6.5	6.5	7.8	7.2	8.2	7.4	6.9
Nonconcessional finance	12.1	11.6	10	11.8	-0.3	8.8	-7.9	5.7	15.2
Bilateral	2.9	3.9	4.5	3.4	-2.5	5	-12.7	-8	0.8
Multilateral	9.2	7.6	5.5	8.4	2.3	3.7	4.8	13.7	14.4
<i>Memo items</i>									
Use of IMF credit	0.1	3.2	1.2	1.7	1.6	16.8	1	14.7	21
Technical cooperation grants	14.3	15.9	18	18.6	17.3	20.6	19.4	17	16.1

(Source: World Bank, 1999a)

This trend can be attributed in large part to G-7 policies, influenced as it is by popular opinion in their countries. Other influences include the deficit-reducing fiscal measures of the early nineties, a growing popular skepticism over the efficacy of aid, complex civil conflicts in recipient countries, and, with the end of Cold War, a retraction of strategic support to several countries (World Bank, 1999). In addition, military intervention and humanitarian efforts, together with massive IMF bailouts of the economies in crisis may, have heightened domestic concerns over fiscal over-extension. Despite the recoveries of most G-7 economies, and continual improvement in the capacity of many recipient countries to effectively channel, utilize and account for aid, this decline (as shown in the table below) appears unlikely to change in the near term.

Table 3. Fiscal balances, government expenditures, and ODA in G-7 countries, 1992-93 vs. 1996-97 (percent of GDP)

	Improvement in fiscal deficit	Change in govt. outlays	Change in net ODA
United States	3.8	-2.1	-0.07
Japan	-3.8	2.9	-0.07
Germany	-0.1	-0.5	-0.07
France	1.3	0	-0.16
Italy	4.9	-3.7	-0.17
United Kingdom	4.1	-2.7	-0.04
Canada	7.2	-6.7	-0.13
Total	2.1	-1.2	-0.09

(Source: World Bank, 1999a)

Accompanying the downturn in aid flows are both the pressure of the debt overhang and the continued slow growth. According to the World Bank (1999a):

- Outstanding external public and publicly guaranteed liabilities of developing countries are currently more than two and a half times their international reserves. Sixty percent of these are at floating interest rates.
- The developing country 1999 growth forecast was at its lowest since 1982, at 1.5 percent.

This scenario raises questions of FDI's suitability as the dominant source of development finance, and of the impact on sustainable development of this shifting terrain. FDI and commercial bank loans meet certain development objectives by targeting handfuls of large-scale projects, such as infrastructure and industrial development. Such projects incur relatively low administrative costs to the investor, with funding moved through fairly direct channels. Through these projects, finance is utilized for projects that generally provide jobs, a return on investment, contribute to economic growth, and can foster competitiveness in the global economy. However, while such investment may be a necessary component of the development process, it generally does not meet the internationally recognized needs of *sustainable* development. It can, in fact, be argued that such projects provide few jobs, encourage little local reinvestment and contribute to unsustainable economic and social patterns when compared with alternatives.

2.2 Impact on Sustainable Development

While aid for development is laden with difficulties – inefficiency, ineffectiveness, corruption, misuse – the professional consensus is that aid within a supportive domestic and international policy framework, is the best – indeed, the only – method of enabling certain types of essential development activity. Heightened capacity and strong institutions are widely recognized as the cornerstones of poverty alleviation and sustainable development. These, however worthy, are objectives which commercial finance has no clear and immediate incentive to pursue; grant resources remain a critical link to these activities, enabling development of village organizations, rural technical capacity, rights protection, and more. With the precipitous drop in this form of finance, progress toward sustainable development is indeed in question.

A solution may be found in the alternative tools through which development finance can be utilized, from medium-scale partnering projects, to small-scale franchising, to micro-credit. Finance directed to these levels, in the form of credit or aid can elicit a range of positive responses in local job creation and patterns of reinvestment. Additionally, in a number of successful examples, smaller-scale finance is being directed toward the creation of large numbers of jobs which can provide not only a living

wage and a package of social goods (such as capacity building for rights protection and community empowerment), but can involve more sustainable “throughput” of resources. Such jobs, with their implicit social and environmental connections, are coming to be known as “sustainable livelihoods”.

