

# »» Materials on Development Finance



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Education should not be a privilege:  
Creating new possibilities through demand-  
side financed education in development  
cooperation

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## Executive summary

Education is a cornerstone towards sustainable development of a nation's economy – increasing the standard of living of its citizens. A rising number of school children in developing and emerging countries are completing their primary education and look further to increase their chance of a higher future income by attending secondary schools, vocational training facilities or universities. The increasing demand further stems from a growing population. Since public education budgets are often tight, however, this trend is leading to a decline in standards or a charge of tuition fees. This in turn deprives a vast number of talented but indigent young adolescents of attending higher education, which is fatal for the nation's development.

Against this backdrop, the so called *demand-side financed education* is becoming increasingly important in developing and emerging countries. *Demand-side financed education* is directed at financing pupils, trainees, and students through e.g. scholarships, vouchers or educational loans. This relatively new tool complements KfW Development Bank's existing activities on the supply-side of education, which primarily involves the financing of educational infrastructure. The aim of demand-side financed education is to give graduates or trainees with a low financial status the opportunity to attend high-quality educational institutions.

KfW Development Bank employs various instruments available for demand-side financed education – ranging from scholarships to educational loans. The intensity of the use of instruments is individually adjusted to meet the need of the country in question. The range of instruments is subject to constant development, thus expanding the bank's activities in the field of education financing.

## Education as a basis for social and economic development

Each year spent in school will increase future income by an average of 10%. In fact, the return on education is often even higher in low and medium-income countries.<sup>1</sup> High-quality education stimulates economic growth and poses a key factor for long-term economic development.<sup>2</sup> The enhancement of education standards also comes along with social benefits, such as decreasing gender inequality, fewer teenage pregnancies, lower rates of maternal and child mortality, declining crime rates<sup>3</sup>, and a positive influence on democratic tendencies.<sup>4</sup> It is foremost education that can break the cycle of poverty and the long-term reliance on foreign aid.

Thanks to international educational initiatives, 90% of the world's children are currently completing primary education. In developing countries, however, the graduation rates continue to be significantly lower. This also includes academic achievements. The numbers of pupils in developing and emerging countries continue to rise due to the demographic uptrend, although population growth has slowed in most cases. The result is a sharp increase in demand for subsequent educational offerings, i.e. secondary, vocational or university education.

In many countries the education budgets are falling short to meet the growing demand for higher education. It is not uncommon that educational institutions are overwhelmed with the influx of students. This is leading to overcrowded secondary schools and universities, a chronic shortage of teachers, and consequently a decline of quality of public educational institutions. As a result, fees are often introduced in order to transfer some of the costs of higher education to the students themselves. Private educational institutions, which usually charge tuition fees, are playing a more and more important role. These trends present an increasing risk that underprivileged sections of society will be kept from attending good educational institutions. This potentially deprives the socially disadvantaged such as the poor, minorities, and women/girls of a fair chance of equal educational opportunities.

Rising costs of education make it increasingly difficult for children from disadvantaged sections of society to access secondary schools, universities, and vocational trainings.

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<sup>1</sup> Psacharopoulos & Patrinos: "Returns to Investment in Education: A Further Update", *Education Economics*, Vol. 12, No. 2, August 2004.

<sup>2</sup> Hanushek & Wößmann: "The Role of Education Quality and Economic Growth", *World Bank Policy Research Working Paper 4122*, 2007.

<sup>3</sup> Lochner, L. and E. Moretti: "The Effect of Education on Crime: Evidence from Prison Inmates, Arrests, and Self-Reports", *American Economic Review*, 94(1), 155-189, 2004.

<sup>4</sup> A cross-sectional analysis of available studies assumes a correlation between education and democratic development, while the impact on conflict prevention is questionable. Source: *Argumentation Framework: The Effects of Education on Development*, Margarita Langthaler, Austrian Foundation for Development Research (OFSE), publisher: GIZ, April 2013.

## Financing education as a responsibility of development cooperation

The primary goal of international development cooperation is to help young people to gain access not only to primary education but also to high-quality higher education, regardless of their social background.

The education sector makes a distinction between *supply-side* and *demand-side* financed education. As part of the financial development cooperation (FC), support on the supply-side traditionally involves public educational institutions. Typical projects include, among others, the construction of school or university facilities, teacher training centres, or simply providing teaching and learning materials.

Alongside of that, **demand-side financed education** is becoming increasingly pivotal. It involves providing direct support to the beneficiaries of education (i.e. pupils, students or their parents). The assistance is primarily focused on disadvantaged, low-income and/or particularly high-performing target groups. The assistance is coupled with a specific purpose as well as certain criteria: firstly, the educational institutions chosen by the beneficiaries of education should provide an adequate level of quality; secondly, the relevance of trainings or courses with respect to the labour market are often a central criterion in order to ensure that the students find suitable work once their education or training is completed.

