DevelopmentAid Dialogues

Season 3. Episode 8: Raj M. Desai: Rethinking Development Finance in an Age of Shrinking Aid

Hisham Allam: Hello everyone. Welcome to DevelopmentAid Dialogues. Today we are addressing a critical challenge facing the global development community, the sharp decline in official development assistance, and its impact on country that rely heavily on external aid to meet their development goals. This shift comes at a moment when needs are rising due to complex crisis around the world, making it more urgent than ever to understand how countries and aid actors can adapt to rapidly changing financing landscape.

Our guest today is Professor Raj M Desai, Professor of International Development and Vice Dean for Graduate and Faculty Affairs at Georgetown University's School of Foreign Service. Raj is a well-known expert on foreign aid, economic reform and development finance, with decades of experience working alongside international organizations and governments.

Raj, welcome to DevelopmentAid Dialogues. It's an honor to have you with us today.

Raj M. Desai: Thank you, Hisham. It's a pleasure to be here.

Hisham Allam: Raj. First, what are the main reasons behind the sharp fall in official development assistance worldwide? And how urgent is this issue for different regions, particularly the least developed countries and Sub-Saharan Africa?

Raj M. Desai: This is the heart of the matter, the sharp fall in official development assistance that we've seen in donor budgets this year. This is not something that has come out of nowhere. We have seen downward pressure on official development assistance for several years now, and I think there are a couple of reasons.

In particular, we have talked about donor fatigue for a very long time, and I think that with a combination of factors, particularly due to conflicts in parts of the world, in Afghanistan, Iraq, and Syria. The result of refugee flows, the fiscal consequences of the global financial crisis in 2008 there has been, much more, political support for shrinking, foreign aid budgets across the world, often multiple political parties, not just the more nationalist populist parties. In the United States, we have seen that the one area, even before Donald Trump became president the second time, the one area where Republican leaning voters and democratic leaning voters agree should be reduced in terms of the public budget is always foreign aid.

In the United States, of course most voters overestimate how much foreign aid we actually give. If you ask people what percentage of the federal budget they think consists of foreign aid, they'll say something like

10% or even more. When in reality it's less than 1%. So, there's a distortion in the image. Nevertheless, there has been bipartisan support for shrinking the foreign aid budget. And so, one of the reasons I think that Elon Musk and his Doge, department of Government Effectiveness Group went after foreign aid. Because there's not much of a domestic constituency that supports that, which is not the case, for example, with the Defense Department or some other parts of the government for which there are many domestic constituents that support it.

So, this has been something that's been going on. A lot of donor countries in Europe particularly have said that their overseas development assistance, their official development assistance budget needs to be reallocated to settle refugees in countries where they're arriving. So that has cut into the amount of foreign aid that is available for regions in the world for low income, least developed countries. And then more recently you've seen the rise in populist nationalist parties that actually oppose foreign aid from traditional donors. And this is not just limited to a small group of countries. You've seen a lot of political reaction to foreign aid.

And the last thing I think is that with the Russian invasion of Ukraine in 2022 there has been a shift of pressure, I should say. To shift funds towards security among the Western European and for some eastern European donors that has required them to reallocate official development assistance to security.

We see this in the UK, in Germany, in Sweden, Netherlands, that are allocating money away from aid towards defense, towards their own security.

Hisham Allam: That's very helpful to understand the stage. At the same time, donor countries face increasing fiscal constraints. How would this shaping priorities and the overall availability of official development assistance?

Raj M. Desai: I think this has accelerated some reforms that have been in place for several years now. They have just been accelerated with the donor fiscal constraints. So, one area in which most donors have been trying to move is towards greater harmonization and coordination so that they're not duplicating efforts, they're not stepping on each other's toes. In 2005, there was the famous Paris Aid Declaration that identified the five famous Paris principles of aid that included harmonization, country ownership, more coordination of donors, less fragmentation, things like that. There are a series of objectives that were meant to make aid more effective. So, there's always been this search for effectiveness in aid because the argument is that these are taxpayer dollars from donors and they want to ensure that the money is not leaking, it's not being wasted. And it's being mused in the most effective way. So that has accelerated more recently. The other issue, I think that, and I mentioned that there's been an allocation towards security. There is a greater concern about security and the connections between security and development. Now, this has always been there to some extent particularly in the early 2000 when we had, conflicts in Afghanistan and Iraq as well as concerns about terrorism. There was the famous development defense nexus. It did not really evolve in a more sophisticated way except that the argument being that providing development assistance to fragile states would prevent conflict.