3. An Alternative Approach

3.1 Sustainable Livelihoods as a Development Goal

A central goal for any developing country today, as for any industrialised, is sustainable development. A term too freely dispensed with, sustainable development as a concept has yet to land on undisputed soil, but a convergence is emerging, captured best by Sachs (1999), in the following three tenets: first, that human beings should be able to enjoy a decent quality of life; second, that humanity should become capable of respecting the finiteness of the biosphere; and, third, that neither the aspiration for the good life nor the recognition of global biophysical limits should preclude the search for greater justice in the world.

By this definition, the harmonization of growth with social and ecological parameters means, not only protection of rights and conservation of natural resources, but the eradication of poverty. By its very name, UNCED made clear that poverty and environment are inextricably linked; as was articulated in Rio, eight years past, the two must be tackled in unison if progress is to be made on the international environmental agenda. And yet, despite the persistence and the socio-political and ecological implications of poverty (and considerable knowledge and experience to address it), it has not risen to the top of the real policy agenda anywhere in the world. Development policy continues to center on industrialization, and far less on poverty. Current technological options are also skewed in favor of the industrial sector. As a result, the capital cost of creating the millions of jobs needed each year in poorer countries, in the modern industrial sector, could be many times higher than a country's GNP. Given the present ecological price tag of modern industry, this approach is clearly not among the solutions to global environmental problems, and given the expense, simply cannot be the solution for eradicating poverty.

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

In the recent World Bank publication, *Assessing Aid* (1999), the most pressing question is identified as: “how can development assistance be most effective in reducing poverty?” The answer, it can be argued is that the single most effective use of development finance for reducing poverty and advancing the goals of Agenda 21 is the **creation of sustainable livelihoods**. More than simply job creation, this approach aims at *sustainability*, ecological as well as social and economic, rather than on short run interventions. Such programs help the poor to build on and expand their asset base through social mobilization, credit, technology, and policy and governance reform. Sustainable livelihoods programs start from varying entry points, depending on local conditions and needs – micro-credit, community development, appropriate technology, enterprise development, or protection of rights and access to natural resources. They also concentrate in different sectors for investment – water, construction, home-based industry, agriculture, and others, but have a broadly common approach to poverty eradication.

In particular, the sustainable livelihoods approach takes a dynamic view of poverty – namely as vulnerability to shocks – and therefore aims to enhance the resilience of communities to cope with such shocks. Thus, it seeks to enhance the social capital of the poor and their access to natural capital,

rather than concentrating solely on income or financial/ physical capital. It seeks to mainstream gender empowerment, rather than treating this as an add-on or ancillary objective. In short, it focuses broadly on livelihoods rather than income or jobs.

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

To close the unemployment gap by the year 2015, India will need to create 12 to 15 million jobs off the farm, each year. "Modern" big industry is not capable of creating this many workplaces. In India today, it can hardly create two million jobs per year. The capital cost of creating one workplace in the modern industrial sector in India is well over \$100,000 – often including a significant component of imported technology and equipment. At this rate, just the creation of twelve million jobs each year would by itself cost four to six times the GNP of the country.

Job creation can clearly take many forms. However, in less developed countries, job creation needs to be geared away from a handful of capital-intensive jobs, toward large numbers of lower impact livelihoods. Jobs are needed that produce, at a minimum, the goods and services required to fulfil basic needs, generate the widespread income and therefore purchasing power necessary to give people access to these goods and services, and regenerate, rather than degrade, the environment and its resources. Because of the contribution they can make to economic efficiency, social equity and environmental quality, the term 'sustainable livelihoods' has been coined.

These livelihoods are particularly well-suited to the needs of women, the poor and the marginalised. By providing people with income and some degree of financial security, they are an excellent means of empowering people within their communities (i.e., enhancing the capacity to act). Together with programmes for education of girls and women, sustainable livelihoods may be the most effective stimuli for smaller families and lower birth rates.

