



HEINRICH
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***Financing Development
Towards the MDGs
What Needs to be Done?***

An Issues Paper and Call to Action

By

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Foreword

"We have the opportunity in the coming decade to cut world poverty by half. Billions more people could enjoy the fruits of the global economy. Tens of millions of lives can be saved. The practical solutions exist. The political framework is established. And for the first time, the cost is utterly affordable. Whatever one's motivation for attacking the crisis of extreme poverty—human rights, religious values, security, fiscal prudence, ideology—the solutions are the same. All that is needed is action."

– Investing in Development, the Millennium Project Report

In the year 2000, the world's leaders met in the United Nations General Assembly to set out a new global vision for humanity. They agreed to goals, subsequently known as the Millennium Development Goals - to halve world poverty and hunger by the year 2015; to achieve universal primary education; to promote gender equality and empower women; to reduce child mortality; improve maternal health; to combat HIV/AIDS and other diseases; and to ensure environmental sustainability.

Since then, these goals have been adopted by most major donor agencies, bilateral as well as multilateral ones, as guiding principles for their strategies for poverty eradication. The OECD 'confirmed their commitment' to reducing poverty in all its dimensions and to achieving the International Development Goals.¹ The IMF and World Bank too claim to have coordinated their efforts behind this set of goals. Most importantly, the adoption of the targets has motivated a fundamental shift within development thinking – away from a narrow focus on inputs, towards a fundamental concern with outcomes for the poor of the world.

Unfortunately, reality has not kept pace with the rhetoric and promises which now risk sounding increasingly hollow. Rich countries are still miles from meeting the target of 0.7 % of GDP as ODA agreed to as far back as 1970.

Crushing levels of debt burdens remain and developing countries collectively pay more in debt service than they get in aid flows. Even in some of the most impoverished countries debt service can exceed MDG related health and education spending.

Trade and financial liberalization of the kind being pushed in recent years has failed to deliver the desired results. High levels of rich country subsidies and continually worsening terms of trade mean that the current imbalance between the rich and poor countries is being reinforced.

Worse, even resources that rightfully belong to developing countries are flowing out of the countries in the form of dirty money flows that amount to hundreds of billions of dollars every year.

The clock is ticking – every 3.6 seconds someone in the developing world dies of starvation. Every 30 seconds, a child in Africa is killed by malaria, a preventable disease. Too many have died and too many lives have been blighted. Every year, every month, every day and every second of delay is morally unacceptable. The time to act is now!

¹ OECD/DAC Guidelines on Poverty Reduction: In the Face of Poverty

Even as the world watched – expectantly – the world’s rich countries once again failed to deliver what is so badly needed. The much hyped recent G-8 summit held at Gleneagles in Scotland, took a very small step forward on debt and aid when what was needed was a giant leap. On trade and climate change the summit was a near total failure.

We must hear the clock – and not squander any more opportunities for immediate and decisive action on development. The UN summit to be held in New York in September 2005 must deliver where the G-8 summit has failed.

This paper is targeted at policy makers, development professionals in governments, development institutions, NGOs and at the general public. Our intention is to contribute to the discussion by highlighting key issues and potential solutions. We focus on the politically realistic proposals that are feasible in the short to medium term, which if implemented could save millions of lives.

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Executive Summary

The very modest commitments announced at the recent G-8 summit only serve to highlight the urgent need for large scale action on financing development. This paper helps highlight some ways that large new resources for development could be mobilized urgently.

Equally as important as delivering significant increases in external resources to developing countries are the questions of mobilizing increasing amounts of internal resources and stopping resources fleeing the country in the form of capital flight.

There is, no doubt, an urgent need to enhance the delivery of external resources to developing countries to both address historical imbalances and to meet basic humanitarian needs as enshrined in the Millennium Development Goals. A simple increase in aid of the kind needed to meet the MDGs does not seem to be forthcoming despite some promising steps taken at the G8 Summit in Gleneagles. This makes it all the much more urgent to explore various mechanisms that fall under the 'innovative sources of financing' categorization. Some such as remittances and international taxation are particularly relevant.

Remittances from workers abroad have become a major and stable source of external finance for a number of developing countries. However, the money from these remittances does not go into the revenue of the government but instead goes into private hands. The costs of transferring resources from abroad regularly exceed ten percent of the face value of the transactions. Action to reduce these costs would help increase the amounts of remittance flows at least by a few billion dollars annually. Developed countries should also share tax revenues on immigrant remittances with the recipient countries. Even a 50% sharing could help increase developing country government resources by billions of dollars annually. Another idea would be to consider making remittances tax exempt.

A number of developing countries hold massive amounts of foreign exchange reserves which have large opportunity costs associated with them. Such reserves also help subsidize consumption in a number of developed countries, especially the United States. Legislating for a currency transaction tax in developing countries or issuing large amounts of special drawing rights (SDRs) to developing countries will help them significantly reduce the amounts of reserves they hold and devote the resources released to development initiatives instead.

Financial transaction taxes and environmental taxes can help mobilize billions of dollars of new money that can be ring fenced for development purposes. Such proposals have the advantage of mobilizing recurring and predictable sources of revenue with minimum distortionary effects on the economy. The International Financing Facility (IFF), a recent British proposal, can help frontload some of the additional money raised through various initiatives for investment in time-sensitive initiatives such as immunization. This is needed now, if the Millennium Development Goals (MDGs) are to be achieved at all, especially in Sub-Saharan Africa.

Mobilizing significant quantities of domestic resources in developing countries through increased emphasis on micro-savings and non conventional savings can also help add billions of dollars to money available for development. Perhaps the largest possible contribution on the domestic resource front can be made by capturing and

harnessing vast amounts of latent social capital that exists in most developing country rural communities.

In order to stem the leakage of domestic resources, it is critical to cancel unpayable debt immediately and take steps for a fair treatment of all outstanding arrears and debt stocks that remain after the cancellation.

Even more important for stopping the leakage of resources is the need to clamp down on tax haven activity, which facilitates capital flight out of developing countries. This occurs mostly in the form of trade related mis-pricing of imports and exports and the illegal movement of wealth abroad.

Co-ordinated action against the race to the bottom in taxation to attract inward investment would also help developing country governments mobilize a much larger and fairer amount of tax revenues from companies, investors and rich individuals.

These actions to stem capital flight and tax avoidance have an added advantage as they will also help developed countries increase their tax mobilization significantly and also successfully close some of the loopholes that terrorist financing networks exploit.

I. Introduction

Before getting into the discussion about how best to finance the achievement of the MDGs in the short term, it is important to look at how much they are estimated to cost. Costing the MDGs is the first step towards achieving them. Global cost estimates help identify the large gap that exists between the resources available to developing countries and the resources needed to achieve the MDGs. The Monterrey Conference on Financing for Development in spring 2002 first drew attention to the dramatic shortfalls in resources required to achieve the internationally agreed development goals, including those contained in the Millennium Declaration.

In the technical section of the Report of the High Panel on Financing for Development, also called "Zedillo Report", it is suggested that "the cost of achieving the 2015 goals would probably be on the order of an extra \$50 billion a year".² However, the figures provided in the Zedillo Report are only meant to indicate "an order of magnitude" of the incremental funds required to reach the Millennium Development Goals.

Using two different approaches, the World Bank reached estimates that range between \$54 and 62 billion a year, and from \$35 to 76 billion per year. The background paper for the Human Development Report 2003 takes a similar but different approach as the "Zedillo Report" and reaches the estimate of about \$76 billion. The Millennium Project report has estimated the additional ODA flows needed to meet the MDGs at between \$48 and \$76 billion every year from 2006-2015.

While the Monterrey Conference concluded that the first port of call for financing the MDGs should be domestic resource mobilization, it is widely agreed that large chunks of additional external resources would also be needed, especially for the least developed countries. So while we need to maximize the development potential of domestically available resources, external sources of finance need also to be mobilized at levels far in excess of their current levels.

This conclusion is reinforced by a set of four country case studies that are included in the Appendix to the report. Calculations performed on the finances of Malawi, Mozambique, Tanzania and Uganda clearly show that these countries (and by generalization other similar low income countries) will not be able to mobilize enough domestic resources to meet the MDGs. Just this group of four countries will need as much as \$33 billion of additional ODA flow which is over and above the projected grants that they are expected to receive between now and 2015. This is more than 75% of their expected GDP in 2015 - a very substantial sum of money by all measures. The case studies also reinforce the superiority of grant based financing by showing that even concessional debt flows to finance the MDGs could result in these countries ending up with unsustainable debt burdens.

The discussion around attempts to meet the MDGs has mainly focussed mostly around three issues, namely aid, debt and trade as possible mechanisms to raise enough resources to meet the MDGs.

² United Nations "Report of the High Level Panel on Financing for Development" (Zedillo Report) (2001). Technical Report, p.16. <http://www.un.org/reports/financing/>.

Despite having signed up to a commitment to give 0.7% of their GDP as ODA in 1970 under a UN General Assembly Resolution, rich countries have been allocating progressively smaller proportions of their GDP as ODA. Though the actual amounts have fluctuated, the trend towards lower levels has been clear with ODA having decreased from 0.51% of GDP in 1960 to less than 0.3% in 2004. There have been increasing calls for the rich countries to meet their commitments – in the past couple of years this has resulted in six countries, namely Belgium, Finland, France, Ireland, Spain and the UK specifying timetables to meet the 0.7% target before 2015. Just recently, Germany has joined this group. Five countries – Denmark, Luxembourg, Netherlands, Norway and Sweden already give more than 0.7% of GDP as ODA. The EU has also adopted the 0.7% target as a collective goal to be reached by 2015.

However, this is not enough. The fact that most OECD countries have not kept their promises to meet the 0.7% of GDP ODA level target that they have signed up to means that the development community has needed to look beyond conventional sources of ODA to try mobilize enough resources to meet the MDG commitments. This has led to a proliferation of various alternatives, amongst them the so called 'innovative sources of financing' that have been suggested as a way of raising resources for development.

While some of them are nothing more than suggestions to improve government revenue in OECD countries with a view to allocating more of this new revenue to development through traditional ODA channels, some other proposals are far more ambitious and go beyond the current development paradigm.

This paper discusses the role of Special Drawing Rights, the International Financing Facility, the Currency Transaction Tax and the Aviation Tax as possible 'innovative sources of development financing.'

Debt is discussed in the context of more debt relief which would imply that some of the money that currently flows out of the poorest countries in the form of debt servicing could instead be diverted to development (MDG) expenditure within the country. For example, our calculations show that a quarter of the domestic resources available for development spending in Malawi, Mozambique, Tanzania and Uganda are currently being diverted to servicing debt. The unconditional cancellation of this debt would free up additional resources for use in development. For a broader group of low income countries, annual debt servicing to multilateral institutions such as the International Monetary Fund and the World Bank alone amounts to \$13 billion, which is greater than the amount of effective grant aid flowing into these countries.

Clearly, efforts to deliver more aid make much more sense once debt cancellation ensures that this massive outflow of scarce resources stops. That is why debt cancellation is such a critical step for the purpose of helping meet the MDGs.

Trade is more of a systemic reform issue the benefits of which are likely to accrue to developing countries through a fairer regime that does away with rich country farm subsidies and quota restrictions on imports from developing countries. For trade to benefit poor countries, it is critical that they be allowed sufficient policy space and not be forced to liberalize their trade regimes.

However, the discussion on 'debt, aid and trade' has left out two very major issues that lie at the very core of financing the MDGs. These are the issues of 'domestic

resource mobilization' and 'plugging the leaks' which envisages action against the channels through which capital is able to flee developing countries and billions of dollars of taxes remain unpaid.

These issues are briefly addressed in this paper with a much more detailed treatment in forthcoming publications.

In summary, there are three main issues in financing development. One – how to enable developing countries to maximize the resources they can mobilize domestically, two – what mechanisms and source of external funds can be used to supplement these domestic resources effectively, three – how to ensure that these resources, both domestic and external, stay within the developing country and are used to finance development in an effective and efficient way.

Amongst the issues addressed in this paper, innovative mechanisms to raise domestic resources belong to the first category, the international financing facility and taxes proposed under the 'innovative sources of financing' belong to the second and measures such as tax justice and tax co-operation form part of the third category.

Measures are evaluated on the basis of their revenue potential, beneficial side effects, political feasibility and ease of implementation.

