

On a highway to help: multilateral development bank financing and support for infrastructure

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Multilateral Development Banks (MDBs) are important providers of financial and non-financial support to developing countries to assist with meeting their infrastructure needs. Australia contributes to these multilateral efforts and has identified infrastructure financing as a priority for its 2014 G20 Presidency. This article explores the traditional and emerging forms of infrastructure financing support that MDBs provide to developing countries, in order to inform discussions of potential new facilities.

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Introduction

Multilateral Development Banks (MDBs) are important providers of financial and technical assistance to developing countries. Financing infrastructure investment is a key area of MDB support and has been identified by the G20 as a priority in its investment and infrastructure agenda. This article explores the traditional and emerging forms of infrastructure financing support being provided by MDBs, in order to inform discussions of potential new facilities.

Australia is a member of three MDBs.² In 2012-13 Australia provided \$522.6 million to the World Bank, including \$315.7 million in funding for joint activities.³ The Asian Development Bank (ADB) is also an important development partner for Australia. Australia is the second largest donor to the ADB's concessional lending arm, the Asian Development Fund (ADF), and the 5th largest shareholder of the ADB. Australia's contribution to the ADF in the period 2013-16 will be \$629 million.

Infrastructure for development

The development of productive infrastructure encourages economic growth, private enterprise and employment. It contributes to the reduction of poverty and improves livelihoods through access to basic services. Reliable electricity supply, efficient transport systems, a clean water supply, access to sanitation, and modern telecommunications improve the health and wellbeing of the poor and allow them to better engage with the formal economy and lift themselves out of poverty (see for example BenYishay and Tunstall, 2011). While the extent to which infrastructure development contributes to economic growth has been the subject of academic debate, there is evidence that infrastructure services make a substantial contribution to GDP, generally exceeding the cost of provision (Esfahani and Ramirez, 2003).

The diversity of developing countries is relevant in considering their infrastructure needs and financing capacities. Middle-income countries, for example, have access to international capital markets and may only require MDB technical assistance; whereas low-income countries may be more financially risky so MDB financing and assistance is appropriate. Moreover, some countries, such as fragile, conflict-affected and small island states, may lack even basic access to finance and greater MDB assistance is warranted.

More than US\$800 billion is invested in infrastructure in developing countries each year (ECDPM, 2013). While most of this investment comes from domestic sources, the provision of MDB financing of infrastructure globally is important. The World Bank provided US\$25.2 billion in 2011 for infrastructure-related projects (World Bank, 2012c), accounting for almost half the average total funds disbursed by the World Bank annually; and the ADB lent US\$7.5 billion for infrastructure in 2012, 64 per cent of its total lending (ADB, 2012b). Bilateral Official Development Assistance (ODA) from advanced countries has played only a limited role in filling the infrastructure financing gap, providing approximately 2.5 – 3 per cent of total investment in developing country infrastructure (World Bank, 2012b).

2 Australia is a member of the Asian Development Bank (ADB), the European Bank for Reconstruction and Development (EBRD), and the five constituent institutions that make up the World Bank Group. This article focuses on the ADB and World Bank, given that these two MDBs are the recipients of most of Australia's annual multilateral funding and Australia has worked closely with both banks on infrastructure projects.

3 Despite Australia's significant contributions to the World Bank, the size of the organisation is such that we maintain a relatively modest shareholding of 1.56 per cent in the World Bank's International Bank for Reconstruction and Development (IBRD).

Despite this investment, a significant gap exists between funds that are currently financing infrastructure projects in developing countries and the funding required by recipient countries to achieve desired development outcomes. MDBs and other international organisations have made attempts to estimate the size of the gap. Their use of different methodologies and definitions has resulted in different estimates of the scale of financing required. Some of these estimates are provided in Box 1, but we do not attempt to establish their accuracy.