Evidently, supply-side and demand-side financed education are complementary and reinforce each other. Hence, the establishment of a comprehensive system of scholarships or student loans necessitates a sufficient number of available places at educational institutions that provide a certain quality of education and relevance with respect to the labour market. Even the most modern and high-quality secondary school is ineffectual if the students cannot afford to attend it.

This paper shows how the tools of demand-side finance can contribute to the goal of giving socially and financially underprivileged but talented adolescents, access to high-quality higher education.

## The inherent conflict between fairness and efficiency in financing higher education

From the economic point of view, education is an investment in human capital that increases future labour productivity. The process of education, however, is costly. Direct costs, for instance, involve tuition fees and indirect costs such as school uniforms, transportation, accommodation, living expenses, and opportunity costs through loss of income. However, higher private and social returns are generally expected once the students complete their education.

From the perspective of education economics, the public financial contribution to early childhood education and general education should be high considering the substantial social returns.<sup>5</sup> In the stages of further education, e.g. vocational training and academic education, adolescents, their families and the private sector should assume a greater share of the costs of education.

Since higher education usually leads to higher private returns, it is reasonable for students and apprentices to share some of the costs of their education. However, it is important to include talented adolescents who do not have the financial capability to attend institutions of further education.

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<sup>5</sup>

As part of the "Education for All" initiative, developing and emerging countries provide free primary education, i.e. the primary school fees have been abolished. However, the public share of investment in early childhood education is generally low in developing and emerging countries.

If a substantially higher income can be expected after education has been completed, this is reasonable in terms of fairness considering the scarcity of public funding.



However, this leads to the risk that talented but indigent adolescents will be excluded from the benefits of further education. These people are often unable to afford the costs for vocational training or a degree course, even if their desired training or course offers a good future income. Since many developing and emerging countries lack of a sufficiently developed financial system, they are confronted with limited credit availability – a form of a market failure. The major reason is that human capital is not considered a security asset against credit default. Talented adolescents from low-income families usually neither own a house nor a property that could serve as collateral. One way to tackle this issue through Financial Cooperation is to set up a well-functioning system of scholarships and educational loans.

### Potentials arising from demand-side financed education in development cooperation

**Demand-side financed education** pursues different **objectives**. The aim of development cooperation is to improve **access** to education for disadvantaged sections of society in order to mitigate social and economic inequalities. Furthermore, the improvement of educational institutions is frequently targeted. Offering a great number of educational institutions to choose from generates competition which can improve their quality.

Demand-side financed education can provide financial support to gifted but indigent adolescents enabling them to attend institutions of further education.

The **instruments used in demand-side financed education** include:

- **Scholarships:** Scholarships are grants awarded to talented but disadvantaged young adolescents that enable them to access high-quality education by covering some or all of the direct and/or indirect costs involved. A distinction is made between merit-based scholarships for students with exceptional performances and need-based scholarships orientated at the recipient's means. Most scholarships financed by KfW Development Bank on behalf of the German Federal Ministry of Economic Cooperation and Development

(BMZ) are a mixed form: on the one hand supporting students who are unable to afford higher education while also supporting talented students so that they may contribute as specialists or managers to their country's development. This is ensured by selecting those students for scholarships that are already socially involved. In addition to the selection of scholarship recipients, the success of the programme depends fundamentally on the educational institutions selected and their accreditation, as well as the subject areas and specialisations. Decisive criteria include a high standard of teaching and mentoring in schools, as well as a scholastic relevance to the labour market, high academic standards and appropriate equipment in universities.

- **Educational loans:** Educational loans are predominantly used for secondary as well as tertiary education to cover direct costs (and in some cases even the indirect costs) of education. Due to a lack of collateral, talented adolescents from low-income families typically have no access to loans at commercial conditions, even if they stand to achieve a high future income once they have completed their education or training. In this case, the role of KfW Development Bank can be to provide low-interest loans via financial institutions while assuming part of the default risk.