II. Establishing the Need for More Aid and Debt Cancellation

While the case for increased overseas development assistance (ODA) has already been made many times, most recently in the 'Investing in Development' report by the Millennium Project, we reinforce it through a set of four case studies studying MDG related resource shortfall in Malawi, Mozambique, Tanzania and Uganda. The case studies use publicly available data and the authors own calculations. The model used is very basic with the intention of providing rule of thumb estimates for resource shortfall, not detailed macroeconomic forecasts. More detailed analysis has been relegated to the Appendix with just the results being discussed in this section.

Background

The case studies use information on the domestic and foreign resources available to each of these countries; analyse each of their budgets and current expenditure commitments; and make estimates of the external resources needed by each of these countries to attain the MDGs.

They then analyse various sources of funds including debt cancellation, grants, concessional and non concessional loans that these countries can use in order to plug this financing gap. Finally, the discussion focuses on how the findings of these case studies can be generalized first to the HIPC group and then more broadly to a group of low income countries.

Results in Brief

Domestic Revenue for governments is the first port of call for financing development related spending in developing countries.

Year	Malawi		Mozambique		Tanzania		Uganda	
	GDP	Revenue	GDP	Revenue	GDP	Revenue	GDP	Revenue
2005	1,964	393	4,734	625	11,768	1,483	7,232	911
2010	2,229	446	6,486	921	15,748	2,142	9,363	1,273
2015	2,509	502	8,886	1,351	21,074	3,077	12,306	1,797

While it is clear that at a global level the resources that exist fall far short of the money needed to finance the MDGs, it is important nonetheless to look at country level costings for the purpose of calculating the resource needs for individual countries. The table highlights the total amount of money needed to finance the MDGs between 2000 and 2015.

In US\$ million	Malawi	Mozambique	Tanzania	Uganda	Total
MDG Costs	8,864	15,632	29,440	18,448	72,384

A significant amount of money that currently flows into these countries as overseas development assistance (ODA) flows out in the form of debt servicing. As much as a quarter of the domestic revenue that is available for MDG related spending gets diverted into servicing debt. The following table shows the amount of money that will

flow out of these countries in the form of debt servicing³. (This does not include all debt servicing but does account for a substantial part that was contracted before the cut off points in the HIPC initiative.)

<i>In US\$ million</i>	Malawi	Mozambique	Tanzania	Uganda	Total
Debt Service	587	615	718	1,059	2,979

The next table shows the MDG resource gap that exists for all of these four countries and shows how much debt they would need in case this resource gap was financed by new debt. It is clear that this is not a realistic way of financing the MDG gap.

<i>In US\$ million</i>	Malawi	Mozambique	Tanzania	Uganda
Total MDG Resource Gap	6,935	11,966	21,908	16,702
Expected GDP in 2015	2,509	8,886	21,074	12,306
Minimum Debt to GDP Ratio	276.4%	134.7%	104.0%	135.7%

This is a minimum estimate assuming that there will be no repayments and interest due up until 2015. This would be comparable to terms under the International Development Association (IDA), the concessional lending arm of the World Bank, where there is a ten year grace period.

To illustrate the unsuitability of market borrowing for financing the MDGs, the case study uses a hypothetical scenario of Malawi financing its MDG gap through private sector borrowings. Our calculations show that even on the best terms Malawi would already be borrowing \$1 billion by 2009 (50% GDP) of which less than a fifth would go towards financing the MDGs and the rest would be used for debt servicing. Clearly, such a scenario is completely unaffordable.

Debt cancellation is the most efficient form of aid delivery as it has minimal administrative costs and provides direct budget support (that may be ring fenced for social and health related expenditure) so the government can target the funds as per local priorities.

However, as the case studies show, this is by no means sufficient. A multiple of the resources released by debt relief would actually be required to achieve the MDGs. Also, as we have just seen, debt is not a good way to finance the MDG resource gap in the set of countries under consideration. While total debt cancellation will release some additional resources, most of the MDG resource deficit would realistically need to be financed by new resources in the form of grants.

This is why the recent new commitments of additional debt cancellation and 'new' aid that were made at the Gleneagles G-8 summit would not be enough. The debt that is being cancelled is only for a select group of countries and then not the 100% cancellation that is so urgently needed. Less than half of the 'new' aid commitments would actually be new and they are not enough to bridge the resource gap that continues to exist.

³ This does not include the recent debt cancellation that has been offered at the recent G-8 summit as that offer has not been implemented yet.

Conclusion

It is important to note that all the countries used in the case studies belong to the Heavily Indebted Group of Countries (HIPCs). The selection for the HIPC process which then led to a significant but insufficient reduction in debt stocks was such that "neither the poorest nor the most indebted countries" qualified. The HIPC countries were not necessarily the countries facing the largest resource gaps for meeting the MDGs.

It also important to note that the debt ratios of some post-decision point HIPCs (i.e. countries that qualified for some debt relief under the HIPCs Initiative) are now lower than those of comparable non HIPC low income countries such as Nigeria. HIPCs also tend to attract more than a proportional share of new ODA flows. All of this means that there are at least some non HIPC low income countries that are facing more severe resource constraints than the HIPC countries considered in these case studies. This discussion is very important for generalizing the findings of the case studies.

Of the four countries used as case studies three (Mozambique, Tanzania and Uganda) have shown a high rate of GDP growth in recent years. These are also expected to keep growing at an annual rate of between 5% and 7% till 2015. It is important to note that this high rate of growth is an exception rather than a rule in HIPCs. Most HIPCs have grown much more slowly or not at all. The GDP of Burundi for instance contracted at an annual rate of 8% between 1998 and 2002.

Uganda was the first HIPC to reach completion point. Tanzania and Mozambique have also reached completion point. This again is far from typical for HIPCs; less than half have reached completion point. The countries used in these case studies are in fact the 'performers' amongst the HIPC group. Uganda, for instance is often held up as role model for other HIPCs to follow. Given that grant flows are at least partially contingent on performance - so donor country agencies and multilateral institutions can demonstrate successes and results - this group of countries is also expected to receive a higher proportion of grants than the other 'non performing' HIPCs.

We have shown that even this 'model' group of HIPCs with good policies, reduced debts, high grant inflows and most important high expected growth rates falls far short of mobilizing resources needed to meet the MDGs. While total debt cancellation is a critical first step in releasing additional resources that can be used to meet the MDGs, it is by no means enough. These countries as a group also need at least a doubling of current grant levels.

Based on this conclusion and the fact that other HIPCs are generally worse off, it is then possible to generalize that other HIPCs would need at least the same level (proportionately) of additional resources.

This strengthens the findings of other studies⁴, which conclude that in order to meet the MDGs, HIPCs need total debt cancellation and a doubling of current ODA levels.

⁴ Such as 'The Unbreakable Link: Debt Relief and the Millennium Development Goals', Jubilee Research at the New Economics Foundation, 2002

Moreover, our analysis does not account for any 'economic shocks' even though it is very likely that the HIPC group would see many shocks over the next few years, including economic shocks due to sustained high prices for petroleum. Such occurrences would serve to further increase the resources needed for the MDGs.

Also, it is possible to generalize even further by saying that at least some of the non HIPC group of countries (as discussed earlier in this section) would be worse off than the countries under consideration and hence would need at least the same amount (proportionately) of new resources.

In conclusion, we suggest that total debt cancellation and additional grant financing be contingent only on MDG financing needs. The case studies have helped reinforce these needs; we recommend 100% debt cancellation, a significant increase in ODA levels and a total switch from concessional loans to grants for low income countries that face a shortfall of resources needed to meet the MDGs. The commitments of the G8 made in Gleneagles in early July 2005, while a step in the right direction, are clearly too little, most likely delivered too late to ensure MDG achievement even for the beneficiary countries in Africa.

III. Innovative Sources of Financing

Introduction

It is clear that in the absence of forthcoming commitments from the largest economies such as the United States and Japan the aggregate target of 0.7% of GDP of ODA flows will not be met at least in the near future, and this underscores the urgent need to look at alternative ways of mobilizing enough external resources to help fund the MDGs.

This has led to a proliferation of various alternatives, amongst them the so called 'innovative sources of financing' that have been suggested as a way of raising resources for development. The discussion has been gathering momentum with the publication of major studies in the past year. These studies⁵ and political backing from countries such as France, Brazil, Chile, Spain and more recently Germany has meant that proposals such as aviation taxes and currency transaction taxes, which were not on the agenda of most policymakers, have suddenly taken centre stage.

These innovative sources of financing contain several proposals as diverse as

- 1) **new international taxes** on financial transactions and the use of environmental resources etc.;
- 2) **frontloading of development resources** through borrowing against future aid commitments through mechanisms such as the 'International Financing Facility'; and
- 3) **the issuance of vast quantities of new special drawing rights (SDRs)** dedicated to development etc.

Some of these are discussed in greater detail in this section.

A. Issuing New Special Drawing Rights⁶

What are Special Drawing Rights?

A special drawing right (SDR) is an international reserve asset created under the articles of the International Monetary Fund (IMF). The SDR is not a claim on the IMF but is a potential claim on the freely usable currencies of its creditor member countries. SDRs are exchangeable for other country currencies that can be used as an international means of payment. For example, if Ghana is short of foreign exchange it can exchange some of the SDRs it owns for an equivalent amount of Pound Sterling from the Bank of England. These exchanges are done through the IMF or directly between central banks. The SDR value is calculated as a weighted basket of the US Dollar, Japanese Yen, the Euro and the British Pound.

The IMF alone is authorized to create SDRs which then have to be allocated to its members in proportion to their IMF quotas. Decisions on SDR allocations are usually taken on a five-year basis and follow a set procedure where the Managing Director makes a proposal to the Executive Board, which must approve it by 85% voting majority. To date there have only been two allocations of SDRs totalling SDR 21.4 billion. A third allocation, though approved by 77% of voting majority in 1997, has

⁵ Especially the report by the 'groupe de travail sur les nouvelles contributions financieres internationales' that is better known as the Landau report. Available at http://www.diplomatie.gouv.fr/actual/pdf/landau_report.pdf

⁶ See 'Money Creation' by Sony Kapoor and David Boyle, 2004

still not come into effect because of opposition from the US Congress since the United States as largest IMF share holder has an effective veto.

Countries maintaining SDR stocks equal to their allocated quota have no costs. However, countries that have used part of their quota to purchase other currencies have to pay an SDR interest rate on the amount of SDRs used. This interest rate is based on the short term interest rates for the SDR constituent currencies. Similarly, countries that hold excess SDRs over their allocated quotas are paid an SDR interest rate on the excess amount they hold.

Proposals for Using SDRs as a Tool for Development⁷

There have been several proposals for reinvigorating SDRs in recent years for various purposes that range from contingency financing and reserve allocation to debt cancellation and the provision of global public goods.

They all broadly fit into three categories; first as a source of credit for IMF borrower countries, second as a source of cheap reserve holdings, and third as a means of directly financing development and provision of global public goods.

For Additional Lending and Contingent Facilities

The use of SDRs for providing more IMF credit either under contingencies or under other circumstances is not very radical and is, in fact, very similar to the way that the International Monetary Fund system currently operates. Under this, the IMF borrows money from financially strong members and lends it to weaker members that are facing a temporary balance of payments problem causing a shortage of foreign exchange. The IMF charges the debtor nations an interest on the amount borrowed and passes it on to the creditor countries after deducting a margin to cover operating costs.

Using SDRs donated to the Fund or weaker members or created by the Fund for the purpose of increasing liquidity has similar implications where rich countries would temporarily exchange their currencies for SDRs but would then need to be paid an interest on the amount of SDRs exchanged. So the mechanism is in principle similar to the current working of the Fund and is in fact in many ways equivalent to increasing the size of the IMF.

In any case, this use of the SDR does not contribute directly to the objective of mobilizing resources for development though there might be indirect benefits that accrue through a more stable financial environment for developing countries under a greater availability of contingent financing in the face of a crisis or macroeconomic imbalance.

⁷ Clark and Polak (2002): *International Liquidity and the Role of the SDR in the International Monetary System*, IMF working paper, Washington.

As a Reserve Asset of Choice

The SDR was originally intended as a reserve asset that countries could hold in lieu of gold and other hard currencies such as the US dollar. It works best in this original role but its use is severely restricted by the very small size of SDRs in circulation which amounts to only about 1% of the total reserve holdings in the world.