3.2 Recognition of Alternative Scales

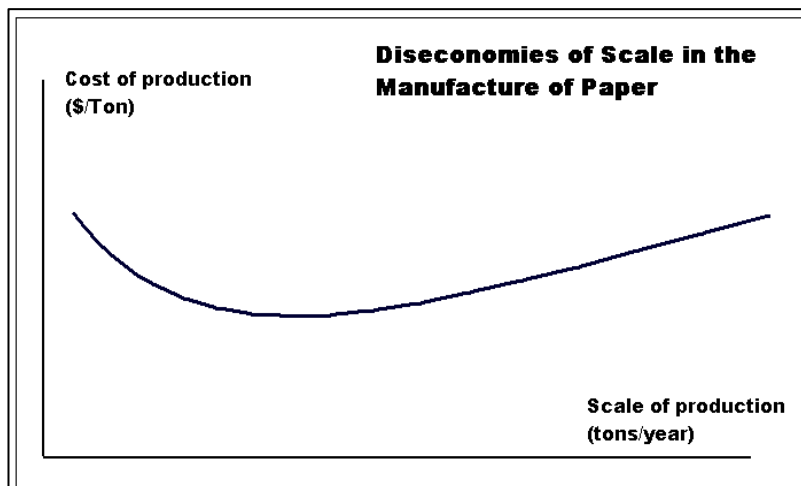
Countries now need to create sustainable livelihoods on a large scale, and to accelerate the rate of growth of their economies. Eradication of poverty within a reasonable time frame will need double digit growth rates.

The reasons for failure on these fronts thus far lie, ironically, in the very structure of industrial production that has provided so many benefits for so many people all over the world: its emphasis on mechanisation, centralisation, large scale, and use of energy- and material-intensive technologies. The imperatives of competitiveness in the global economy encourage the choice of complex and expensive types of production systems. The technology used is generally capital intensive and labour displacing, the fossil fuels, raw materials and components are often imported and of uncertain availability, and the management systems required are sophisticated and costly. Such systems need large investments, have long start-up gestation periods and create few jobs.

There are, of course, sectors for which the economies of scale favour large, mechanised production units (e.g., steel making, oil refining, petrochemicals and automobile manufacture). But there are many sectors where economies of scale are not relevant. Most industries producing basic goods for rural populations are commercially viable even at quite small scales. And because of the low capital requirements, they can have high returns on investment - in some cases even double those for their larger counterparts. In small and mini plants, the scarce capital is recovered in a much shorter time, making it possible to reinvest it in further production and job creation.

Clearly, a better mix of large, small and mini industries is now needed. Given the continued failure of policies to address the needs of the small, mini and micro sectors, a proper balance will require greatly enhanced encouragement and incentives to such industries. Indeed, if the full economic and environmental costs of the processes and resources used in manufacturing and delivering products is taken into account, and no "perverse" subsidies are allowed for energy, transportation, financial and other services, small scale production becomes quite competitive, and warrants the financial encouragement granted larger endeavors.

Figure 1.



A study sponsored by the Overseas Development Administration (now DFID) of the UK has clearly demonstrated that financing for mini enterprises (as defined here) is a critical gap in the development arena. Today, there exists a widespread recognition among the international development community of the importance of financing sustainable enterprises in developing economies, but very few mechanisms are yet available on the ground. The availability of grants is dropping, and conventional financing institutions remain inaccessible because smaller-scale sustainable livelihoods projects generally have little collateral to pledge and no trade record to demonstrate a steady cash flow. Given the small size and weighty administrative costs of such allocations, and the sparse credit histories and high perceived risk of many borrowers and grant recipients, finance continues to be the missing link to widespread creation of sustainable livelihoods.

3.3 Enhancing Demand for Finance

Alternative forms of finance are clearly an essential component of effective development portfolios. Further, the risk of directing finance through these mechanisms, to sustainable development activities, must be reduced if they are to be effective. The more ambiguous factors are those needed to make such forms of finance viable to lenders and grant-makers, and accessible to users. The important lessons for this effort, however, are no different from those that have emerged from recent development literature and experience – namely, that capacity building and institutional strengthening lead to greater legitimacy and support, at all levels, of development activities.

When applied to the question of development finance, the key and innovative attribute of these methods, is that they imply an alternative approach: a focus on demand. Indeed, while the policies of key entities on the supply side of the finance issue – the World Bank, commercial banks, aid agencies – are important factors, the key determinants of a lasting solution will better be identified through analysis and strengthening of demand. The reduction in risk and handling costs (essential to successful lending) and restoration of grant-maker confidence (essential to aid) cannot be addressed through changes in supply. Movement on both fronts is central to future small-scale sustainable development activities, and must each be approached through a strengthening of project efficacy and

accountability, and, in the longer-term, records of credit-worthiness. In other words, risk reduction, efficiency and restoration of legitimacy can only be achieved by strengthening the demand for finance.