Box 1: The global infrastructure financing gap

The World Bank has estimated that an additional US\$1 trillion per annum to 2020 is required by developing countries to keep pace with consumer and producer demand for infrastructure. To keep pace with projected global GDP growth, the infrastructure financing gap increases to an estimated US\$57 trillion over the period to 2030 (MDB Working Group on Infrastructure, 2011). Alternatively, the World Economic Forum estimates that close to US\$2 trillion per annum will be required to meet the infrastructure needs of developing economies by 2030 (WEF, 2012).

For the Asia-Pacific, the ADB estimates that \$750 billion in financing each year will be required by 2020 to meet the region's infrastructure needs (ADB, 2011).

Like estimates of the infrastructure financing gap, estimates of the global pool of private savings that could finance infrastructure also vary, but figures cited by the World Bank suggest that existing global savings potentially available for infrastructure investment total US\$17 trillion (World Bank, 2013d). For the private sector to finance infrastructure, whether in a developed or developing country, they will naturally expect a project to generate sufficient cash flow in order to provide an investment return. This cash flow is what makes a project economically viable, or 'bankable', and will ultimately need to be funded by user charges and/or public sector payments.⁴

Aside from finance, strengthening the broader investment climate in developing countries – the regulatory and legal frameworks that provide assurance to investors and certainty to populations – is necessary to encourage greater private sector investment in infrastructure. Improvements in infrastructure planning, the development of pipelines of viable projects and better project selection and delivery are also critical. While MDBs and donors have an important role in assisting developing countries to improve their regulatory environments, developing countries themselves are ultimately responsible for taking the steps that will encourage long-term investment, and for contributing their own funding.

Infrastructure is currently a focus for the G20 (see Box 2) and improving the global investment environment to facilitate the development of productive infrastructure is a priority for the G20 in Australia's 2014 host year.

4 It is therefore useful to differentiate between the terms funding and financing, which tend to be used interchangeably. Funding refers to how infrastructure is paid for. It consists of government expenditure or direct user charges (in a sense, it is money that is not intended to be returned). Financing refers to the raising of debt and/or equity to purchase and operate an asset, such as a power station, that is too expensive to simply buy outright. Financiers naturally expect a return from their investment (so this can be thought of as money that is intended to be returned). Refer Infrastructure Finance Working Group (2012) for more on this.

Box 2: G20 initiatives

The G20 has, since the first Leaders' Meeting in 2008, championed MDB support for infrastructure development, including the agreement in London in 2009 to increase MDB capital resources by US\$100 billion⁵; the announcement in Seoul in 2010 of a high level panel to recommend measures to mobilise infrastructure financing and review MDBs' policy frameworks; general support for the panel's recommendations in Cannes in 2011; and the commissioning in Los Cabos of Finance Ministers and Central Bank Governors 'to consider ways in which the G20 can foster investment in infrastructure,' including through MDB financing and technical support.

G20 Finance Ministers and Central Bank Governors met in February 2013 and considered the Chelsky and Morel paper (see below) and other diagnostic papers on factors affecting long-term investment financing. Ministers and Governors established a Study Group on Financing for Investment to consider issues raised in the diagnostic papers and the role of the private sector and official sources (including MDBs) of long-term financing. In October 2013 they noted the work underway in the MDBs 'to mobilize and catalyze additional financing for infrastructure investment' – reiterating a sentiment expressed by Leaders in Saint Petersburg in September. This work has been elevated to an Investment and Infrastructure Working Group in Australia's 2014 host year.

How MDBs support infrastructure development

MDBs are evaluating how their activities impact on infrastructure development in developing countries and considering ways to expand their involvement. To inform recent G20 meetings, the World Bank (Chelsky and Morel, 2013) led the preparation of a paper on the role of MDBs in support of long-term financing. Infrastructure development often requires long-term financing given the high construction costs and long asset lives of facilities like road, ports and power stations.