Now there is much more of a focused attempt, I think to connect foreign aid programs to security in fragile states. And the other thing I would say is that donors want benefits. To some extent, foreign aid has always been transactional. It is always a part of foreign policy a country's foreign affairs and donors want benefits. We've seen this with the newer bilaterals like China and Russia and Saudi Arabia and other Gulf countries. They want commercial, strategic and other benefits from providing aid. And now we see the same thing with the traditional development assistance committee donors that want benefits for their population so that they can show that providing foreign aid actually provides benefits to the home country.

Hisham Allam: Raj, you have mentioned some important challenges. Given this growing financial gap, what options do countries have to fill it? Are there examples of strategies or approaches that have proven effective?

Raj M. Desai: I think that there are strategies, there are approaches that aid recipients can take to replace the loss in foreign aid.

First of all, let me preface this by saying that we expect that by 2026 the total official development assistance, which reached a peak of about a little under 200 and 225, 200 $50 billion depending on how you count it in 2023. So, from that point, and that was driven in part by a boost after the COVID pandemic.

Since then, it has fallen. It fell in 2004. It is expected to further fall in 2025. And so, by 2026, the expectation is that global foreign aid will have fallen by about 25%, not just driven by the US but by a lot of official donors. So, this is one of the largest drops in foreign aid since we've been tracking official development assistance.

So, the question you ask is, what can countries do to fill these gaps? I think there are five broad strategies, and I'm happy to talk about each of them or any of them in depth. The first one, of course, is what is referred to as domestic resource mobilization, meaning figuring out ways to raise more taxes, generate more domestic revenue in a stable medium term framework so that one does not have to rely on as much budget support.

The second is diaspora financing. Now many countries have large diasporas that live outside of their borders. Many developing countries have large diasporas. Right now, what is happening is that diasporas provide remittances, which are private transfers that go from one private pocket to the other. But there are examples of diaspora financing in which the money actually enters the formal financial system or provides money to the government through bonds. And there has not been that much use of diaspora instruments. But that is an opportunity for some countries.

The third area would be cross-border private philanthropy. private philanthropy has exploded in the last 20 years. The last numbers we have is that cross-border philanthropy is over $70 billion in total global flows. Now that's obviously very different than 250 or 225 billion, but once you take out from official aid, things like debt relief, technical cooperation overhead costs, money to Ukraine, which we expect to be a short-term thing you that amount of money. Once you take that out, the gap is actually much closer. So, one is on the rise cross-border private philanthropy. One is shrinking official development aid. And so eventually these are going to converge and there are lots of ways in which countries can engage make their environments more favorable to cross-border philanthropy. And by cross-border philanthropy, work donations from charitable organizations, individuals, the work of foundations as well as some of the more mega foundations that we've heard of, such as google.org or, the Bezos Earth Fund, the Gates Foundation, obviously. Some of these organizations provide more money to certain countries and certain sectors than the World Bank does. So, this has been a big explosion in cross-border philanthropy.

The fourth is what is sometimes called blended finance or impact investment, which is really focusing on private capital, attracting private capital by managing the risk that they face. And we can certainly talk about that.

And then the fifth option that countries may have is to engage with some of the newer donors. We now know a lot more about China's, aid practices, but it's not just China that has been a newer important player on the aid landscape. Saudi Arabia, Qatar, UAE all have major foreign aid programs now. Countries like India and Brazil that previously were mostly aid recipients now have foreign aid programs. Turkey, Indonesia, Vietnam, these are countries that we think of as aid recipients that now have their own foreign aid programs. There's a lot of room here for scaling up, but some of these donors might be capable of pooling resources or engaging in what is called triangulation, a co-financing with other public donors or with private investors to de-risk.

In addition, there are these new multilaterals, the Asian Infrastructure Investment Bank, the New Development Bank what sometimes is referred to as the Bricks Bank. These types of multilaterals do have a goal of increasing their portfolios. And so, these are the groups that could be options to replace some of that lost ODA.