3.3.1 Capacity building and institutional strengthening

Numerous alternative finance models exist, such as micro-credit, franchising and partnering. The variety of available supplier/purchaser relationships confirms that development finance need not enlist traditional models in order to be effectively utilized and can, in fact, be hindered through limitation to these models. In cases where proven, smaller-scale applications of development finance are deemed too expensive an undertaking by conventional creditors such as the banking sector, valuable opportunities for job creation and growth are lost.

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

The notions of building capacity and strong institutions have received significant attention in recent years, mainly in the context of national development and environmental management. It is now widely held that capacity is required to meet a variety of challenges in these domains. Agenda 21 states, for example, that the "fundamental goal of capacity building is to enhance the ability to evaluate policy choices and modes of implementation of development options, based on an understanding of...specific needs as perceived by the people of the country concerned".

Most of the discussion surrounding capacity building focuses on improved management of development and environment projects, at the national level, through strengthened human resources, improved institutions and inter-institutional linkages, and through the creation of an enabling policy environment (see, for example, UNDP 1997 and OECD 1995). While attention has been directed toward capacity building of the NGO community, this effort has not undertaken the issue of small-scale finance with adequate rigor. Little direct attention has been geared toward the capacity building of non-governmental organizations to handle and administer this level of development finance, a factor which may have served to slow the evolution of development work in general. It is through the framework of the NGO community, after all, that various target groups – rural populations, ecologically vulnerable groups, the informal sector, women – are most readily accessed, and it is through these groups, then, that small-scale development finance can be most effectively utilized.

South Asia, as an example, is characterized by the world's largest concentration of poverty and low human development, as well as a deepening crisis of environmental degradation, malgovernance, and geopolitical tension. The bright light in this situation has been the performance of the non-government sector. Here, and around the globe, this sector has offered up alternative leadership for sustainable development as well as regional cooperation.

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

Strong institutions, in the context of development finance, would mean that the handling costs of large numbers of small grants or loans could be borne more inexpensively, at the NGO level. They could also create confidence among large lenders, lowering the rate at which loans can be made to institutions, and thus the rate at which the loan can be passed on to small-scale projects and entrepreneurs. A number of NGOs are currently capable of stepping into both the role of small- or mini-scale intermediary creditor, creating the institutional skeleton of a supplier's market for this type of credit, and the role of project finance monitor. But these groups often lack the legal and financial support to do so. Furthermore, additional groups will be needed, but many lack the technical capacity to assume such a role.

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

The two groups – intermediaries and recipients – possess a number of the tools to build and run alternative scale finance and monitoring systems. They do, however, require increased capacity – through technical and networking assistance, access to technology, training programs, etc. – to do so. Two factors in particular call for such an international capacity building effort for both intermediaries and recipients. First, the scope of demand for this sort of credit framework – estimated to be in the millions of borrowers in India alone; and second, the existing capacity and potential which can be capitalized upon through network building, mutual learning, etc. (A third may be new international calls for a global grant-making institution on the scale of the World Bank – if not the Bank itself. Though unlikely, a strong renewal in this type of aid could be greatly encouraged by stronger recipient capacity.) In short, finance is not only needed to meet sustainable development's goal of strengthened capacity – both of the individual, the community and the institution – but capacity is needed now in order to mobilize and utilize this finance.

FOOTNOTE: In reality, the division employed here, between recipient and intermediary, may be a misleading dichotomy, as the strengthening of demand means a strengthening of the many layers of the finance process. In a strong and transparent system, in other words, an NGO may borrow money from commercial vendors to lend to a community, which may in turn lend to individuals. The issues of scale and layering require exploration and research, ideally through the experiences of an international capacity building effort.

3.3.2 Reducing Risk and Building Legitimacy

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

Thus, the framework through which both lender and donor funds are brought to bear on a development issue needs to be made more efficient, through niche-filling in the supplier chain, more transparent, through improved monitoring and institutional strengthening, and more effective, by bringing finance to the level of the economy where the greatest number of new jobs and real income are generated. Similarly, efforts aimed at bringing credit to the small-scale entrepreneur, can help domestic development transfers by restoring legitimacy to domestic, public sector activities, such as tax collection. The connection of these “legitimacy frameworks” requires an effective, transparent intermediary mechanism. The process of coupling these ends of the development finance chain can be initiated through the fostering of:

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

Legitimacy is a cornerstone of development activities, and with its deterioration come a number of impediments to the development process. These impediments tend ultimately to impact the movement of finance. The approval and release of funding can be obstructed, and finance can be ineffectively disbursed and under-utilized.