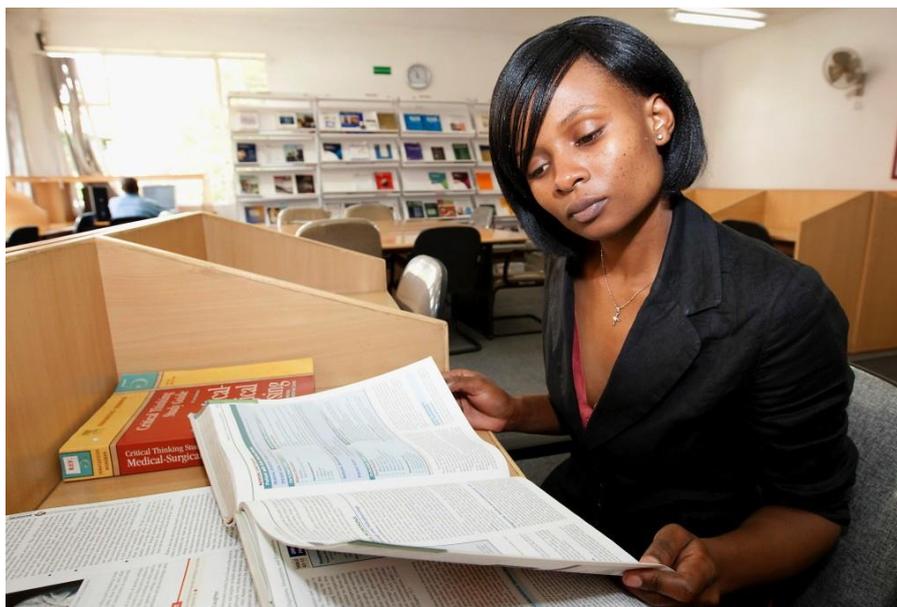


- **Credit-equivalent instruments** such as *human capital contracts*: Unlike loans, recipients repay a fixed percentage of their future income over a limited period of time.
- **Education vouchers:** Education vouchers can be redeemed at qualified vocational colleges and universities, usually for short training courses. The recipients of vouchers can individually choose a suitable education provider among the existing private or public institutions. The intention is to increase **competition** among educational institutions and thereby to improve the quality of educational programmes in the medium run. The accreditations of educational institutions as well as their qualification certificates are particularly important in terms of acceptance by and relevance to the labour market. The use of these earmarked subsidies is also conceivable in pre-school care, e.g. in order to allow children from low-income families to attend kindergartens or pre-schools.

- **(Conditional) cash transfers:** *Conditional cash transfers* are payments to low-income families that are tied to certain conditions or intended to evoke certain behaviour, e.g. school attendance of girls. Their main purpose is to improve access to primary education and avert child labour.

Which financial instrument is most suitable depends on the challenges prevalent in a particular country and its local labour market. Scholarships and student loans may be suitable instruments to encounter a shortage of specialists or managers. However, student loans should only be granted if the prospects of employment on the labour market are promising. Furthermore students would need to be able to pay back their student loans once they have completed their degree programme. If this is not the case, targeted subsidies for education are more reasonable.

Instruments aimed at demand-side financed education must be tailored to the needs of the local or regional labour market.



### Demand-side financed education in projects of the KfW Group

For KfW Development Bank, which is responsible for Financial Cooperation (FC) with emerging and developing countries<sup>6</sup>, vocational training and university education play an increasingly important role in the field of education finance, alongside the expansion of primary education. KfW Development Bank has over 30 years of experience in the field of education financing, and is currently financing projects in the **education sector** with a total volume of EUR 1.5 billion. Additionally it has comprehensive expertise in the development of financial systems (micro-finance in particular) and is able to apply its many years of experience in the implementation of student and educational loans in Germany.<sup>7</sup> This expertise allows KfW Development Bank to comprehensively advise its partner institutions on the introduction of educational loans.

Financial support itself is not enough to accomplish a significant improvement in career prospects. The relevance and quality of the education provided, and complementary *coaching*, are also crucial.

Every project financed by KfW Development Bank is locally developed in concordance and close consultation with local authorities and ministries. Thus, it is made sure that the projects are tailored to meet the prior needs of the country. KfW Development Bank has currently ongoing projects of education financing

Thanks to its many years of experience with instruments of demand-side financed education in Germany and other countries, KfW has gathered valuable expertise to advise partner countries on the design and implementation of such instruments.

<sup>6</sup> Acts mainly on behalf of the German Federal Ministry for Economic Cooperation and Development (BMZ) but also on behalf of supranational organisations such as the EU.

<sup>7</sup> Between the launch of the programme on April 1<sup>st</sup> 2006 and the end of 2014, KfW issued 206.000 KfW student loans to students at public or publicly recognised universities in Germany. In 2014 alone, 34.780 commitments were issued with a total volume of almost EUR 1.4 billion.

in Sub-Saharan Africa and Latin America. The total volume of ongoing and planned projects currently amounts to EUR 77.3 million.<sup>8</sup>

### Scholarships

KfW Development Bank supports pupils and students in Sub-Saharan Africa on behalf of the BMZ by granting scholarships. In order to allow talented but financially disadvantaged young adolescents to study, KfW Development Bank prioritises spreading awareness of available scholarships, specifically addressing disadvantaged adolescents. Motivation and social engagement of pupils and students also depict relevant criteria for consideration. The ultimate goal is to educate future leaders and multipliers who can contribute to the economic and social advancement of their country.