Hisham Allam: That leads us nicely to my next question. In the face of shrinking budgets from traditional donors, what innovative financing mechanisms do you see gaining traction? Are there risks involved in leaning more heavily on private capital?

Raj M. Desai: Yes, there are definitely risks involved, but that is the area where I think there's the most room for innovation.

And the mechanisms gaining attention include blended finance what are sometimes referred to as sovereign de-risking facilities and so on. So, there is a term that is called mobilized private finance. So mobilized private finance in the aid language dictionary, just means private finance that is mobilized as a result of official development assistance that is de-risking that private finance. So that has increased quite a bit, almost doubling from about 40 billion or so in 2016 to a little under 70 billion in 2023. But to put that in perspective, that's about one sixth of 1% of developing country GDP. And it, so it's not a very large amount in the scheme of things.

And also most of it goes to just a few sectors, particularly infrastructure. And most of it goes to a few middle-income countries. So, in many ways, this is supposed to be de-risked private finance, but it acts very similar to regular private capital flows. Meaning it's going to as few sectors in a few middle-income countries.

So, the poorest countries, the lower income countries, are being left behind. Now the problem is risk. The President of the World Bank, the presidents of other multilateral development banks and others will tell you that there are lots of opportunities for investors to achieve returns on projects that would benefit development outcomes.

A few years ago there was something referred to as the Business and Sustainable Development Commission, which made the case for the business community to play a more active role in achieving the sustainable development goals that argued that the private investors should play a more active role in the UN's sustainable development goals, and argued that a lack of progress in sustainable development would cause the global economy to become more fragile.

The problem is that it really hasn't materialized. It's still just a trickle. And the reason is because of the perception of risk. The real problem is that risk perceptions tend to be very biased against poorer capital scarce countries, even when the actual risks are not necessarily that large. So, there is some data from a survey of I think close to 20,000 development projects, showing that the actual default rate is quite low.

It's under 4%. Now, that's comparable to non-investment grade projects that you would find in investment bank portfolios in wealthier countries. 4% is a pretty low default rate. Yet the perception is that risk in poorer countries is much higher because sovereign default rates might be considered higher.

Now, if you're concerned about the sovereign ceiling, the issue there is always how do you recover post default? In that case, we actually have evidence that the post default recovery rates are almost 75%, and that tends to outperform developing country global bond loan portfolios. So, the perception and the reality are quite different.

And with this idea that global geopolitical risks are at a very high level right now, the horizon doesn't look very good for these types of innovative financial instruments, even though I think they could play a bigger role than they play. What are the risks?

The risks that heavy reliance on private finance can divert aid towards only bankable projects, and that means that you would end up neglecting certain social sectors, healthcare, education and so on, that you would neglect fragile states, which often need quite a lot of basic financing to rebuild infrastructure and to rebuild a housing stock to help demobilize combatants and so on through job creation programs and private investors will probably stay away from that.

In addition, it can also transfer fiscal risks to recipient governments because what these innovative financial instruments mean, or they typically imply, is that part of the risk, partly through perhaps guarantees or some kind of loss capital guarantee. Part of the risk is covered either by a donor or by the recipient government.

What that means is the recipient government is accumulating these contingent liabilities, and that means that in the event that global financial volatility starts to increase, that this can cause fiscal problems for recipient government, that's a major risk.

Hisham Allam: Building on that point, we know that private capital and the new actors, as you have mentioned, the Gulf Country, Japan, Turkey, and others are playing a large role in development, finance. What opportunities and the challenges that this shift bring?

Raj M. Desai: So there, there are lots of opportunities in terms of the shifting aid landscape simply because there are so many more players that are out there.

The main thing is that when it comes to engaging with these newer donors they do business slightly differently than the traditional development assistance. Committee donors, the DAC, the famous DAC donors. In particular the engaging with newer bilateral partners in specific areas or through what is called triangular cooperation.

Co-financing by traditional and emerging donors requires a little bit of a stronger aid coordination mechanism. And this is something where a lot of recipient countries haven't really stepped up. They have not really created these aid coordination mechanisms, even though that's one of the Paris Declaration objectives.

Now there are some characteristics of these newer donors that are different. So first of all, aid tends to be very commercial and foreign policy driven. Now, you could argue that traditional aid is also foreign and commercial policy driven, and that is true. But development assistance from China or from other donors, bilateral donors is much more overtly commercial policy driven.