Chelsky and Morel considered the 'additionality' provided by MDBs to long-term financing. This included whether a project would have gone ahead without official-sector involvement which, if so, would represent a waste of MDB resources. This concept of 'additionality' is also referred to as 'catalysing', 'mobilising' or 'crowding in'⁶ new resources. The extent of additionality MDBs provide for infrastructure financing cannot easily be proven (or indeed disproven, such as when an investor says s/he would not have invested if not for the presence of an MDB).

The paper identifies a variety of ways in which MDBs contribute to long-term investment, which we have grouped into four basic categories, as follows.

Direct financial assistance from MDBs

The provision of traditional financial products (loans, grants, equity and guarantees) has been the primary mechanism for MDBs to assist developing member countries. With their AAA-rated financial position – underwritten by the financial strength of their major shareholders and historically conservative portfolio management – MDBs have been able to provide developing countries with financial products at prices that those countries would not have been able to secure from financial markets independently. For some fragile and conflict-affected countries, with no access to formal financial markets, MDBs are the only source of high quality financial products.

5 This funding was not specifically earmarked for infrastructure, but given the high proportions of MDB assistance that flow to infrastructure (as noted earlier in this paper), the infrastructure portion is likely to be similarly high.

6 'Crowding in' is emerging as a term used in contrast to the more pejorative 'crowding out', which refers to government (or, potentially, MDB) activity undermining potential growth of the private sector through excessive borrowing and/or spending.

The loans an MDB provides offer greater flexibility for developing countries (and private sector investors in developing countries) in relation to interest rates, loan fees and repayment terms. The World Bank's concessional lending arm, the International Development Association (IDA), for example, provides loans and grants with little or no interest, and with repayment periods as long as 40 years. Developing countries also benefit from MDBs being able to issue products in foreign or local currencies, providing loans counter-cyclically, and targeting public goods that the private sector may have little appetite to finance.

MDBs are also able to provide financial support to private sector investors *in* developing countries, rather than *to* the governments of developing countries, in the form of loans, equity investments and guarantees.⁷ Equity investments refer to the purchase of shares or similar instruments directly, or indirectly through private equity funds (to which we return later in this article), in companies in developing countries. Guarantees are insurance products. MDBs often provide political and non-commercial risk cover for things like currency inconvertibility, expropriation, politically-motivated violence or sovereign breach of contract – thus addressing key risks which can impede investment by the private sector.⁸

Indirect financial assistance — the MDB as catalyst

In providing the loans and equity investments referenced above, an MDB can bring other financing partners into the transaction through syndications or other co-financing arrangements. These partners could include other MDBs, private companies and funds, commercial banks, and quasi-sovereign investors.⁹ As a first lender or lead financier, the MDB is able to bring these investors on board by virtue of its global/regional presence, technical expertise, due diligence, negotiation capability and, in some cases, by extending its preferred creditor status to other investors. For an outside investor, these benefits serve to reduce the financial risk of, and regulatory costs associated with, investing in a given developing country.

Non-financial MDB project assistance

Beyond direct and indirect financial assistance, there is a wide array of project preparation facilities through which the MDBs support developing countries' infrastructure projects. Whether as a project participant, or engaged in a consulting capacity for its technical expertise, an MDB can improve the quality of a project by applying prudent risk management policies, project design standards, governance, environmental and transparency safeguards, and related advisory or capacity building services that are not readily available in many developing countries.

There can also be a regional integration component to infrastructure projects, such as roads or power networks, which cross international borders. In these cases, infrastructure projects potentially provide broader benefits of supporting cross-border trade and communication, and promoting regional economic integration. MDBs are well-placed to assist with such projects, some of which may be beyond the financial or technical capacity of a single country. This is of particular relevance to regionally constituted MDBs like the ADB.

7 The World Bank Group provides private sector finance through its subsidiary the International Finance Corporation (IFC). The ADB refers to private sector lending as non-sovereign operations – financing that is not guaranteed by a government or guaranteed by a government under certain terms.