With a breakdown in legitimacy, the process of financing development activities can fail at a number of points. At a bi- or multilateral level, trust of the public of the donor countries, the members of a donor foundation, the overseeing agency of the donor government, the public or private recipient agency, and even the financial conduit can be lost. Domestically, the generation of development finance can be hindered by government corruption or public disapproval in the use of taxes, and thus the process of tax collection itself.

For many nations, efforts to provide quality services and products that contribute to national development, through strengthened capacity, are quickly encountered by the larger issues of social instability and economic crisis. A number of socioeconomic and political constraints can affect the performance of the public sector in countries that have experienced economic recession and social conflict. As the United Nations Research Institute for Social Development (1999) points out, these constraints include fiscal instability, the effects of income/employment reforms and workplace survival strategies on public sector performance, the impacts of centralization and decentralization on public sector accountability, and the ineffectiveness of emerging democratic governance in crisis-ridden countries.

Again, just as the supply of finance for development services can be inhibited – in this case by malgovernance and decayed legitimacy – the demand for development services can also be depressed. Essentially, the utilization of development finance can be impeded through a loss of trust on the part of prospective recipients in the loan- or grant-making process. Potential consumers of credit are less eager to purchase credit when it is supplied through channels – public sector, or private – that have displayed an inability or unwillingness to confer with civil society over development objectives, or worse, have exhibited signs of corruption and mismanagement.

These are longstanding issues, not quickly overcome, which many nations experience to varying degrees. Efforts are ongoing within the UN and other multilateral agencies, to address the impacts of these constraints. However, the particular impact of malgovernance and mismanagement on not only supply, but *demand* of development finance is an area of focus that is currently underdeveloped.

Both a reduction in lending risk and an increase in legitimacy of the development finance process, in the eye of both supplier and consumer, can be achieved, but will require programmatic efforts to enhance:

- efficiency, transparency and competence of the public, private and NGO groups involved in the aid and credit processes, through increased managerial and institutional capacity
- public policies that encourage and facilitate private sector investment in alternative scale enterprises
- communication of credit options and alternatives to the pool of potential borrowers
- the process of exploring and developing alternative credit mechanisms
- research capacity in the study of development finance reform
- capacity and network building geared specifically toward a civil society-based intermediary lending community
- capacity and network building geared specifically toward a civil society-based monitoring mechanism
- networking and debate among process participants toward increases, at all levels, of development management capacity
- visibility of the process and its outcomes both for civil society (domestic and international) and for the aid and commercial lending communities
- communication of success stories, and the dissemination of best-practice knowledge

4. Conclusion

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

It is this latter class, however, that begins to meet the internationally articulated objectives of Agenda 21 by fostering sustainable growth, and the latter which itself requires fostering through a realignment and reinvigoration of the development finance framework. Economic liberalisation and increased warnings of biospheric limits are fueling a growing recognition of the need for more sustainable forms of development. The imperative of poverty reduction has guided a number of development practitioners toward the sustainable livelihoods approach and, under a less defined rubric, is guiding policy-level decision-makers toward the notion that large numbers of such livelihoods are possible and essential. While, in the globalized market, poor countries will continue to need large industries, particularly to build and maintain competitiveness, they need even more a vast array of small ones.

The key barriers to creating sustainable livelihoods on a broad scale are limited capacity – in large part, low technical and managerial skill levels, limited access to the right technologies, inadequacy of marketing channels and purchasing power – and the absence of financial mechanisms and facilities geared to meet their needs.

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

potential for generating surplus, savings or reinvestment. Compounding the quandary is the fact that many potential clients are manifestly more profitable, less risky and better in tune with the needs of the local and regional economy than their larger, well-financed counterparts.

These borrowers include a wide range of industries, trades, and communities capable of “boot strapping” local, and consequently national, economies. Among these, a large number could contribute to sustainable development by enhancing coping strategies and protecting communities from shocks, by fulfilling basic needs, creating livelihoods, generating purchasing power and conserving natural resources. Grant-based projects will continue to be an essential compliment to commercial lending, as clients – both institutions and communities – begin the self-nurturing process of capacity building.