In fact even if the size of SDRs were to drastically increase they would not be a very good reserve asset under the current system of SDR allocation. Under the articles of the IMF SDRs can only be allocated in the proportion of their IMF quota which is still dominated by the rich countries. Current stocks of international reserves however are held mostly by developing countries. So, unless the allocation system changes in favour of greater allocations to developing countries or unless the rich countries donate their quotas to developing countries, increased allocations of SDRs would still not serve a very useful role as a reserve asset.

However, if mechanisms of allocating significant amounts of SDRs to developing countries could be agreed on, the SDR could play a major role in the international monetary system as a reserve asset of choice held by developing countries. These countries currently hold as much as \$1,800 billion (more than SDR 1,200 billion) of reserve assets. Most such assets are held in the form of rich country government securities (especially US treasury bonds) that yield very low interest earnings. At the same time, most developing countries have borrowed billions of dollars denominated in foreign exchange and are paying a much higher interest rate on these borrowings. So they incur a strong opportunity cost on holding these reserves which amount to more than \$100 billion every year.

Having SDRs available would mean that instead of holding vast quantities of foreign currencies at a high opportunity cost, developing countries could exchange their SDR holdings for foreign currencies in times of need at a small interest rate that is payable only as long as they need the foreign currency. So allocating large amounts of SDRs to developing countries could potentially free up large amounts of money currently locked up in reserve holdings and free the countries from the high annual interest burden and opportunity costs of maintaining currency reserves. This money could then be allocated to finance development spending. So using SDRs in such a way is conducive with the objective of financing development.

However, most benefits would accrue to countries such as China, India, Brazil and Argentina which currently hold high stocks of foreign exchange reserves and the Least Developed Group of countries (LDCs) would only see a small fraction of the benefits. Given that it is the Least Developed Group of Countries that face the most urgent need for financing development, this mechanism of the allocation of large quantities of SDRs to developing countries will not deliver the required resources for financing development. It remains however a very desirable proposal because of large potential positive impact on the broader group of developing countries.

To Finance Debt Relief, Public Goods and Development Expenditure

This use for the SDRs resonates best with the theme of mobilizing resources for development in order to meet the MDGs. However, this is also the most technically challenging potential use of the SDRs.

In fact, there is nothing under the current SDR regime that prevents the use of SDRs for expenditure on development or related items. India could, for example, exchange some of its SDR quota for US dollars (say \$ 50 million) and then use those US dollars to purchase HIV/AIDS medicines to distribute to patients in India. However, India would then continue to pay an interest (at the SDR rate of interest) on the SDRs used. This is then equivalent to India getting a perpetual loan of \$50 million (at the SDR interest rate) and using the proceeds to purchase HIV/AIDS medicines.

Since this transaction is equivalent to a loan and because the SDR holdings of India (or any other country for that matter) are so small, such transactions of using SDRs to finance development expenditure do not exist. However, it is important to note that the interest rate at which the SDRs can be used to finance development expenditure is much lower than the interest rates available to most developing countries on most other forms of borrowing. So a strong incentive exists for countries to finance part of their development expenditure needs through SDRs.

Thus, increased allocations of SDRs to developing countries or an international agency such as the UN could be used to finance development and public goods. However, there will always be an interest which would need to be paid in perpetuity. The extent to which this regime improves on the current availability of say concessional lending facilities from the International Development Association will depend to a large extent on the specific mechanism used for SDR allocation, spending and interest payments.

In theory at least, large SDR allocations to developing countries and multilateral institutions can be used to finance development expenditure and public goods though the financing takes the form of a perpetual loan at a concessional interest rate.

It has been proposed that allocations of SDRs can be used to pay off developing country debt. This again is entirely possible under the current SDR regime where SDRs can be used to repay both Paris Club and IMF debt. Using SDRs to tackle developing country debt could happen by issuing developing countries large amounts of SDRs which they then use to repay their creditors. However, as we have shown in a previous section, the debt does not disappear but instead gets converted to a low interest perpetual loan. Nevertheless, if this loan replaces a higher interest non concessional loan, the exercise might still be worthwhile for a small group of developing countries. For the creditor countries a higher but finite payment stream (debt servicing on outstanding loans) gets replaced by a lower but infinite payment stream (SDR interest payments). Private sector loans can be repaid in exactly the same manner as financing development expenditure, which was discussed in a previous paragraph.

The other way of doing this would be to cancel developing country debt and compensate creditor countries by a new issue of SDRs equivalent to the amount of debt owed to them. This has no adverse consequences for debtor countries which can now use the money that was being diverted into debt servicing for development related expenditure. For the creditor countries this has a cost as they no longer get paid in usable currencies but instead gain a reserve asset (SDRs) that they may or may not need or want. One factor mitigating the costs to creditor countries would be if the addition of the SDR as a reserve asset frees up holdings of foreign currencies,

which can then be used in lieu of the monies that were coming in from debt repayments.

As the preceding section shows, while theoretically feasible, SDRs are not a very useful tool to provide debt relief for developing countries.

The Political Feasibility of Additional SDR Allocations

Large quantities of SDRs allocated to developing countries, as we have seen, can be used both for reserve purposes and for development expenditure. When these SDRs are first issued, developing countries will sell large quantities of dollar and other foreign currency assets that they currently hold as they replace foreign exchange denominated assets with SDRs.

This could create some potentially serious monetary consequences for the developed countries which see assets denominated in their currencies being sold off. A sell-off of US dollar denominated government bonds, for example, could result in a rise in US interest rates and/or a sharp fall in the dollar. When some other countries, in a bid to spend money on development, exchange their new SDR holdings for US dollars and then spend these dollars that too could have consequences for the US dollar and create excess liquidity in the United States.

Thus, there are some potential pitfalls and costs for developed countries that arise from the issuance of large quantities of SDRs to developing countries.

SDR allocations would not be very direct way of providing resources for development to the least developed countries and would be much more useful in freeing up resources for use by the middle income and emerging market economies. Also, there is little to guarantee that resources freed up through the issuance of SDRs would be used in the areas that are regarded as a priority by the politically dominant developed countries.

The issuance of new SDRs could also potentially increase the role of the International Monetary Fund (IMF) and many non governmental organizations (NGOs) as well as some powerful rich country governments are heavily opposed to such an increase.

The acid test of political feasibility comes from the history of SDRs. There have only been two successful allocations of relatively small amounts which were dominated by allocations to rich countries. The third proposed allocation – though supported by Fund staff as well as 73% voting majority at the board of the IMF – has been held up by US congress opposition since 1997.

Given the potential costs to the major creditor countries (especially the US since the vast majority of reserves are currently held in US dollar assets), the uncertainty of benefits to the least developed countries most in need of immediate assistance, and the historical and ongoing opposition by the US Congress, which wields an effective veto, it is unlikely that any proposal to use SDRs for development is politically realistic, at least in the short run.

However, the idea to expand the use of SDRs as a reserve asset by increased allocations to developing countries is a good idea, and efforts to move ahead on the proposal should continue in the medium term.

B. Launching an International Financing Facility

What is the International Financing Facility (IFF)

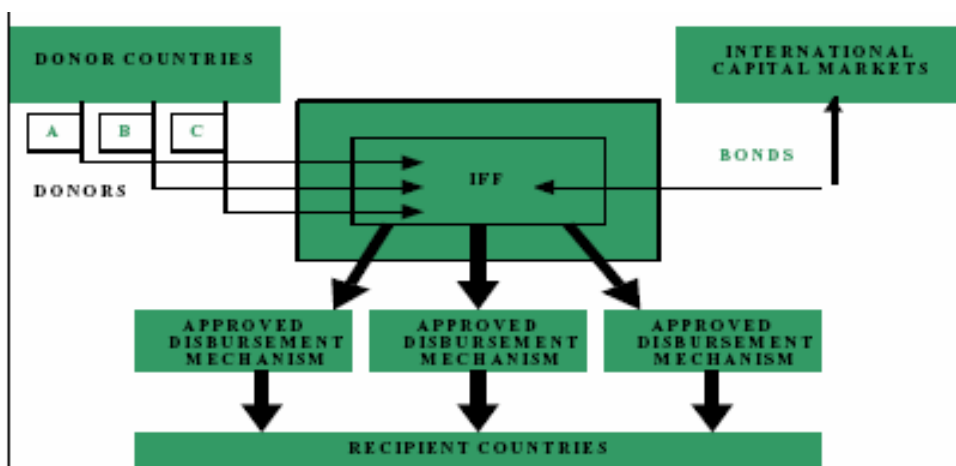
Not only is there a need to increase the total amount of ODA but there is also a need to do it urgently. The time dimension is extremely critical if the MDGs are to be met. In some African countries, for example, teachers are dying from HIV/AIDS faster than they can be trained.

Donor countries have not met their pledges for 0.7 % of GDP as ODA and on current trend will not do so for many years. However, such a time frame in the context of increasing ODA would cost real human beings their lives and blight the quality of millions more.

It is in this context that the idea of an 'International Financing Facility' could make economic and moral sense. The IFF is a temporary financing mechanism for frontloading ODA that was put forward by the UK Treasury. It will work by borrowing in the international capital markets against future ODA commitments of a group of countries to generate as much as \$50 billion in new ODA flows up to the year 2015.

How Would It Work?

The IFF income would consist of annual payments from donor countries, and the disbursements to recipient countries would take place through existing bilateral and multilateral channels. Donor countries will pledge legally binding streams of multi-year payments to the IFF. The current income streams would be leveraged by borrowing in the international capital markets through issuing bonds which would then be repaid over a number of years by using the future income streams.



The IFF would be structured in such a way that the bonds get an AAA credit rating, which would ensure that the interest cost payable is minimised. This IFF is modelled after securitization deals, which are very widespread in the international capital markets. The disbursement from the IFF could amount to as much as \$50 billion every year up to 2015, but the actual amount is highly dependant on how many donor countries sign up. The disbursement would fall sharply in 2015 after which new donor inflows would be used primarily for the purpose of repayment of bonds.

The Potential Advantages of the IFF

The moral case for the IFF is clear. As donor countries continue to delay over new ODA commitments, a human tragedy continues to unfold in Sub-Saharan Africa and elsewhere. In a way, the IFF is a recognition that things are not well, and it seeks to make the best of a very unsatisfactory ODA situation by frontloading small future commitments to generate critical mass in the medium term so that lives could be saved.

There is also a strong economic argument for the adoption of an IFF, because there are certain public interventions that have a very strong time dimension and a rate of socioeconomic return that is far in excess of costs. The clearest example of such an intervention is vaccination where an intervention now in an order of magnitude is better than an intervention in the next generation. This is especially true when such an intervention also carries with it subsidiary benefits of reducing the number of potential victims below the critical mass required for a parasite to remain endemic. The elimination of small pox and the near disappearance of polio are good examples of the effectiveness of such interventions.

The IFF plans to draw upon existing multilateral aid disbursement mechanisms, and this puts it at an advantage over other proposals such as the US Millennium Challenge Account, which can reverse some of the progress seen in aid harmonization by insisting on a bilateral only relationship.

The predictability and stability of aid flows under the IFF could help engender a more effective aid regime and enable proper planning and allocation of ODA related expenditure in recipient countries. This is very critical given that it has recently been highlighted that traditional ODA flows are four times as volatile as the GDPs of developing countries. Such unpredictability can have serious adverse macroeconomic impacts, and the IFF could set a precedent for the principle of stable aid flows that could then be used for other ODA commitments too.

The IFF also internalizes some other good principles of ODA financing. These are:

- 1) **Primarily grant based financing**, which is a welcome move away from the debt based financing that has resulted in problems of severe indebtedness in several developing countries.
- 2) **Untying all aid**, which has hitherto been tied to the delivery of goods and services from the donor country and thus limited choice for recipient countries and made aid more ineffective.
- 3) **A focus on low income countries** that most need additional financing.
- 4) **Grants** will be focussed on poverty reduction expenditure

The Potential Disadvantages of the IFF

While it does appear to make sense to frontload resources, some caveats are in order; achieving the MDGs will not get us to the end goal – after all they only call for a halving of poverty, maternal and child mortality. Millions more would continue to die and live in penury even as the world celebrates the achievement of some quantifiable goals. Economic theory clearly highlights that the marginal cost of eliminating poverty will be much higher than halving it – so in fact more resources could be required to proceed on from the MDGs than are required to reach them in the first place. It is at this time (post 2015) that the source of funding from the IFF would dry up, and in fact a part of donor country aid budgets would be allocated to repaying the IFF bonds. So there is a real danger that the IFF could leave a large funding gap just when more funding is needed.