#### Example project

#### Kenya: Supporting secondary education in impoverished urban areas – also a model for higher education



Despite Kenya's economic progress in recent years and a growing middle class, Kenyan society is still lacking of significant economic and social equalities. The social mobility is low. Attempts to improve one's standing within society through education are often foiled by relatively high direct and indirect costs of further education. Scholarships are an instrument which specifically targets high-performing but disadvantaged children, enabling them to improve their standing within society through education. KfW Development Bank is currently financing almost 1,000 scholarships for high-performing but indigent children in secondary schools in Kenya. KfW Development Bank's most important partner in the implementation of scholarships is the Equity Group Foundation (EGF) of Kenya's Equity Bank. Needy children with outstanding performances are offered *leadership workshops* and *mentoring* programmes in order to support them throughout school by promoting their sense of social responsibility and prepare them for future leadership functions. The aim of the "Wings to Fly" programme is to bring forth a new generation of responsible leaders. 60 % of KfW scholarships are awarded to girls in furtherance of their future prospects.

KfW Development Bank contributes EUR 6.4 million to finance this programme via a Kenyan foundation (*Equity Group Foundation*) on behalf of the BMZ. The foundation is furthermore funded by private donors such as the *Equity Bank* and the *MasterCard Foundation*.

In addition to the project in Kenya, the BMZ is also promoting scholarship programmes for courses at the Universidad Rafael Landívar (URL) in Guatemala and the Pan-African University (PAU) in Algeria.

<sup>8</sup>

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## Educational loans

KfW Development Bank is actively supporting microfinance institutions (MFIs) in Sub-Saharan Africa and Latin America by introducing educational loans on behalf of the BMZ. Apprentices and students are offered long-term finance and repayment-free periods based on the duration of their education and presumed future income. This requires the furtherance of financial know-how and a strong effort to involve other MFIs. In order to establish a system of student loans, KfW also provides guarantees, thus assuming part of the MFI's risk.

### Example project

#### Latin America: The *Higher Education Finance Fund (HEFF)*



The HEFF education fund supports microfinance institutions (MFIs) in seven Latin American countries in providing educational loans for vocational training and university education. The target group are students and apprentices from low-income families who are creditworthy by virtue of their prospective incomes. The introduction of this financial product, new to the partner countries, allows the MFIs to expand their financing offers and thereby contributes to the development regional financial systems. As of August 2014, seven MFIs had already incorporated student loans into their range of products and issued around 550 loans since December 2011. Four other MFIs are currently prepared to issue student loans. The student loans are long-term oriented and include repayment-free periods to meet the needs of the target group. The beneficiaries are generally children of the MFI's clients, who act as guarantors. MFIs are able to access families' credit histories, which simplifies the process of checking for creditworthiness of their student clients. As a result, the interest rates on the student loans are usually lower than those of a typical microloan. KfW Development Bank, on behalf of the BMZ, is the largest of six investors with a fiduciary holding of EUR 9.3 million in the education fund's total volume of USD 34 million.<sup>9</sup> In addition to the HEFF, KfW Development Bank promotes a similar fund aimed at financing education in Sub-Saharan Africa, the Regional Education Finance Fund for Africa (REFFA), with a current volume of EUR 18 million.

<sup>9</sup> Other investors are Norfund, the Overseas Private Investment Corporation (OPIC), Swiss Investment Fund for Emerging Markets (SIFEM)/OBVIAM, Calvert Foundation and Deutsche Bank Foundation.

## Conclusion and outlook

Education is crucial in the fight against poverty and plays a key role in the advancement of sustainable economic and social development. Good vocational training and secondary education as well as tertiary education can improve young adolescents' career prospects and raise a country's general economic productivity in the long run. Rapid population growth, rising enrolment rates and an increasing number of primary education graduates, however, are testing the boundaries of public finance in developing and emerging countries. Aside of supply-side finance, demand-side financed education depicts a useful complementary instrument, particularly in the field of higher education.

Furthermore, it is an essential goal of higher education to adjust the teaching content in terms of its relevance to the local labour market. The instruments of demand-side financing can be used to increase the involvement of the private sector, hence making the teaching content more practically oriented and relevant. The role of the state is to regulate and ensure the quality of the education provided. This necessitates a close cooperation and consultation between public and private sectors. Demand-side financed education can only have a positive impact if there is an adequate supply of high-quality educational institutions available to young adolescents. Ultimately, both sides of the equation must receive enough support to promote opportunities and fairness in education.

KfW Development Bank is already contributing to this effort. Nevertheless, demand-side financed education will be further expanded in the future next to the proven success of supply-side financed education of the past years.

The relevance of taught content to the local labour market and the high-quality standard of education are utterly important.

## **Photos**

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