8 For example, the World Bank Group's Multilateral Investment Guarantee Agency (MIGA) guarantees investments in developing countries against political and other non-commercial risks.

9 Such as export credit agencies, sovereign wealth funds or state-owned enterprises.

MDBs improving the investment climate

MDB support can also assist developing countries to improve the underlying investment climate, such that the assistance described above might eventually become unnecessary. The investment climate, which includes underlying principles like the rule of law, property and creditor rights, sound government finances, competition and consumer protection, provides investors with confidence that their investment will not be expropriated, subjected to political interference or discriminated against.

These are the kinds of factors considered in the World Bank's *Doing Business Report*, which seeks to encourage more efficient regulation by comparing regulatory environments across economies and over time. The Report's simple and transparent methodology provides governments and regulators with a useful guide to identify areas of potential economic reform in support of an improved investment climate.

MDB assistance also allows developing countries to improve the infrastructure financing aspects of the investment climate through encouraging the establishment and development of domestic capital markets. This includes well-functioning currency, equity and bond markets, financial regulators, and local insurance providers. With this kind of *financial infrastructure* in place, countries can better utilise local savings to finance their own infrastructure needs. MDB involvement can also support nascent domestic financial markets in linking to regional and international markets.

Infrastructure in MDB strategies

The World Bank is seeking, under its updated infrastructure strategy, to encourage greater private sector involvement in the sector in order to increase the overall financing envelope for infrastructure (World Bank, 2012c). The ADB's *Strategy 2020*, approved in 2008 and currently subject to a midterm review under new President Takehiko Nakao, put infrastructure first among the Bank's five priority areas¹⁰ that would together represent 80 per cent of its operations. The document was blunt in stating that '[n]eglect and years of insufficient investment in infrastructure have led to overcrowded, unsanitary, unhealthy living conditions in the region's large cities.' The Bank undertook to be an agent for change, with greater effort to catalyse private sector involvement, more finance for infrastructure, advice to governments on the investment environment, and support for public-private partnerships. Though not limited to infrastructure, the ADB refers to the trio of finance, partnerships (third party finance) and knowledge (technical assistance) it provides as *Finance++*, which it is seeking to make 'an integral part of its long-term mission' (ADB, 2013b).

Given the extensive support – both financial and non-financial – for infrastructure that MDBs are already providing to developing countries, there is debate within the G20 and amongst MDB shareholders over what else, if anything, MDBs would be able to provide. To inform that debate, the following section explores several emerging models of infrastructure financing support that MDBs are increasingly employing.

Emerging models of MDB infrastructure financing support

The scale and reach of MDBs support to developing countries allows them to trial non-traditional forms of development assistance, which, if successful, can be integrated into the wider suite of programs. We focus on three models of MDB assistance that, while being relatively mature in the developed world, are emerging as important mechanisms for promoting greater private sector

¹⁰ The five core operational areas articulated are: (i) infrastructure; (ii) environment, including climate change; (iii) regional cooperation and integration; (iv) financial sector development; and (v) education.

involvement in infrastructure in developing countries: private equity funds, public-private partnerships, and output-based aid. This section explores each, and their risks, in turn.

Private equity funds

A private equity fund is an investment vehicle through which investors pool their funds, which are then invested in private, both listed and unlisted, companies. The private equity fund itself is usually unlisted, targeted at institutional investors, structured to receive funds over a set time period, and managed by a specialist private equity firm. Given their time-bound design, private equity funds seek to exit their investments and return the funds (plus any yield income and capital appreciation) to investors (Kaplan and Strömberg, 2008). This approach has been used to acquire controlling shares in distressed companies (sometimes using debt as well, which is called a 'leveraged buyout'), turn them around, and hopefully make a profit upon exiting.