This danger is amplified by the fact that after all the publicity and grandstanding associated with the MDGs there is a likelihood of public fatigue with the idea of devoting ever more resources especially on something that will not have the public profile that the MDGs have acquired. So post MDG development needs, which continue to be critical, are in serious danger of being under-funded.

Even more critically, there is a real possibility that despite the rhetoric and publicity, the MDGs will not be met in 2015. In fact, frontloaded resource flows from the IFF could peter out even before they were able to fulfil their stated objectives of helping ensure that the MDGs are met in time. All these issues raise some serious questions about the wisdom of embarking on an International Financing Facility.

The IFF will also result in a substantial transfer of resources to the private sector in terms of transaction and administrative costs. The authors' estimates reveal that unless the private sector is willing to work pro bono, sums of money well in excess of \$3-\$5 billion could end up in the pockets of investment banks as fees and commissions. Surely, this is not an efficient use of scarce public resources being targeted at saving lives in the poorest countries in Africa and elsewhere.

Some of the problems that face the IFF could be mitigated if a recurring and sizeable source of future revenue was identified and earmarked for future IFF repayments. A global tax generating enough revenues could easily be one such vehicle.

The Political Feasibility of the IFF

The UK government has been actively campaigning for the adoption of an International Financing Facility that is broadly supported by a large group of donor countries. The ideal situation would be to get all major donor governments on board. This would help the IFF mobilize the \$16 billion every year of additional aid commitments that were pledged at Monterrey and help frontload it to generate as much as \$50 billion of additional ODA in the medium term (i.e. before 2015).

The base case calculations for the IFF and the headline figure of being able to double aid from \$50 billion to \$100 billion are both based on this assumption that all major donor countries will sign up to the IFF and commit the additional amounts of ODA pledged at Monterrey to the facility.

However, to date France and the UK are the only two countries that have committed themselves to the IFF, and the likelihood of anything more than a very partial sign up by donor countries seems highly remote, making the headline figure of \$50 billion of new ODA flows extremely misleading.

An only partial sign up can also introduce further technical complications that make the IFF less attractive. First, it is likely that the relative burden of IFF administrative cost is likely to increase the smaller it is. Second, there would be a critical minimum size of IFF bond issues again related to the size of the IFF which would be widely accepted in the market. Third, the smaller the number of countries, the riskier the IFF bonds become and the higher the interest rates that the capital markets would demand. So, the expenses and administrative burdens associated with the IFF would cease to make sense below a certain critical threshold of size of the coalition and size of the facility. Hence, a broad signup is critical to the success of the facility.

There are certain other technical considerations to be taken into account such as how future ODA commitments would be accounted for in the donor country budgets. This issue is of critical importance to many donor countries and is being currently examined by EUROSTAT, the statistical department of the European Union.

The question about the political feasibility of the IFF remains open. On the one hand, support from the UK and France will ensure that it stays on the political agenda. On the other, the lack of support from other donor countries could seriously jeopardize its objectives and even its technical feasibility. It is however possible that some more countries such as Canada, Germany and Spain would sign up in the near future and allow for a partial IFF to be launched in the short term. Universal support for the IFF seems well nigh impossible at this stage. That the IFF was a non-event at the recent G-8 summit only serves to strengthen the belief that if the initiative does go ahead it will be in a significantly watered down form.

A parallel initiative called the IFF for Immunization (IFFIm), which also seeks to establish the soundness of the principles underlying the IFF, has already seen significant progress. It seeks to finance immunization programs in low income countries to the tune of \$4-\$6 billion over the next ten years and is being done in partnership with the Global Alliance on Vaccines and Immunization (GAVI). The UK and France have already pledged support, and it is likely that Canada and some other countries will also sign on. There has also been a pledge of private sector support from Bill Gates.

The IFFm seems to be politically feasible in the short term, but this may not directly translate into the feasibility of the main IFF initiative. While extremely useful from a development perspective, the IFFm is a specialized facility that neither seeks to and nor has the resources for plugging a significant proportion of the funding gap that exists to fund the MDGs.

C. Environmental Taxes

It is clear now that a lot of economic growth that has been generated since the advent of the industrial revolution has been built on an erosion of natural resources – a number of which cannot be replenished.

The use of these resources has serious consequences for the environment. This list is very large and broad in its scope and includes things as diverse as the creation of an ozone hole, global warming as a result of greenhouse gas emissions, and a dramatic fall in biodiversity, unprecedented deforestation and an accelerating exploitation of non-replenishable mineral resources. It is now widely accepted that the real costs of these environmental changes have not been internalized and that for any form of economic growth to continue over the long term in a sustainable way it is necessary not just to slow this destruction of the environment but also to reverse the decline very sharply.

This then is the clearest motivation for the introduction of a broad range of environmental taxes which could help internalize the real costs of using non-renewable resources and so facilitate more accurate economic decisions that lead to sustainable models of growth. However, the recent G-8 summit was extremely disappointing on this front since not only did it not suggest any bold new proposals to tackle environmental degradation, it also failed to address the urgent issue of greenhouse gas related global warming in any substantial way.

However, several ideas do exist – amongst them taxing sources of greenhouse gas emissions and other atmospheric and environmental pollutants. Regimes of such environmental taxes exist especially in 'green' countries such as Sweden, Denmark, Germany, and the Netherlands.

Ideas on taxing deforestation and the reduction in biodiversity are more recent and relatively untested. They can prove very challenging given that most of the environmental degradation is now actually happening in developing countries – often countries with poor tax administration regimes, pockets of extreme need and poverty and a large and powerful illegal logging and deforestation sector. However, the need to act has seldom been greater. What is needed is external and robust support from OECD countries – which having severely damaged their own environment on the way to 'development' now have a very strong selfish interest in stopping emerging economies from going down the same route. The rainforests of Brazil for example are known to be responsible for processing a third of the total CO₂ that is recycled by plants throughout the world. These forests are also amongst the most threatened and endangered.

Agreements on taxation of mineral resources can benefit in three ways – first, they can help internalize the real costs of using resources that are limited (thus correct a significant market failure as the markets continue to operate as though these resources are inexhaustible); second, they can help pay for the investment needed to help repair the permanent environmental scars and damage that mining is responsible for; and third, they can help developing countries, which are a massive net exporter of such natural resources and commodities, enjoy better terms of trade and earn higher revenues which can then be used for development.

However, many challenges need to be overcome before such a group of taxes or levies can be implemented widely. Mining tax regimes exist in many countries, both developing and developed, but the aggregate effective rates of taxation on mining are either similar to other industries or more alarmingly, lower. There is an urgent need for concerted action on the imposition of a broad based tax on the extractive industry which can then help finance development.

Environmental taxes – as being discussed within the current context of innovative sources of development – have a role which differs from the protection of the environment. At the kind of levels that they are being discussed, these taxes may not lead to the major changes of behaviour that are needed with urgency to reverse or halt the accelerating environmental damage. Their primary purpose then would be to raise revenues for development – no doubt is a very worthwhile goal in itself. Besides, even a very small tax on negative environmental externalities would provide both a precedent and a legal and institutional framework for higher taxes for when enough political will can be generated.

However, alternatives exist to direct environmental taxes. One example is an auction regime where once a target for emissions, mining output or other environmental goods is decided the rights to its use are auctioned in the open market and can then be bought and sold like other financial assets in private exchanges. Such a system will raise revenue at the stage of the auction, and in an ideal situation, the revenue raised would be equivalent to a tax revenue that would have resulted in a behavioural change of the required magnitude.

The Aviation Tax⁸

Globally, air travel is the fastest growing source of greenhouse gases (GHGs) which are primarily responsible for climate change. Aviation currently accounts for only 3.5% of the total emissions but is not covered by the Kyoto Protocol, the international agreement to reduce greenhouse gas emissions. In a likely scenario, aviation could contribute 15% of the total GHG emission by 2050 without accounting for the reduction in other sources as a result of the Kyoto Protocol and perhaps as much as 25% if the Kyoto protocol (and its potential successor) is successful.

Many studies have established that because of the nature of air travel its effect on climate change is as much as two to four times more than its contribution to GHG emissions may seem to suggest. The gases and particles emitted by aircrafts into the upper reaches of the troposphere and into the lower stratosphere have a larger impact as do the condensation trails formed. These could lead to higher cirrus cloud formation, which contribute to climate change. Nitrogen oxides emitted by aircrafts at high altitudes also add to global warming.

Over short hauls, air travel can produce as much as three times more GHGs per passenger than rail, and almost 70% of the flights within European airspace are short haul. Unlike petrol and diesel, which are both heavily taxed, jet fuel is currently untaxed. In the UK for example, petrol duties can contribute to as much as 80% of the costs at the pump, but no tax is paid on airplane fuel.

All of this points to a very strong case for the taxation of aviation fuel. In addition, aviation is on average used much more by the more prosperous income groups, so the incidence of tax would be socially progressive.

On the other hand, airlines do pay several other taxes. Amongst them is a flat rate air passenger duty levied on flights by the UK that some budget airlines claim amounts to *a de facto* 100% tax on fuel for short haul flights. Some other taxes that

⁸ See 'Innovative Sources of Financing – A Realistic Appraisal', Sony Kapoor 2005.

air passengers may pay are arrival or departure tax, airport tax, insurance charge etc. The air passenger duty, for example, raises almost \$1.8 billion in revenue in the UK.

Airlines are up in arms against the introduction of yet another tax on aviation saying that the fragile condition of the airline industry and record high fuel prices mean that as many as a third of the European airlines could be forced out of business by next year if a significant additional tax was levied. Still others such as British Airways are protesting saying that they are already enrolled in an emissions trading scheme, which would help cut down airline emissions, and another environmentally related tax is thus unnecessary.

There are three issues that need to be discussed further. First, would such a tax be technically feasible? Second, what form should the tax take? And third, will it have a significant impact on reducing emissions? Two further issues are the question of political feasibility and revenue potential.

That the tax will raise revenue is demonstrated by the successful existence of a multitude of other taxes on air travel some of which raise substantial amounts of revenue (such as the airline passenger duty mentioned in the previous section). The main obstacle in levying a fuel tax is the existence of an international treaty that explicitly forbids it. This dates back to the 1944 Chicago Convention when the motivation was to encourage air travel, which was still a nascent industry. The assembly of the International Civil Aviation Organization (ICAO), a UN body, which oversees international air traffic regulation, ruled out the introduction of any international tax on jet fuel till at least 2007. Another problem is that the more than hundred bilateral air service agreements, which exempt fuel used internationally from taxation, would be extremely complicated to renegotiate in the absence of a broad international consensus.

There are two possible ways out. One is to tax something other than fuel – for example by increasing the air passenger duty, or airport taxes, or the introduction of a tax on emissions or on the use of air corridors. The second is to tax fuel on domestic flights or better get a regional agreement with the most promising possibility being in the European Union.

The debate as to what form exactly the tax should take is a related one. The incentive system would work best if it directly taxed fuel as the airlines would have an incentive to reduce costs through cutting fuel consumption. However, parties on both sides of the debate agree that at the tax levels being discussed, the reduction in emissions would be small. It is estimated that even a 100% tax on jet fuel would only reduce demand in 2020 by 10% of the forecast level. Jet fuel currently constitutes only about 15% of the cost of flying. An increase of airport charges by 50% on average is likely to reduce forecast demand by 7.5%.

There is also a risk of perverse incentives as long as a global agreement is not reached. For instance, if Europe levied a tax on aviation fuel, airlines may have the incentive to get higher fuel fill-ups in other un-taxed jurisdictions and may emit more GHGs travelling with a heavier fuel load. This has already been seen on a smaller scale in the United States, where Chicago charges a higher tax rate than most other airports, and airlines take less fuel there and more elsewhere. It is likely though that

the effect of this perverse incentive may not erode all the environmental benefits from taxing fuel.

Other ways of reducing GHG emissions by the airline industry can be introduced. These would include compulsory participation in a cap and trade GHG emission quota scheme or much higher environmental levies that are truly able to internalize the cost of the damage to the environment. However, a much broader political agreement is needed to introduce such measures.