The body of projects and enterprises which create sustainable livelihoods can grow rapidly provided a systematic infrastructure is built up to provide them the needed support. Both the tenets of Rio and conventional development wisdom call for action in this direction. In a number of nations, recent government policy statements indicate a growing recognition of the desirability of this type of approach. Successful models exist which can be readily replicated, yet real action on the ground remains limited. In its response to the questions of future development finance, the international community would be well-advised to encourage these alternatives, and to place the development of this type of framework and the capacity of participant groups, at the center of its strategy.

Annex I

Examples of Alternative Finance

1. Micro Credit

The Micro Credit Summit convened in 1996 at Washington, D.C. by several private foundations and supported by the World Bank and UNDP highlighted the wide range of experiences with mobilising mini-level capital in various parts of the world. Examples from Bangladesh, India, Indonesia, Thailand, Kenya, Senegal, Egypt, Peru, Venezuela, Costa Rica, the US and many other countries served to demonstrate that new financing mechanisms can reach large numbers of people who have

thus far been left out of the formal, mainstream economy. They showed how dramatic a transformation micro and mini credit can bring about in the lives of poor people. They also served to show that micro and mini credit institutions have a very respectable rate of recovery for their loans, despite the relatively high interest rates charged. More than 10 million people spread over all continents have received and repaid micro credit.

Starting in the late 1970s, several organisations have pioneered mechanisms that have now accumulated decades of successful lending to borrowers of very small loans. These lending programmes vary considerably in their detailed design, but most are based on group lending and rely on peer and community pressure to facilitate recovery. Small but formal groups are formed, usually followed by awareness and training sessions. Their pooled savings, together with additional funds from an external source, are then lent to one or more members. Additional members can receive loans only after earlier ones are repaid. The interest rates, designed to cover the costs to the organisation of raising money and managing the loan, can be quite high (20 to 25%)- but much lower than those of traditional moneylenders. The best known lenders of this type include the Grameen Bank in Bangladesh, SEWA in India and the World Women's Banking in North America, Latin America and Asia. A particular form of this type of lending, the "Self-help Group" (SHG), is now being officially promoted in India and is eligible for accessing funds from several Government agencies.

2. Mini Credit for Mini Enterprises

Small and medium-sized enterprises, already form the backbone of a number of developing country economies. In India, for example, they account far more than 60% of the industrial production and for more than 65% of industrial exports. They account for more than 70% of industrial employment. When adjusted for the vast subsidies and infrastructure that large scale industry can take advantage of, their real contribution to the economy is even higher.

Sustainable enterprises are usually quite small. They have between one and 100 employees, with an average around 20. They are generally informal and flexible and quite labour intensive. However, being small, dispersed and largely unregulated, mini enterprises can often have environmental and social impacts that are fairly negative. To overcome this, they need access to better technologies as well as other supports.

Many technologies for such enterprises already exist. So does the demand for their products. What prevents the poor from setting up such enterprises is their lack of access to these technologies and their inability to put together the financial capital required. What prevents them, once set up, from becoming profitable is the absence of entrepreneurial and management skills, infrastructure and marketing channels. Much more public investment is needed to provide these, but probably not nearly as much as is being made today for the benefit of large, urban industries.

Several mechanisms are now evolving to help enterprises overcome the barriers to obtaining technology, to using effective transport and communication facilities and to introducing modern management methods.

But credit continues to be the key missing link.

Despite considerable policy-level recognition in India of the importance of the mini and small industrial sectors, formal mechanisms to provide financial support to it are quite limited. Even where such supports exist, they are further limited in scope to financing very traditional economic activities such as purchase of cattle for dairy or traction, tailoring, retailing and equipment servicing. Most of these activities offer almost no possibility for generating surpluses, savings or investments in improved productivity of better income opportunities.

On the other hand, technology-based mini-industries, being unfamiliar to most lending agencies, find it far more difficult to raise financing, even though they are manifestly more profitable, less risky and better in tune with the needs of an economy pursuing sustainable development.

While currently finance is rather readily available to ‘small and medium enterprises’ (those with capital requirements of Rs. 10 lakhs (\$25,000) or more), and increasingly available to micro industries (needing capital of less than Rs.10,000 (\$250)), it is precisely the mini enterprises that fall in the range between these two categories, and are thus overlooked. Mini enterprises, with capital investment of Rs 10,000 to Rs. 10 lakhs, optimise the twin objectives of sustainable livelihoods and returns on investment. They are small enough to be responsive to the local economy yet large enough to employ technologies and skilled workers and to maximise labour productivity. At the same time, they are big enough to take advantage of public infrastructure, credit facilities, technology support and marketing channels provided these are available.