Private equity funds can also target their investment portfolios to a particular type of asset or geographic area, such as infrastructure in emerging markets. Chowdhury, Orr and Settel (2009) have identified this as a trend among MDBs' private sector operations, including the ADB and the World Bank's IFC. They argue that targeting infrastructure is 'politically easier' for MDBs because the provision of these kinds of public goods has historically been a public sector responsibility, and MDBs have experience directly supporting such projects.

By investing in a private equity fund, rather than in projects directly, an MDB can promote greater reputational credibility, development credentials and good governance, whilst drawing on the deal-making capabilities of the private sector. With these benefits, MDBs argue they can 'catalyse' or 'mobilise' greater private sector involvement in financing infrastructure in developing countries.¹¹ Like any investment, there is a risk that yield income will fall short of expectations, or that the value of the fund's underlying infrastructure investments will decline. Accordingly, retaining quality fund managers is an important challenge for MDBs involved in these funds.

Moreover, Chowdhury et al identify one of the key challenges for MDBs in utilising private equity funds as reconciling the profit motive of private sector investors and the development motive of MDBs. This is evident in reporting frameworks, where typical rate-of-return metrics need to be supplemented with metrics on infrastructure coverage, access and service quality. MDBs also need to remain cognisant of safeguarding their AAA credit rating and shareholders' callable capital (see Box 3) when investing in higher-risk asset classes such as private equity funds.

¹¹ See, for example, the websites of the private sector financing arms of the ADB (www.adb.org/site/private-sector-financing/main) and the World Bank (www.ifc.org), which provide investment, advisory and asset management services to the private sector in developing countries.

Box 3: MDB callable capital

An MDB's callable capital is the collective financial commitment, as distinct from paid-in capital actually disbursed, from member states to meet the liabilities of the MDB. As this is a formal commitment from sovereign states, callable capital underlies the MDBs' financial strength and enables them to raise debt from international capital markets on favourable terms.

As an example, for its 5.8 per cent shareholding in the ADB, the Australian Government's uncalled capital subscription in the Bank is US\$7 billion (around \$6.8 billion), which is reported as a contingent liability in the annual Budget papers (Australian Government, 2013).

In the event of financial difficulty, such as an inability to repay loans following investment failures, member states would be obliged to meet their share of those repayments. No MDB has ever needed to draw on its callable capital.

Public-Private Partnerships (PPPs)

PPPs are long-term relationships between private contractors and the government to provide for the construction, operation and maintenance of infrastructure assets (English, 2006). The OECD (2011) identifies the key features distinguishing a PPP approach as including: a focus on purchasing services rather than assets; clear specification of outputs; appropriate risk of asset performance being borne by the private party; and assessments of value for money.

PPPs have been commonplace in Australia since the 1990s. Australia is also actively involved in the region, including through the Asia-Pacific Economic Cooperation (APEC) forum, lending our expertise in the area of PPPs, to improve infrastructure outcomes (see Box 4). PPPs are also being used extensively by MDBs, an approach supported by the G20. The ADB is expanding its work with the private sector under its *Strategy 2020* and considers PPPs to be important vehicle for this increased interaction. The World Bank, through the IFC, is heavily involved in supporting PPPs.

One example of this support is the Private Infrastructure Development Group (PIDG) – a multi-donor organisation established by the World Bank in 2002 to increase private sector investment in the world's poorest countries through the use of PPPs. The methods employed to increase investment vary between countries and across the infrastructure sector. For example, PIDG assistance ranges from advice to developing country governments on how best to structure projects to attract investment; to financial cover for specific construction phase risks; to providing guarantees to lenders to support local currency finance for infrastructure projects; and to promoting domestic financing and capital market development. PIDG supports energy generation and distribution, industrial infrastructure, telecommunications, and air transport (World Bank, 2012a).