A fuel tax could end up having a significant impact on the budget section of the airline market where the elasticity of demand is high. A tax on fuel would raise the price of budget airline tickets much more in percentage terms than for other more traditional and expensive airlines. Thus, a tax that is proportional to the price of the ticket rather than a direct tax on fuel would be easier for the airline industry to bear as the travellers (such as business and first class travellers) most able to pay the tax would bear the bulk of the incidence. This would however, not provide a good incentive for lower emissions. Additionally, there would be a problem handling the heavily discounted '1 pound tickets' that some budget airlines now offer.

For the purpose of the discussion then, it is clear that the main purpose of the tax should be to raise revenues for development as it will not in the proposed form be very effective in tackling GHG emissions in any case. This gives policy makers much more flexibility in devising a proposal since the pressure to fulfil two distinct goals with one instrument is removed.

We consider some other ways that aviation could be taxed in order to generate revenues for development. The use of airports is already taxed, and the tax could be hiked to generate additional revenues for development. This might present certain problems with regards to a non universal consensus. The tax on airport usage could be implemented unilaterally or by a small group of countries especially as long as they do not include a major hub such as London, Amsterdam or Paris.

While most flights going into say Belgium go there primarily to pick up or drop off Belgian residents, the situation is quite different for an airport hub such as Amsterdam where a majority of the flights/passengers that come in use it as a transit point. So if a significant airport tax is levied in the Netherlands but not in Belgium there would be an incentive for at least some of the air traffic to move to Belgium. However, the strength of this concern is diminished by the fact that most airports have widely varied airport taxes with the highest taxes being as much as ten times the lowest ones. So, a selective implementation would not distort the current picture substantially, and part of the reason that busy hubs such as Heathrow have higher airport taxes than other smaller airports is to try and decrease congestion.

Air corridors are currently untaxed but provided sufficient political will exists they could easily be taxed. Current air corridors are the result of international agreements and usually have a long history. They exist as they are favoured by one of more of the following factors

- 1) That they provide the shortest route between two or more widely travelled points;

- 2) That they have a number of airports lined up along the path so an airliner in an emergency can land safely at one of the several airports that line the route;
- 3) That they are a safe corridor with few threats from rouge states, terrorists or hostile militaries;
- 4) That they fall within a defined jet stream area and outside of known areas of hostile weather and flying conditions; and
- 5) That the states which allow their airspace to be part of a corridor are willing to allow their airspace to be used for such a purpose

There are then significant advantages to the existence of current air corridors, which cannot easily be eroded by an introduction of a small tax, although there would in all likelihood be a small move from taxed corridors to untaxed ones within the limit of reasonable expense. However, an international agreement of some critical size would be needed to make this proposal feasible. One interesting and related case being discussed currently in the US is that the tax authorities in the US are demanding Mexican airlines to pay years of back taxes. What is interesting about the demand is that the US claims that it has a right to the tax liability on a proportion of the salary of staff working on Mexican flights, this proportion being the percentage of time that the staff members spend on their jobs in US airspace.

Taxing air tickets is yet another way of moving forward. However, this presents certain complications surrounding competition between different airlines. One simple way to implement this tax would be for instance to tax the airline which issues the ticket in the jurisdiction where it operates from. However, in practice this could be problematic especially if neighbouring countries with competitor airlines do not implement the tax. Another way would be to tax the airline and to tax the local issue of tickets on other airlines. However, there is a risk that the latter could easily be avoided simply by moving the point of the issue of tickets.

What would perhaps work best would be a charge calculated on the basis of the capacity or the passenger load of each plane flying in and out of a jurisdiction. The UK for example successfully imposes an air passenger duty which is calculated on the basis of the number of passengers. This raises more than \$1.8 billion of revenue every year. The extension of such a duty to air freight and to a broader jurisdiction with other European countries signing on would generate significant additional revenues.

What would be most progressive would be a variable duty (as a percentage of the face value of air tickets) with a minimum amount similar to the air passenger duty currently in operation in the UK set up to catch the cut-price tickets priced at 1 pound which would otherwise be able to avoid the tax. Such a tax would make the incidence fall on the most prosperous segments of air passengers and would maximise revenue collection. However, it would need broader international support than a flat rate duty which could easily be implemented unilaterally.

Political Feasibility

Another way forward could be a tax on emissions which could be implemented as a charge proportional to fuel consumed (or GHG emissions) by every flight arriving into or leaving a certain jurisdiction such as the UK or the European Union.

Politically, many countries such as France, Italy, Germany and Luxembourg are firmly in support of taxing aviation to finance international development. The UK is broadly supportive though British Prime Minister Tony Blair is on record opposing any significant increase on charges on budget airlines. Sweden, Finland and the United States are currently opposed to the idea with the new members of the European Union also likely to be unfavourable.

Politically, it is likely that some form of a tax on aviation could be introduced in the short to medium term. However, such a tax is unlikely to have very broad support at least to begin with. It is however possible to introduce it regionally, in a group of countries and indeed even unilaterally.

Nevertheless, even if such a tax is a tax on fuel, which would be difficult to implement especially in the short term, implementing countries should have no illusions about the effects it will have on emissions reduction. Policy makers should be very clear about what they expect from the tax. Any of the proposals currently being discussed and indeed any of the proposals mentioned in the above discussions will primarily provide a tool for raising revenues and not for reducing emissions.

As much as \$20 billion of revenue for international development could be generated every year in Europe alone if there was a wide agreement within Europe about the need for imposing such a tax. A smaller group of countries would mean that the revenues are more than proportionately smaller (as there will be increased scope for avoidance). An air passenger duty, an increase in airport taxes and a tax on emissions would all be easier to implement than a tax on airline fuel in the short term, and thus any of these duty or tax proposals should perhaps be the way that governments move forward. This should be accompanied by parallel initiatives to find realistic and workable ways of tackling the very serious threat posed by pollution from the airline industry at a global level.

Despite very persistent lobbying by the airline industry and some genuine concerns about the present fragile state of the industry, it is likely that at least some countries will implement an aviation tax of some form in the near future.

In fact, European countries have already announced a decision to introduce a tax on air tickets intended to raise funds for development. The proposal is however voluntary with countries not being bound by the agreement. The tax, in this current form, is unlikely to raise much revenue and most the discussion above, which was written before this announcement, remains relevant.

D. The Currency Transaction Tax⁹

The Case for Action in the Foreign Exchange Markets

Just as environmental damage gives rise to a negative externality, there are some negative externalities associated with currency markets. This has largely happened

⁹ This section is based primarily on 'Currency Transaction Taxes; Enhancing Financial Stability and Financing Development', Sony Kapoor 2004 available at www.tobintax.org.uk/download.php?id=270

as a result of excessive volatility associated mainly with large speculative activity. This sometimes results in spectacular events such as the currency crisis that gripped parts of South East and East Asia in 1997-1998, which in turn significantly increase the incidence of poverty and lead to enhanced social, economic and environmental problems and can set back in months what has taken years of development effort to achieve.

However, even in the absence of such spectacular events foreign exchange market volatility (or the mere threat of it) imposes very high costs on developing countries. There are over 300 episodes of speculative attacks on currencies (according to a World Bank definition) in the past 40 years of which just over a third were successful. Though many of them did not generate the publicity associated with the crashes in 1997-98, the damage that they did to the economies and societies of the affected countries was no less significant. This was a result of the high social and economic costs imposed by the measures taken to defend against currency attacks such as hiking short term interest rates to punitive levels.

A new phenomenon has come about post 1997 – 98 where developing countries in a bid to prevent an attack on their currencies have started accumulating large amounts of foreign exchange reserves. It is estimated that developing countries now hold in excess of 1,800 billion dollars of foreign exchange reserves which represents a more than 300% growth since 1997-98 levels. This would not be problematic were it not for the presence of two substantial costs to holding these reserves.

One is the recurring costs that arise from the fact that the borrowing used to finance the purchase of foreign exchange assets such as US Government Treasury Bonds (which constitutes over 60% of the reserves foreign exchange assets of emerging market economies) is more expensive than the return that such assets generate. In the case of Brazil for example, more than \$50 billion of foreign exchange reserves held mostly as dollar assets generate about 3% in annual return or \$1.5 billion. At the same time, Brazil has substantially higher foreign exchange borrowings at interest rates as high as 15%. Thus, holding foreign exchange reserves imposes an opportunity cost of as much as \$6 billion every year on Brazil – more than 1% of the country's GDP. For India, the opportunity cost is estimated to be as much as 1.5% of its GDP every year. The collective costs to developing countries are estimated to be greater than \$100 billion annually – a sum greater than the amount of ODA flowing to developing countries.

The other source of loss is capital loss, which has been especially pronounced since 2002 when the US dollar, the most widely held reserve currency, has fallen by more than 16% against a broader basket group of currencies. This has resulted in as much as a \$150 billion capital loss to emerging market economies with the loss to some individual countries being several percentage points of their respective GDP.

This discussion shows that there could be significant gains for developing countries and the world economy if a suitable public intervention that would reduce the negative externality of excessive volatility could be identified.

Some Characteristics of the Currency Markets

The foreign exchange (FX) market is the largest market in the world worth over 475,000 billion dollars every year. It is also highly profitable, generating between \$40 billion and \$60 billion dollars of direct profit every year. Compared with other financial markets, the FX market is unusual in being very loosely regulated and not having any direct taxes.

The FX market has a very short term focus with almost 80% of the trades having a maturity of less than one week. It is not unusual for the price of heavily traded currencies to change as many as 100,000 times a day or 70 times a second.

The incentive structure build into the market – the way that the currency traders get compensated – means that FX market professionals have a collective interest in having highly volatile markets as higher volatility means higher profits and bigger pay checks.

More than two thirds of the currency traders surveyed say that up to a horizon of six months economic fundamentals are not the most important factor in determining exchange rates. Instead they point to speculation, herd mentality and technical factors – all having a very short term focus. More than three quarters of currency traders surveyed said they thought speculation was the single most important factor in keeping a currency away from the value that was justified by economic fundamentals.

As we saw in the previous section, excessive speculation on a currency can sometimes have disastrous effects for the countries concerned as was clearly evidenced in the South East Asian crisis.

So a public intervention must be aimed at reducing volatility by reducing speculation and the short term focus of the market.

The Currency Transaction Tax

A tax on currency transactions can help significantly reduce the likelihood of currency crisis and extreme volatility by modifying the incentive structure in the foreign exchange market.

It is also clear that any tax on currency transactions has the potential to raise substantial revenues simply because the volume of transactions is so large.

A tax on foreign exchange transactions can thus have a 'double dividend' by first, raising revenues for development and second, acting as a disincentive for speculation-related volatility, which can like pollution be viewed as a negative externality.

However, these two goals which are both worthwhile seem to be incompatible at first glance. There is widespread agreement that a politically feasible tax rate to generate revenue would need to be very small – 0.001% or thereabouts and that such a small rate would do little to discourage instability causing speculation. A much larger rate – a few percentage points which would effectively discourage speculation – could

shrink the market to a level where the revenues raised may not be that large; it would also be politically extremely difficult to implement.

However, unlike the case of environmental taxes where the focus needs to be on one or the other and where the high rates needed to modify behaviour sufficiently are politically difficult, a currency transaction tax (CTT) proposition that successfully combines both goals exists.

This is the so called two-tier tax¹⁰ which is comprised of a small base tax which raises revenue and a much higher variable second tier tax which gets activated only in circumstances where a currency is facing a speculative attack or high volatility. The two-tiered variable tax has a very small base rate (say 0.001%) that applies constantly and is used to raise revenue. In times of high volatility – for instance when the exchange rate has fluctuated by more than a pre-determined limit of say 5% in a single day – a higher ‘punitive’ rate of tax can kick in and act to discourage further instability enhancing activity in the market.

A small base tax rate will not cause economic distortions or liquidity problems and would be politically easier to get an agreement behind than the traditionally talked about much higher rates of taxation in the CTT debate.

The higher punitive rate that kicks in when volatility is high increases the costs of excessive speculation and makes it easier for central banks to defend currencies. Through this dual action – it changes trader behaviour by reducing the likelihood of the success of speculative attacks and increasing the costs of failure of the attack.

Having such a tax in place will allow emerging market economies to offload as much as half of their foreign exchange reserves without increasing the threat of currency attacks and can thus result in the allocation of hundreds of billions of dollars currently locked in reserves into much more essential health, education and infrastructure related development spending.

Additionally, it also allows developing countries to more robustly defend their currencies against excessive volatility at much smaller social and economic costs to their citizens.