There are numerous technology based mini industries in this range that could be set up today and run profitably. Such enterprises can create, directly, several workplaces, each at a capital investment of Rs.20,000 to 50,000. In addition, they indirectly lead to the creation of several more jobs, upstream or downstream, usually at an even lower capital cost. Such workplaces, in the village or small town, yield incomes for workers whose purchasing power is comparable to, if not better than, those created at a hundred times the cost in large urban industries. At the same time, they permit very high returns on investment, sometimes with payback periods of less than a year.

The 1996 Micro Credit Summit underlined what is still missing in the field of mini credit. The bulk of the examples were limited to credit for the “self-employed”. These are basically micro industries that range from street vendors and domestic helpers to manufacturers of handicrafts, industrial components and small products like packaged spices, garments and toys. Some are based on agriculture and animal husbandry; others provide components and inputs to larger industries. A large percentage of them are subsistence occupations admittedly a great achievement for people who earlier could hardly survive on their earnings. Since their ROI varies between 10% and 30%, few of them can, however, generate the kinds of surpluses that enable a business to invest in technology and improved productivity, a prerequisite for genuine economic development.

The next step in the mini credit revolution has to be the evolution of new kinds of enterprises that will mobilise resources and create steady jobs for larger numbers of local people, beyond the immediate family. FUNDES, a Swiss initiative that has pioneered financing mechanisms (based primarily on guaranteeing bank loans) in several Latin American countries, has over the past decade provided several examples of mini and small industries that can be made commercially viable with minimal financial support. However, it is also becoming apparent that the bank guarantee approach has its limitations.

Much of the success of the industrial sectors of Japan, Taiwan, Korea and Singapore rests on the aggressive policy and financial support given to mini and small scale industry. In these economies, mini enterprises often received these supports, together with technology, marketing and other services from larger companies for whom they manufactured OEM components, but the main source of financing was institutional.

IFC sponsored mini enterprise lending in Pakistan, Jamaica and other countries has shown that such borrowers have excellent repayment records and that such financing mechanisms can themselves be commercially viable. The experience, for example, of Oryx in Pakistan shows that provided the lending agency tunes its operational style somewhat to the local behaviour patterns and culture and maintains close monitoring and follow up of the loans, recovery can be extremely high, often above

98%. World Bank studies have shown that the rate of return accruing from funding these enterprises can also be excellent.

ROLE OF MINI ENTERPRISES IN SUSTAINABLE DEVELOPMENT

Credit to	ROI	Recovery	Livelihoods Potential (Investment in Rs. Per Job)	Transformation	Reach	Impact
Micro Enterprises	High	Very Good	Highest (1K to 10K)	Survival to Subsistence	Household, Local Neighb'd Village	Family self-sufficiency
Mini Enterprises	Very High	Good to very good	Very High (5K to 30K)	Subsistence to Security (for workers) and surplus (for entrepreneur)	Local Neighb'd Community Village, Town	Local self-reliance

Small Enterprises	High	Average to good	High (20K to 5L)	Surplus to Savings and Productive Assets	Town, Region, OEM	Resilient Industrial base
Medium Enterprises	Medium	Good	Medium (1L to 20L)	Assets to Major Capital Investment	Region, OEM, Exports	Quality, Standardised products
Large Enterprises	Medium to Low	Good to Very Good	Low (10L to 1C)	Capital Investment to Private Wealth	Buyer of OEM, National Market, Exports	Global Competitive-ness