In 2012, the then AusAID's Australian Multilateral Assessment (AMA) found that the overall performance of PIDG was strong, and particularly so in the measure of PIDG's focus on achieving value for money (AusAID, 2012a). Risks around the delivery of aid in this manner remain. PPPs are complex financial and legal arrangements and appropriately pricing services to encourage investment is difficult, as is ensuring the risks and responsibilities associated with projects are effectively allocated between private and public sector participants.

Box 4: APEC initiatives

At the most recent APEC Finance Ministers' Meeting hosted by Indonesia in September 2013, Finance Ministers agreed to create an APEC PPP Experts Advisory Panel which would develop a 'repository of skills' to promote PPP best practices, including through a pilot PPP Centre under the Indonesian Ministry of Finance. This was subsequently endorsed by APEC Leaders at their Summit in October 2013.

The challenges associated with attracting private capital to fund public infrastructure projects, particularly in Asia, are considerable and often relate to the economic viability of projects. The broad role of the Panel is to draw on the experience and resources of other APEC economies and multilateral development partners, including the World Bank, the ADB and the Organisation for Economic Co-operation and Development (OECD).

The pilot PPP Centre will be commissioned to develop a pipeline of viable Indonesian public infrastructure projects in order to attract private sector investment, which would include undertaking the appropriate due diligence (such as cost benefit analyses and meeting regulatory requirements).

Output-based Aid

Output-Based Aid (OBA) is an approach designed to increase access to and delivery of basic services (outputs) to people living in poverty using performance-based incentives, rewards, or subsidies. OBA links the payment of aid to the delivery of specific services. Under an OBA scheme, service delivery is contracted out to a third party, which receives a payment from the MDB (or other aid agency) to either complement or replace user charging. The third party is responsible for 'pre-financing' the projects until services are delivered. The subsidy is performance-based, meaning that most of the subsidy is paid only after the services have been delivered and independently verified. By focusing on service outputs, OBA represents a change from traditional methods of aid that focus on inputs to service providers.

Infrastructure projects can employ an OBA approach. For example, a project may involve providing a solar energy system to poor households with payments made to the service provider when the solar panels have been installed and sustainable maintenance programs demonstrated. Road projects have employed an OBA approach by having payments to contractors made for kilometres of road constructed and maintained. The World Bank's Global Partnership on Output-Based Aid is an example of a program attempting to improve the delivery of basic infrastructure and social services to the poor by integrating the OBA approach across MDB financing operations (World Bank, 2013b).

The challenge for the OBA approach is to ensure that the right incentives are established so outputs meet appropriate project specifications. Payments based on each kilometre of road built could provide a perverse incentive for a contractor to build an unnecessarily longer route. Risks also exist around governance, potentially leading to collusion, price fixing and mis-targeting of projects, such that intended beneficiaries are denied services and geographic reach is insufficient (Mumssen and Kenny, 2007).

Conclusion

This article has shown that multilateral development banks provide a variety of financial and non-financial services to support infrastructure in developing countries. Utilising their strong financial positions, the MDBs provide direct loans, grants and equity to infrastructure projects or funds; and bring in third party investors to likewise contribute. Drawing on their expertise and reputation, the MDBs provide project consulting services, technical assistance, and work to improve the investment climate such that investors will, in time, invest regardless of MDB involvement.

The sheer size of the developing world's infrastructure needs is well beyond MDBs' financial resources, but it may not be beyond the private sector's – provided there are sufficient incentives to invest. Outside of the traditional forms of financial and non-financial assistance, MDBs are increasingly using alternative financing models to encourage greater involvement from the private sectors of both the developed and the developing world through a variety of forms of finance. These forms, as explored in this article, variously draw on private sector expertise, private funds, new ways of mitigating project risks, and innovations in funding outputs rather than inputs.

These are welcome developments that have the potential to mobilise additional finance, and encourage greater private sector involvement in infrastructure. However, as non-traditional forms of infrastructure financing can involve greater complexities and risks than MDBs have traditionally borne, effectively managing these risks and protecting members' callable capital remains paramount.

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