So, a country like China as a donor will expect certain things in return, certain access to mineral rights, mining rights, access to infrastructure and so on. Having said that China's aid tends to be what is called programmable.

The idea here is that there's much more money that goes to actual programs without budget support. They don't give money to the government budget, they give money directly to projects. That aid is often tied to using Chinese contractors, Chinese labor, in some cases. Countries like Russia and Turkey also very much like China, do not believe in conditionality. They operate on a principle of non-interference. So, the types of conditionality that would be imposed by traditional donors is not going to be there. And the last thing is there's less transparency. So, in fact, when it comes to Chinese development assistance, we don't know what is concessional financing and what is non-concessional financing because China does not really separate that.

We do have some evidence that Chinese ODA or ODA funding is at about probably between six and $8 billion, but it also provides a lot of non-concessional funding that actually tend to dominate its flow. So that's another big difference.

Hisham Allam: In light of that, how can developing countries strike a balance between seeking external funding and strengthening domestic resource mobilization?

Raj M. Desai: So, some would say that external financing can complement domestic efforts, but it can't replace them. It can't substitute, and so the priority should be to widen the tax base to reduce exemptions to digitalize revenue connection, to protect certain revenues for infrastructure or social investment.

There is some truth to that. And the argument here would be that any external resources, whether it's foreign aid or whether it's some of the more innovative approaches through blended finance or diaspora channels should be used catalytic, which is that it should reinforce domestic fiscal capacity and not undermine it or replace it.

There's always the fear in the development community that one of the consequences of aid flows is aid dependence in which the domestic fiscal institutions are neglected because most of the aid is handled through implementation units created by the donors rather than through the country systems themselves.

Now, obviously, in certain countries. Particularly fragile states, it would be very difficult to rely on country systems. But the objective of developing countries should be to seek external funding in a way that compliments and builds up those country systems so that they are capable of mobilizing more domestic revenue.

Hisham Allam: Before we move on. What role do you see for regional cooperation in South Partnerships amidst this donor shaft?

Raj M. Desai: The south partnerships and regional partnerships. Offer a lot more peer-based learning for recipients. There is the greater possibility of triangular cooperation where you have a recipient government and cooperating with a regional donor as well as another donor, whether it's a multilateral or traditional bilateral donor or someone else.

The co-financing opportunities are also there for South partnerships, and that kind of collaboration can help standardize certain de-risking tools in particular regions. It can allow for project preparation funds that would improve the let's say the bankability of blended finance projects within regions. So, you would expect that lots of small recipient countries could pool resources or that the aid flows could be pooled to create a regional project preparation facility.

And that could be used to provide better prepared projects for recipients in those areas. And then finally, it can also expand access to non-DAC finance pooling efforts of regional recipients. It's not always easy because that requires some of the geopolitical tensions between certain regions, countries within certain regions to be addressed, and that is not always easy.

Those types of arrangements can also come with less transparency, so that needs to be protected against and that some of the higher requirements tied to commercial interest.

Hisham Allam: With the rising geopolitical tensions and shifting priorities, how can international aid remain effective and aligned with the actual needs on the ground?

Raj M. Desai: Foreign aid needs to reorient towards country owned priorities and evidence-based results. And there has to be some way to insulate these programs from donor politics. That is not going to be easy, because as I said, foreign aid is fundamentally a part of foreign policy, and it is impossible in many cases to fully insulate these things from donor politics.

But that means strengthening national aid coordination platforms, improving data transparency integrating and aligning certain standards across countries in particular regions, relying more on south-to-south partnerships and on regional cooperation. I don't think it's a bad thing that there is such a wide variety of choice that countries now have.

If you take a country that is relatively a dependent country like Malawi. 20 years ago, Malawi had a choice of bilateral lending from certain aid agencies, money from the World Bank, and possibly a small amount of money from the era of the African Development Bank. Today, Malawi has a choice, not just of those three, but it can borrow from China, it can borrow from the Gulf cooperation council countries, it can receive money from the Gates Foundation. It can receive money through blended private finance. There are so many choices now, but that means that there must be greater aid coordination, national coordination platforms that ensure that these flows are aligned with national priorities and that they're driven by evidence-based results.