STATUS OF MINI CREDIT IN INDIA

Credit to	Total Capital Investment	Purposes of Loan	Sources in India	Annual Loans in India (Estimated)	Ability Relative to Need	Priority for Investment
Micro Enterprises	1,000 to 10,000 (\$25 to \$250)	Emergencies, Working Capital, HH Industries, Retailing, Trading	Landlords, Middlemen, Family, Friends, Informal Leaders, Grameen, SHG, WWF, SEWA	Formal Sector Rs. 5,000 Crores (\$1 Billion)	Low	2
Mini Enterprises	10,000 to 10 Lakh (\$250 to \$25,000)	Equipment	Family, Friends, Govt. Programmes, SIDBI thru Bank	< Rs. 10 Crores	Very Low	1
Small Enterprises	10 Lakh to 1 Crore (\$25K to \$250 K)	Equipment, Software	Bank, SIDBI, Finance Agency	Rs. 10,000 Crores (\$2.5 Billion)	Medium	3
Medium Enterprises	1 Crore to 10 Crores (\$250 K to \$2.5 M)	Equipment, Software, Personnel	Bank, Finance Agency, Leasing Company	Rs. 30,000 Crores (\$7 Billion)	Medium	4
Large Enterprises	Above 10 Crores (Above \$2.5 M)	Know-How, Equipment, Software, Personnel, Research	Bank, Finance Agency, Leasing Company, IDBI, ICICI	> Rs. 30,000 Crores (\$70 Billion)	Medium	4

ANNEX II

Small credit systems: The Indian experience

In India, the large industrial enterprise has access to an extensive pool of financial resources. The commercial banks alone lend more than Rs. 160,000 crores (\$40 billion). The other sources, including financial institutions like IDBI and ICICI bring the total equity and debt financing available to the large industrial sector to the region of Rs. 300,000 crores (\$60 to 80 billion) each year. Small and medium enterprises are able annually to raise financing of the order of Rs. 40,000 crores, (\$10 billion), most of it going to the larger firms in this group. Most of this money comes from banks in fulfilment of certain lending norms to which they are subject.

At the other end of the spectrum, low-income individuals and households are eligible for numerous micro loans for amounts below Rs. 10,000 (\$250). A few of these have limits of up to Rs. 1 lakh (\$2,500). The term "loan" in this context is a bit of a euphemism because most of the borrowers - and lenders - don't expect them to be paid back. They are loans given out by government agencies and nationalised banks which are "refinanced" (essentially reimbursed) by various government schemes such as the Integrated Rural Development Programme, the Prime Minister's Rozgar Yojana (Employment Plan) and other special programme funds. The total funds sanctioned under the various schemes of government add up to several hundred thousand crores (i.e., several tens of billion dollars).

The second set of micro credit sources in India is in the informal sector. These include moneylenders (whose interest rates can be as high as 200% per year), middle-men, "chit funds" that pool contributions from members, and family and friends. Loans from moneylenders and middle-men are usually exorbitantly expensive and carry the risk of creating a state of permanent bondage for the borrower. In any case, no financially viable production capacity can be built up while servicing debt under such conditions.

The third source, which is gradually growing, is from formal institutions such as banks, co-operatives, and NGO credit facilities. These include, for example, the Self-Employed Womens Association, Working Women's Forum, various Grameen Banks and Self-help Groups providing credit to the very poor, particularly to women and the marginalised.

The mini enterprise sector, as defined here (Rs 10,000 to Rs 10 lakhs i.e., \$250 to \$25,000) gets, collectively throughout the country, well below Rs. in crores (\$2.5 million) per year. There exist very few financing systems for this sector, the largest ones being tiny in comparison with the others. These include numerous mainstream financial institutions, including the rural branches of the nationalised commercial banks numbering in the hundreds of thousands, the Regional Rural Banks in the hundreds, Local Area Banks in the dozens and the Co-operative Banks in the thousands - all with mandates to service the rural economy. Regrettably, while these institutions have a tremendous physical reach, their record of providing finance for investment in mini industries is very poor.

India is fortunate in having a long tradition of entrepreneurship at the small and mini levels. A great majority of these "NRIs" operate successful businesses in manufacturing, services and trade in all parts of the world ranging from North America and the Caribbean through Britain, East Africa and South Africa to South East Asia and the Pacific. Even within the country, it is the small- and, particularly, the mini- enterprise that contributes the bulk of the productive capacity. Yet, neither the centralised economic systems adopted by the newly independent nation in the fifties nor the policies to encourage privatisation pursued since the early 1990s made much effort to nurture this sector which therefore has yet to fulfil its true promise as the backbone of the economy.

The main public sector agencies mandated to promote small and mini enterprises work through intermediaries in the formal sector - primarily by refinancing commercial banks or by lending at concessional rates of interest to other institutions or on-lending purposes. The largest of these (NABARD, SIDBI, RMK and FWWB) started their mini enterprise support programmes around 1992. Combined, they have been able to facilitate delivery of mini credit amounting to well under Rs. 25 Crores (\$ 6 million) – over the entire six year period.