It is possible to raise as much as \$20-\$30 billion of annual revenue for development from a broad implementation of a 0.001% base tax rate on currency transactions

Some Technical Characteristics of the Currency Transaction Tax

Contrary to commonly held perceptions that a currency transaction tax can only work if implemented universally, it is possible to implement the CTT unilaterally on a currency basis. For currencies such as the UK pound, the Swedish, Danish and Norwegian Krone it presents a unique opportunity to implement the tax without first needing to have other countries on board. However, such a tax on the Euro is not possible unless all countries in the Euro area sign up.

¹⁰ First proposed by Paul Bernd Spahn in a paper for the German Development Ministry. This idea has been developed further by Sony Kapoor in his work for the Tobin Tax Network UK and the Dutch NCDO.

The strongest opposition to the CTT till date has come about from the United States, and one other attractive feature of the proposition is that it does not really need the US to participate for the regime to be successful. This is because whenever the US dollar is traded in the foreign exchange market it is always against another (mostly major) currency. As long as a sufficient number of other major currencies such as the Japanese yen, the Euro, the UK pound and the Swiss Franc subscribe to the CTT regime, most US dollar transactions can easily be captured.

To ensure this one could easily introduce a rule that the tax rate when a CTT currency trades against another CTT currency is 0.0005% on each leg of the transaction but for a situation where a CTT currency such as the UK pound trades against a non CTT currency such as the US dollar the tax rate could easily be doubled to 0.001% on the pound leg of the transaction. This would have the effect of raising revenue as though the US dollar was a CTT compliant currency even when it is not.

The revenues generated from a CTT could easily be allocated directly to development. They could also specifically be allocated to replenishing the IFF or paying off the borrowings instead of diverting money away from committed ODA funding. This would help the IFF get a better rating from the credit rating agencies and also make it much more politically acceptable to a much broader range of nations, which are currently undecided.

In aggregate, such a tax can generate as much as \$30 billion in annual revenue and free up billions of dollars of unproductive foreign exchange reserves currently held by developing countries. The money from both could then be used for health, education and development related expenditure. The benefits to the low income countries will derive mainly from the increased ODA flows, and the benefits to the middle income and emerging economies will come mainly from the reserves that get freed up for development related investment and a decrease in the annual opportunity costs.

The Political Feasibility of the Currency Transaction Tax

Unlike several of the other innovative sources of financing proposals such as the IFF, which are relatively new, the CTT has been around for more than 30 years when it was first proposed by James Tobin in the 1970s. While the foreign exchange market has grown a hundred fold in the period and changed beyond recognition from what it looked like in the 1970s, the CTT proposition itself has undergone many changes with the two-tier proposition discussed here being the most advanced version. This version has taken into account the changed market size and structure and offers a way of capitalizing on the 'double dividend' often talked about in the context of taxing currency transactions.

Politically, significant progress had been made in the past few years since the French and Belgian governments have (in principle) signed up to the idea. There is significant political support for the idea in Canada, Spain, Germany and a number of other countries. Most of all, there is a very strong civil society campaign that has been advocating the imposition of such a tax in the immediate aftermath of the South East Asian crisis. The idea has also been supported by many prominent

academics at various times, and most recently, the new reports¹¹ on innovative sources of financing have endorsed the idea. Many foreign exchange specialists¹² have also testified to the feasibility of the implementation of a CTT.

At this point it is important to go back to a technical issue. The first tier (base tax) of the CTT has received much more support in recent times than the second tier (volatility related tax). This is largely because while the political focus in the immediate aftermath of the South East Asian crisis was mainly on enhancing financial stability, in recent years it has shifted mainly to development financing.

It is important to note here that the two tiers of the tax can be implemented independent of each other, so progress on one front does not cannibalize progress on the other front. In fact, given that developed country currencies do not usually suffer from speculative attacks and that they amount for as much as 95% of the total trading volumes, there is a strong case for implementing just the first tier base tax on developed country currencies primarily with a view to raising revenues for development. The second tier can be implemented independently by emerging market economies with the objective of enhancing financial stability and freeing up foreign currency reserves.

There is widespread opposition to the tax from the financial sector lobby, which is especially powerful in countries such as the United States, United Kingdom and Switzerland. However, the political environment has changed favourably fairly quickly in the last few years and there are signs that political support at least for the base tax as a source of development financing is building up. The possibility of unilateral implementation is still not widely accepted and might be holding up political progress.

The total revenues raised by the CTT would depend on the degree of sign up especially from the major currencies such as the Euro, British Pound, Swiss Franc, Japanese Yen and the US dollar. In aggregate, it is fairly likely that a CTT can be implemented by a small group of countries (or even a single country) in the short term, although a more widespread sign up is likely to take much longer. It is also likely that implementation of the second tier by developing countries would only happen after the first tier base tax has proven successful.

Thus, while the potential benefits and possible political feasibility of the CTT suggest continuing campaigns and pressure, it would be unwise to depend solely on this due to the risks of partial sign up and strong opposition from the financial sector.

¹¹ Such as the Landau report detailed in a previous footnote

¹² For example Avinash Persaud, a former head of currency research at JP Morgan, UBS and State Street Bank

IV. The Need and Mechanisms for Action on Debt

In the last section we examined some potential mechanisms for delivering additional resources to developing countries that fall short of resources needed to meet the MDGs. It is also widely known that a large chunk of resources that flow into the most impoverished countries as ODA are used to service past debts. Many countries in the poorest parts of the world spend more money on servicing debt than on health or education related spending.

For example, "Niger spent over a quarter of its revenue on debt while 86% of its population can not read or write. Zambia spent a quarter of its yearly national budget on debt, more than its entire spending on health. Ethiopia spends about \$6 per capita on debt-servicing and \$2.5 per capita on education. In Honduras, Mozambique, Nicaragua, Niger and Uganda, debt repayments have been absorbing more budget resources than health and education combined.

"World Bank figures for 1999 show that \$128 million was being transferred daily from the 62 most impoverished countries to wealthy countries, and that for every dollar countries receive in grant aid, they were repaying \$13 on old debts."¹³

These examples highlight the absurdity of trying to deliver large amounts of official development assistance to the poorest countries just to see it flow out in the form of debt servicing. Sub-Sahara Africa between 1970 and 2002 received \$294 billion of money in the form of debts and paid \$268 billion in debt service, yet remains with an outstanding debt stock of about \$210 billion.

This point is elegantly summarized by an excerpt from 'Investing in Development' – the report of the Millennium Project which says "... dozens of heavily indebted poor and middle-income countries are forced by creditor governments to spend large proportions of their limited tax receipts on debt service, undermining their ability to finance vital investments in human capital and infrastructure. In a pointless and debilitating churning of resources, the creditors provide development assistance with one hand and then withdraw it in debt servicing with the other."

As a solution, the same report recommends "Deepening and extending debt relief and providing grants rather than loans". Furthermore it suggests that "debt sustainability should be redefined as the level of debt consistent with achieving the Millennium Development Goals, arriving in 2015 without a new debt overhang. For many heavily indebted poor countries, this will require 100 percent debt cancellation. For many heavily indebted middle-income countries, this will require more debt relief than has been on offer. For some poor countries left off the heavily indebted poor countries (HIPC) list, such as Nigeria, meeting the MDGs will require significant debt cancellation. A corollary for low-income countries is that current and future ODA should be grants rather than loans."

These points are highlighted and supported by the conclusion of the case studies considered in an earlier section. In the four countries under study, more than \$3 billion, or a full quarter of the domestic resources available to spend towards meeting the MDGs, can be freed up for use in reducing infant mortality and fighting hunger and poverty if the debt owed by these countries is cancelled. The conclusion of the

¹³ "Debt Relief and Girls' Education," http://qbgm-umc.org/umw/action_girlseduc.html#_edn9#_edn9.

analysis in the case studies is clear: "The countries under consideration need 100% debt cancellation, a near doubling of overseas development aid and the disbursement of future aid flows in the form of grants not loans." The case studies also show that financing the MDG gap through debt would not work as the countries under consideration would end up with a new debt overhang in 2015.

There is thus an urgent need for immediate action on debt relief in order to help low income countries meet the MDGs.

A. The Case for Debt Cancellation

It is widely recognised that debt relief is a highly effective resource transfer mechanism: debt relief can provide a much greater degree of predictability than other sources of development financing, and thus it allows governments to make the long-term investments necessary to achieve the MDGs. It supports country ownership since it allows countries to spend their own resources on the priorities they themselves have identified. It is non-cyclical, i.e. unlike aid which can decrease in times of economic downturn, debt relief is neutral. It also has low transaction costs and poses less administrative burden on recipient governments. As even the IMF now indicates, Debt cancellation can "*offer a vehicle for the international community to provide additional resources in a predictable and easy-to-use form to meet the MDGs.*"¹⁴

Despite this, some sceptics continue to cast doubts on the desirability of using debt cancellation as a mechanism for delivering resources.

Some critics say that debt cancellation is inequitable – disproportionately rewarding countries with high levels of debt as those countries would get more resources than others which are less indebted. However, if the leaders of creditor nations are sincere about their commitments to fund the MDGs, then debt cancellation is merely one mechanism (albeit a very efficient one) amongst many to help deliver resources to impoverished countries. So each country would get the resources needed to meet the MDGs with debt cancellation as a part of a broader package of increased ODA flows and other measures such as a fairer trade environment.

It is also said that debt cancellation will create a moral hazard – an expectation of further debt cancellation. We advocate a one off gesture which wipes the slate clean, allows countries to make a fresh start and removes the development inhibiting debt overhang. If, as suggested under the new Debt Sustainability Framework, the new resources delivered to the poorest countries are in the form of grants not loans then there will be no future loans to cancel. Another way to avoid moral hazard is for rich countries to fulfil their commitment to fund the MDGs so the impoverished countries do not need build up unpayable debts as they struggle to provide essential services to their citizens. In fact the IMF itself says that "further debt relief holds out the promise of easing concerns about debt sustainability while attracting additional financing needed to reach the MDGs"¹⁵.

¹⁴ Further Debt Relief for Low Income Countries – Key Issues and Preliminary Considerations, IMF March 2005, emphasis added.

¹⁵ Further Debt Relief for Low Income Countries – Key Issues and Preliminary Considerations, IMF March 2005

Another argument used by opponents of debt cancellation is that the resources released will not necessarily be used for development. However, the fact that most resources released by debt cancellation to date have been used for development purposes shows that these fears are not justified. The HIPC program, though a failure on many fronts, successfully demonstrates that debt cancellation can be a very efficient way of delivering resources to priority sectors. Though the cancellation offered was very limited, even the small amounts on offer had substantial development impacts.

The Africa Commission reports that for example

- In Benin, 54% of the money saved through debt relief has been spent on health, including rural primary health care and HIV programmes.
- In Tanzania, debt relief enabled the government to abolish primary school fees, leading to a 66% increase in attendance.
- After Mozambique was granted debt relief, it was able to offer all children free immunisation.
- In Uganda, debt relief led to 2.2 million people gaining access to clean water.

A recent study of the ten HIPC countries for which adequate data were available¹⁶ has shown that:

- In 1998, debt service took up twice as much, in terms of resources, as spending on health. Since then, spending on health has risen by 70% and is now one third higher than debt repayments.
- There is no evidence to suggest that debt cancellation is being used to fuel military expenditures.

Moreover, the IMF's annual review of the HIPC initiative in September 2004 found that the 27 countries that had received debt relief doubled their spending on poverty-reducing expenditures from 1999-2004.¹⁷

It is clear from the above discussion that

- 1) Significantly more debt relief is needed in order to help finance the MDGs for the lowest income countries
- 2) This debt relief is a very efficient and effective way of helping increase MDG related expenditure in developing countries

B. Proposals for Multilateral Debt Cancellation

Debt owed to the International Monetary Fund (IMF), World Bank and other multilateral banks¹⁸ has grown rapidly in recent years and these are now significant creditors of low income countries. Largely because there are serious consequences for countries which default on payments to these bodies, multilateral debt can be very onerous. Countries that cannot afford to repay still continue service multilateral debt as not doing so would earn them a sharp reprimand from the international

¹⁶ Call for Change, Jubilee debt Campaign UK, 2004

¹⁷ IMF. HIPC Status of Implementation Report, September 2004.

¹⁸ E.g. African Development Bank, Inter American Development Bank

community and perhaps even cut them off from other sources of overseas development assistance.