Hisham Allam: But how can governments, civil society, and international partners best coordinate and respond to these rapidly changing financial landscape?

Raj M. Desai: This is a very difficult question because there have been lots of efforts by these players to coordinate and respond to challenges.

Fundamentally, these are driven by political concerns in donors, and since it's the bilateral donors that still control the bulk of official development assistance, concessional financing, it is difficult to respond to these challenges. And we are seeing this with the collapse in US Development assistance. By 2026 if nothing changes, it is quite likely that US Development assistance will have gone from about $65 billion a year to about $10 billion a year, which in real dollar terms is less than the United States has provided in foreign aid since 1945, since the end of the second World War. Other countries are also reducing those amounts not by the same percent, but certainly it is not headed in a upward direction, and so there needs to be much better joint financing and accountability that integrates domestic resource flows, private capital flows, official development assistance, and philanthropic flows. Diaspora flows allow around national priorities, so aligning domestic resource mobilization with the diaspora, investment strategies, blended finance under a unified strategy that ensures fiscal transparency and that manages contingent liabilities that governments can do. Civil society can reinforce accountability by wanting doing a much better job of tracking disbursements, monitoring results, channeling cross-border philanthropy towards defined standardized reporting. We have tried to improve efforts to standardize reporting of private cross border philanthropy.

Those efforts have yielded some results, but it is not nearly where it should be. Other international partners should pivot from much more fragmented project aid towards co-finance risk shared mechanisms that can build long-term institutional capacity. So, all of these actors that you mentioned could create a more adaptive, flexible system. One that combines more public oversight that attracts private capital, that creates more civic trust domestically that can sustain multiple forms of development finance in an era where donors are retrenching and where global financial flows might be more volatile.

Lastly, creating an open data architecture for aid investment public spending. For example, a digital portal linking budget data, a flows public-private partnerships guarantees would allow citizens, civil society organizations, investors to monitor outcomes, verify results. Through harmonized reporting standards.

And also, it can additionally lower perceived country risk and potentially attract more private investment, more diaspora investment, 'cause the fundamental problem there with this gap between high risk perception and the reality is this big informational asymmetry. And if that can be reduced, that can help realign these perceptions with reality.

Hisham Allam: Lastly, as someone based in the US and active in the aid sector, could you share how recent shifts and budget pressures are being felt among professionals and organizations in American development circles, and what are the prevailing sentiments and how are people on the ground responding to these challenges?

Raj M. Desai: It's no secret that this is a difficult environment. Those who are interested in global development finance, both from a just a moral perspective of helping capital scarce countries, poor countries reduce poverty and prosper. But also from a strategic perspective, for those of us who believe that development assistance has major benefits to donor countries from a global strategic perspective, from a foreign, pure foreign policy, self-interested perspective, for those of us who believe in soft power.

So, it's no secret that these are challenging times. My fear is that some of the issues that have appeared with the drawdown in official development assistance are going to be irreversible. In particular, the loss of credibility when it comes to commitments by donor countries, whether it's development assistance or private investment.

That is a concern. How are practitioners dealing with it? I think they are doing what recipient governments should be doing, which is diversify, moving into private sectors, doing international partnerships, finding alternative approaches to help provide these types of financial flows.

But it has had an impact on the sector, certainly in the United States, and globally, whether it's employ direct employees, contractors, and so on. I've been to countries in which aid programs have been completely zeroed out or dramatically reduced, and it has certainly had an effect on these sectors.

I was in Moldova recently. Which has been facing a significant amount of hybrid warfare from Russia during the period in the runup to its parliamentary elections. Moldova has lost a tremendous amount of financing a lot of which was focusing on building, strengthening civil society, strengthening the ability of the media to filter out disinformation. And protecting money to reinforce and protect its digital infrastructure. A lot of that has been reduced and Moldova is having to diversify. But Moldova, of course, finds itself in the position that many countries find themselves in, which is seeking alternative financing approaches.

Hisham Allam: Thanks so much Professor Raj M Desai for joining us today and sharing your insights. The world of development aid is changing fast and conversations like this help us understand the challenges and find new ways to work together. Thank you to everyone listening. We hope you found this episode useful, stay curious and keep striving for impact. I'm Hisham Allam signing golf. Goodbye.