Even as impoverished countries struggle to raise resources to tackle the scourges of hunger, poverty and disease, more than \$13 billion¹⁹ flows out of these countries in the form of multilateral debt payments every year. This amount is more than the amount of effective grant aid²⁰ flowing into these countries.

Campaigns for debt cancellation through the 90s pressed for cancellation of debt owed to multilateral institutions. Partly in response to this, the World Bank and the IMF launched the Heavily Indebted Poor Country (HIPC) Initiative in 1996 and the Enhanced HIPC in 1999. This initiative included a list of 42 countries and claimed to enable countries to achieve debt sustainability but was very limited in what it actually achieved and defective in the way it did this. While it did result in some debt being cancelled, it was a far cry from the cancellation of unpayable debt called for by the Jubilee 2000 debt campaign which aimed to give a fresh start to debt burdened countries in the new millennium. Moreover, a large part of the debt that was cancelled amounted to little more than a paper transaction as it was debt that was in arrears, i.e. debt that was actually not being repaid in any case. The cancellation of multilateral debt is much more efficient as a resource delivery mechanism because so little of this debt is in arrears.

Renewed calls for cancellation of unpayable multilateral debt were for many years ignored until public pressure, not the least in connection with the campaign to achieve the MDGs, has now finally put it on the agenda of the rich countries which started discussing ways of tackling the multilateral debt crisis in mid 2004. This is a belated recognition of the seriousness of the debt-poverty trap that many of the poorest countries in the world face. Proposals for multilateral debt cancellation were tabled by a number of countries such as the UK, USA, Germany, Norway and the Netherlands. A proposal was also put forward by civil society representatives²¹.

While the proposals discussed various degrees of debt cancellation and different means of funding it, they were mostly incomplete and did not go far enough (except the civil society proposal that was much broader in scope). In line with the disappointing initial proposals, the recent G-8 summit failed to comprehensively address the issue of poor country debt. It has delivered only \$40 billion (over 40 years) of cancellation and that too for a group of only 18 HIPC countries. Campaigners were demanding a treatment of as much as \$500 billion of debt for more than 60 countries that need immediate debt cancellation.

Given that the money needed annually to provide a more comprehensive debt cancellation deal to a much broader group of countries is less than 0.1% of rich country GDP it is unconscionable that they have not acted.

Because it seems unlikely that the rich countries would any time soon put more money into debt cancellation, civil society groups have been pushing for the rich countries to look to the 103 million ounces of undervalued gold worth over \$40 billion lying idle with the IMF²². Other sources such as IBRD reserves also exist²³.

¹⁹ Global Development Finance 2004

²⁰ GDF 2004, Grants excluding technical aid

²¹ See 'Multilateral Debt Cancellation; Recent Proposals Explained', Sony Kapoor for Eurodad 2005 and 'Current Perspectives on Debt Relief', Sony Kapoor for the Commonwealth Finance Ministers meeting, 2004

²² 'Can the IMF and the World Bank cancel 100% HIPC debt', Sony Kapoor for Debt and Development Ireland, September 2003, 'The IMF, gold sales and Multilateral Debt Cancellation' Sony Kapoor for Debt and Development

The Example of IMF Gold²⁴

Groups have argued that the IMF has no real use for the gold and up to \$35 billion worth can be mobilized to cancel debt owed by impoverished countries to the IMF and other multilateral institutions. This is a large chunk of resources which can pay for a significant portion of the money needed to cancel 100% of multilateral debt for impoverished countries.

The biggest obstacle cited by opponents of the use of this gold had been the potential negative impact of the sale of gold on the world price of gold, which could cause damage to gold mining and especially the countries which are major producers, particularly in the developing world. However, a widely circulated paper²⁵ by Debt and Development Ireland clearly showed how IMF gold could be sold without any impact on gold price. The paper suggested that selling gold under the existing Central Bank Gold Agreement – an agreement on a declared and transparent sale of gold belonging to mostly European central banks – would mean that the price would not be affected. The paper also suggested the sale of IMF gold directly to the mostly emerging market central banks that are buying gold would also help minimise and price impact of offloading IMF gold.

These arguments have helped to convince previously sceptical countries and institutions that it is possible to sell IMF gold for debt cancellation without any adverse price impact. Based on this, developing countries, including significant gold producers such as Tanzania, South Africa and Guyana have indicated their support for gold sales to finance debt cancellation.

Most recently, the International Monetary Fund itself joined the chorus. In a recent paper²⁶ discussed at the executive board, the IMF endorsed several mechanisms (specifically the use of the Central Bank Gold Agreement (CBGA) and the sale of gold directly to emerging market central banks) advocated by civil society.

“The direct sale of gold to one or several central banks would involve only a redistribution of existing official gold holdings and therefore should have little effect on the gold market.” The sale of gold under the CBGA would ...” offer the best prospects of limiting any potential adverse effects on the gold market, since the agreed overall sales volume is already in the public domain and has been fully discounted.”

Some critics have expressed concerns that the sale of gold would affect the viability of the IMF and could jeopardize its operations. This is an unfounded fear since the capital held by the IMF will remain unchanged even if all IMF gold were used to fund debt cancellation. The IMF acknowledges that the sale of gold would actually result in a “small increase in the Fund’s liquidity” and that it “need not erode this (the IMF’s balance sheet’s) strength.”

Ireland, September 2004, ‘Paying for 100% Debt cancellation’, Sony Kapoor for EUROAD, Jan 2005, ‘100% Debt Cancellation, MDGs and BWI resources’, IOB (Dutch foreign ministry), Sony Kapoor, June 2004.

²³ ‘World Bank (IBRD) Resources and Debt cancellation’, Sony Kapoor for Jubilee USA Network, 2005

²⁴ See ‘Mobilizing IMF Gold for Debt Cancellation’, Sony Kapoor in Development 2005 Issue 48

²⁵ ‘The IMF, Gold sales and Multilateral Debt Cancellation’ by Sony Kapoor for Debt and Development Ireland, September 2004.

²⁶ Financing Further Debt Relief for Low Income Countries – Preliminary Considerations, IMF March 2005

Also, the only real way the IMF can utilize this gold as capital is if it can sell the gold and hold on to the proceeds. This is politically extremely unlikely. In fact, the IMF recognizes this itself when it says that "gold... is illiquid for prudential purposes given the broad consensus required among the members for such a decision".

Some other critics have said that using IMF gold for debt cancellation is like "selling the family silver." In financial practice, it is considered prudent to use regular sources of revenue for recurring expenses and capital for one off expenditure. The cancellation of 100% of impoverished country multilateral debt is a one off gesture, like a capital expenditure, that would for the first time 'wipe the slate clean' and allow nations to make a fresh start without debilitating debt servicing and a damaging debt overhang.

Still others have expressed concerns that the sale of IMF gold for debt cancellation is unfair because it rightfully belongs to its member countries and should be given back to them. This argument is flawed as whatever way debt is cancelled, eventually rich countries will have to bear the bulk of the financial burden. Additional bilateral contributions place the burden on creditor countries. Even if the debt is cancelled using IMF (gold or PRGF) or World Bank (reserves or income, or future repayments) own resources, the burden will eventually fall on rich countries by diminishing the value of their share in these institutions. The resources held by the multilateral institutions eventually belong to their member countries, and a decrease in the total amount of these resources translates into a lower value of the share held by member countries.

Both historical precedents and IMF articles provide for the excess value locked in IMF gold to be used for helping impoverished countries. The fund sold gold between 1976-80 and used part of the proceeds to fund concessional lending to the poorest countries. A second set of gold related transactions in 1999-2000 were used to cancel part of the HIPC debt owed to the IMF. The IMF articles also clearly provide that money in the SDA account (the account that holds the profit from any gold sale) "can be used for distribution to developing countries.

C. The Way Forward on Debt Cancellation²⁷

With the G-8 deal on debt being touted as a major step forward by the proponents of the deal and a 'damp squib' by campaign groups it is unclear as to what the next step forward is. What is clear, however, is that there needs to be a next step.

The first and perhaps easiest way forward is for the rich countries to immediately extend the current deal, which only includes 18 countries, to a much broader group of poor countries. This would require additional resources that could be mobilized through the use of a mix of IMF gold, IBRD reserves and additional contributions by rich countries.

Debt cancellation would wipe the slate clean for some of the poorest countries on earth. It represents one concrete step to help countries get back on track to reach the MDGs, although it is by no means enough.

²⁷ See 'Debt Cancellation; Time to go Nuclear?', Sony Kapoor forthcoming

Failure to act, once again, will have the severest of consequences for large parts of the developing world.

In order to get rich countries to act now on the cancellation of not just multilateral debt but also bilateral and private debt that the poor countries cannot or should not repay, perhaps developing countries should consider some radical steps.

Argentina, gained much from the recent unilateral moratorium and restructuring of its punishing stock of external debt. It has come out a much stronger economy with about a third of the debt burden that it has before the restructuring. Predictions of doom and punishment by external creditors and investors were vastly overblown and there is now a universal agreement that the decision to default was the right thing to do and has had a positive impact on growth in the economy.

In early 2005, the lower house of parliament in Nigeria voted to unilaterally cease repayments on its stock of external debt. The senate blocked the proposal but made it clear that the block was just temporary with the legislation likely to pass next time round. This threat in hand, a group of Nigerian parliamentarians then went to meet the major creditor countries and representatives of the Paris club. The threat of default was taken seriously and the Paris Club which had earlier refused to even begin to consider the case for the cancellation of Nigerian debt agreed to an almost 60% write-off of the debt owed by Nigeria.

Both these events, where tough negotiating positions employed by large developing countries resulted in successful outcomes on debt cancellation without serious negative consequences help make a case for other countries to follow suit.

That is why, one way forward could be for developing countries to threaten to default on their external debt in case the rich countries refuse to provide much needed relief from debt overhang and excessive debt servicing that is depriving millions of resources they badly need. Relatively resource rich countries such as Nigeria or countries with a large debt burden such as Argentina may proceed down this path alone. However, it is likely that if this trickle becomes a flood rich countries would consider some form of punitive action which may be harmful.

For that reason and also so smaller and poorer countries can be in a stronger position, we suggest the establishment of an 'Abuja' club for debtors to parallel the Paris club of creditors. By threatening to take collective action against unpayable debts, this Abuja club of debtors could help start serious negotiations on a fair treatment of all outstanding debt. The debtor countries would then, rather than being powerless, sit as equals with the creditor countries over the negotiating table and would surely be able to accelerate the action on debt and get a better deal on debt restructuring.

They should then, hopefully, be also able to bring the issue of 'illegitimate' and 'odious' debt on the agenda to help reclaim at least some of the stolen proceeds that lie in banks in rich countries. An open discussion on illegitimate and odious debt would also make a much stronger case for increased cancellation as by some estimates as much as a third to half of the debt owed by poor countries comes under these categories and hence should not be repaid in any case.

At minimum, countries should come together to form guidelines that prevent 'odious' lending from happening in the future.

D. A Fair and Transparent Arbitration Process (FTAP)

The Need for an FTAP

Currently, there is no systematic way of dealing with debt problems of developing countries. That is partly responsible for the mess we find ourselves in. While, the establishment of an Abuja club may be a good idea, it would still not address this systemic deficit. That is why it is critical to establish such a system that will not only help deal with current debt problems but also prevent future problems from building up to a crisis.

In the run up to the MDG target year of 2015, we can no longer wait and the problem of debt urgently needs to be tackled in a systemic way. In order to achieve this outcome, it is recommended that an independent, fair and transparent arbitration process (FTAP) be established to adjudicate on cases of unsustainable sovereign debt on a country by country basis.

The role of ensuring the neutrality of the panel would be assigned to the Secretary General of the UN. There would be an automatic standstill of debt payments to all creditors during the process, in order to prevent asset grabbing

Key Elements of an FTAP:

- **Impartiality of decision making.** Unlike the present system where the creditor plays the role of plaintiff judge and jury, FTAP will enshrine the proper independence of the insolvency court.
- **Neutrality of Assessment.** Assessment of the debtor's economic situation will be made by a neutral body which does not represent the interests of either debtor or creditors.
- **Transparency.** Negotiations are open to public scrutiny and recorded.
- **Participation.** Civil society holds the right to access information, and to be heard during negotiations
- **Monitoring.** Civil society will critically review the implementation of the FTAP outcome
- **Debtor's unconditional right to petition.** Sovereign debtors hold unconditional right to petition to enter the insolvency procedure
- **Protection.** Both the sovereignty of the debtor country and the human, social and economic rights of its citizens will be protected, including the country's ability to achieve its MDGs.

- **Conditionalities established by debtor country.** Economic and political measures upon which debt relief under a FTAP is conditional must serve the poor sectors of the debtor society. These will be proposed to the panel by the debtor government, and subsequently monitored by all stakeholders.

Benefits of an FTAP:

- **Restoration of debtor country viability.** FTAP would be modelled on Chapter 9 of the US Legal Code²⁸ which stipulates that the debtor must emerge from insolvency proceedings with adequate prospects of financial and economic stability, including a sufficiency of capital
- **Fairness of outcome.** Because FTAP is impartial, it will be fair to both debtor and creditors. The process will discourage both reckless lending and unwise borrowing in the future.
- **Burden sharing among creditors.** The Bretton Wood Institutions (IMF and World Bank) should shoulder their fair share of debt cancellation as adjudicated under FTAP.
- **Debtor country autonomy protected.** Debtor country governments will be able to devise and implement their own poverty reduction and development policies free from external coercion.
- **Odious debt.** Illegitimate or odious debt will be objectively determined. (*Outside* such an impartial process, the definition of what is 'odious' is always a subjective decision by one or other party in the dispute.)
- **Domestic debt.** Many poor countries have very high domestic debt burdens, in part arising from the need to service external debt and from creditor-imposed conditionalities, and it is impossible to ensure adequate resources for the MDGs unless these are taken into consideration. FTAP will enable a holistic assessment of debt sustainability.
- **Low cost of procedure.** FTAP will not require a standing court but can be convened where necessary, modelled on the many existing examples of independent arbitration procedures for debtors and creditors.

The FTAP presents a way of dealing with the unpayable debts of a country in a systematic and just way. It is critical to note that the acceptance of the civil society proposal on 100% multilateral debt cancellation does not in any way jeopardize the establishment of an FTAP, but actually catalyses it. There exists a unique window of political opportunity to deal with multilateral debt in a very short time frame and this unique opportunity should be used to release resources to poor countries immediately and save millions of lives. The FTAP, by its very nature will be a time consuming process and decisions are likely to take months if not years. So, while 100% multilateral debt cancellation can provide immediate relief to poor countries, the FTAP can provide a complementary funding stream over the medium term.

²⁸ See Chapter 9/11? – Resolving international debt crises – the Jubilee Framework for international insolvency at http://www.jubileeresearch.org/analysis/reports/jubilee_framework.pdf

V. Migrant Remittances

One of the most significant developments in the field of external resource delivery to developing countries has been a large growth in migrant remittances which now constitute as much as a quarter of all external resources flowing to developing countries. Remittances grew from \$15 billion in 1980 to \$80 billion in 2002.

Remittances can help supplement savings in recipient countries, finance consumption, education and investment and act as seed capital for small scale entrepreneurial ventures. Perhaps the biggest attraction of remittances is that they are very stable over time and can in fact be countercyclical and provide social security for the recipient community.

However, their role in development should not be overestimated as remittances are very unevenly distributed both within and across countries. Typically, certain areas within a country account for the largest proportion of emigrants and hence receive a disproportionate share of inward remittances. Also, a group of only twenty countries receives more than 80% of the total remittance flows with just the top three accounting for more than a third.

It is well known that remittances, especially from low income workers (sometimes illegal and underground) in developed countries to poor rural communities in their countries of origin carry the highest transaction costs which can sometimes reach as much as 30%-40% of the face value of the transactions. It is these transfers, not the transfers from the professional emigrants to their urban households, which have the most development potential.

There is thus an urgent need for both developing and developed countries to act to reduce some of the punitive costs associated with remitting money to poor countries. Developing countries can act to ensure that the final distribution costs to the recipients are minimised through an effective and efficient use of channels such as rural banks, micro-credit institutions and post offices.

Developed country governments must act to clamp down on illegal and fly-by-night operators, who fleece unsuspecting recent immigrants. Also, they need to act consciously to enhance the ease of use of legal financial channels. Onerous documentary burdens and a fear of being found out can drive the most vulnerable illegal and underground immigrants in developed countries to seek the much more expensive illegal channels.

There is also a need to stricter licensing laws and encouraging competition and perhaps the need to introduce caps on commission rates for transfers. Likewise, the development of 'home town associations' (associations of migrants who act together) which often help finance the development of community projects in their countries of origin could be encouraged where it is clearly seen to contribute to development. Perhaps, giving tax breaks to such associations at least on the amounts invested in community development projects will increase the resources being transferred and also serve as an incentive for increased contributions to development enhancing initiatives.

An even better idea would be to transfer tax revenues equivalent to the amounts earned on remittances sent abroad to the governments in recipient countries. The

transfer of even a proportion (say half) of these tax revenues could increase transfers by as much as \$5-\$10 billion dollars every year and can go directly into recipient country government budgets to finance development efforts. An alternative could be to make remittances tax deductible, but this would ensure that more money flowed into private hands in recipient countries and may open channels for tax avoidance.

VI. Plugging the (Tax) Leaks²⁹

Developing countries are losing \$500bn (£288bn) to \$800bn in untaxed money that is leaving their economies unchecked. This flight of capital is up to 10 times the \$78bn that developing countries currently receive in aid. For example, the much publicised G8 deals will deliver about \$1bn in debt cancellation and \$25bn in aid flows mostly to sub-Saharan Africa. But this is dwarfed by the \$50bn the region loses in capital flight.

By far the biggest leak is the widespread and pernicious mis-pricing of exports and imports to shift profits out of the country. For example, African diamonds have been exported by businesses at a book price of a fraction of their true value so the real profits only show up in offshore locations.

Firms, especially multinationals, are the biggest culprits using a sophisticated network of notional companies in tax havens to hide billions of dollars of profits from the taxman. The secretive practices of banks in these jurisdictions make it almost impossible to bring the culprits to book.

Other leaks such as criminal proceeds from trafficking and racketeering, and corrupt proceeds from greedy officials are important but much smaller and piggyback on the sophisticated money-moving apparatus set up by western banks and businesses.

Plugging the leaks would allow developing countries to cut their reliance on western governments and the IMF, and reject damaging enforced privatisations and trade liberalisation so often attached as conditions to aid and loans.

Tax havens and banking secrecy cause poverty by facilitating the leakage of scarce money out of developing countries. They also help rich elites and businesses avoid billions of dollars in taxes that could otherwise finance the building of hospitals and schools.

Co-ordinated international action towards shutting down tax havens, eliminating banking secrecy and automatically exchanging information between tax jurisdictions would plug the biggest leaks.

While the incentive for developing countries to act is clear, the hundreds of billions of dollars that rich countries lose in tax revenues are now threatening the very existence of the welfare state. Britain alone loses more than £50bn in taxes every year.

Following Gleneagles, the time is ripe to add the issue of capital flight to the debt, aid and trade triumvirate. With co-ordinated action it is possible to tackle poverty in the developing world and halt the erosion of the welfare state in developed countries.

Taxation is at the heart of the 'social contract' between a modern sovereign state and its citizens. In return for fulfilling duties such as 'paying a fair share of taxes'

²⁹ See 'Plug the Leaks – or Waste the Aid', 11th July 2005 in the Guardian and 'Tax Avoidance, Tax Competition and Globalisation', 2004 both by Sony Kapoor and John Christensen and See 'Exposing the Myth and Plugging the Leaks', Sony Kapoor forthcoming

citizens are provided with security, infrastructure and essential services such as education and basic health services.

Taxation is the primary source of revenue for governments and provides them with funds they need to provide infrastructure, security and amenities to their citizens. The role of governments is especially important in the most impoverished countries where the income level of average citizens is so low that they cannot afford to purchase even the most basic services through private means even in the few cases where such a choice exists.

It is widely acknowledged that without active state intervention and participation in basic health, education and infrastructure services the development of the least developed countries could not be envisaged. It is a very serious matter then that the resources available to them to fund development expenditure are diminishing.

There are three relevant themes here with implications that go far beyond just the effect on developing country government revenues. The three are 'tax avoidance', 'tax evasion' and 'tax competition'. Related themes include 'tax havens', 'transfer mispricing' and 'capital flight'.

One major route by which foreign direct investment (FDI) is expected to contribute to development in a country is through the tax revenue that is generated on the profits of the FDI which then can be used by the government to finance development expenditure. However, faced with an ever increasing negotiating power wielded by multinational corporations (MNCs), desperation for scarce foreign exchange which is needed to pay off huge outstanding debt burdens and severe competition amongst themselves, developing countries are offering increasing sops to MNCs to invest in their country.

A typical example could look like this: MNC XYZ wants to put a \$100 million bottling plant in East Africa to cater to regional demand. It goes to country A and negotiates a 20% concessional tax rate instead of the standard 30%. It then goes to country B and gets them to offer a 10% tax rate using country A's offer as a bargaining chip. With these deals in hand it finally convinces country C to charge only a 5% tax rate and offer the company free land and infrastructure facilities where the costs of these is greater than any tax revenue that would be generated on company XYZ's profits. Thus, country C ends up with a negative effective rate of taxation and countries A and B having lost the investment would offer even steeper tax discounts next time there is an expression of interest from a foreign firm. This example is not academic but reflects the reality on the ground in several impoverished countries where effective tax rates are now turning negative.

Trade is supposed to contribute in a major way to development primarily through revenues generated for the governments as well as through private profit that accrues to the country. More than 60% of international trade is actually intra-company trade – transactions between subsidiaries of the same firm. More than 55% of international trade (in fact most of the intra-company trade) passes through offshore tax havens providing perfect opportunities for transfer mispricing and profits laundering. Ball point pens (not made from gold) priced at \$800 per piece, a litre of apple juice priced at \$1,012, a plastic bucket priced at \$725 – these are some extreme but real examples of transactions that are used to transfer profits out of countries (both developing and developed) to zero tax fiscal paradises (tax havens).

The effect on developing countries is more severe as their tax authorities lack the resources or the sophistication that tax authorities in developed countries have, and hence MNCs find it easier to get away with mis-priced transactions.

Tax evasion and tax avoidance for both companies and rich individuals in developing countries is also widespread with tax havens playing a very major role in facilitating capital flight and money laundering which depletes the governments and countries of scarce resources needed for development. It has been estimated that developing countries collectively lose as much as \$500 billion of money every year to dirty money flows.

This is an order of magnitude higher than current ODA levels, and if even a fraction of these resources can be tapped for development, the level of funding for the MDGs would receive a big boost. These monies are also ideally suited for development as a large fraction of this is money owed to governments in developing countries – i.e. money that can then be directly used to fund development expenditure. It is also better quality money because unlike ODA – which carries with it the weight associated with a donor-recipient unequal relationship – capturing dirty money flows for development empowers developing countries as they get a larger share of what is rightfully theirs. Actually, it is a form of domestic resources – which, as the Monterrey Consensus highlighted, were ideally suited for development.

The actions needed to tackle these issues would benefit both developing and developed economies tremendously. The only real losers might be the small island tax havens which would then need to explore other avenues for raising resources. It is extremely important to note that the gains that tax havens derive from haven-related activities are a very small fraction (much less than 1%) of the losses that these actions inflict on other non-haven nation states. That is why a strong case can be made for the creation of a fund that will help facilitate the transition from a haven economy to a more sustainable and diversified one. This fund could easily be financed out of the proceeds of the gains accruing to developed economies from the abolition of tax haven related activity. This suggestion for a generous fund for tax havens that renounce haven activity would go a long way in reducing the opposition from these countries to moves to crack down on tax haven activity.

Amongst the steps that need to be taken are

- **Establishing a forum for international tax co-operation not just between the OECD countries** that would facilitate an automatic exchange of information between tax authorities so that tax evasion cannot happen through the exploitation of the gaps between various tax jurisdictions. It would lower the incentives and opportunities for tax evasion, tax avoidance and transfer mis-pricing.
- **Having an agreement on a minimum rate of corporation taxation** would be very helpful to put limits to tax competition. The rate does not need to be very high as even a low rate could prevent tax rates from becoming negative.
- **Legislation of a general anti-avoidance principle** would help clamp down on tax avoidance activity by making it illegal to indulge in activities aimed primarily at reducing tax liabilities.

- **Eliminating bank secrecy** would go a long way in catching perpetrators that are currently able to hide behind this secrecy and be safe from being prosecuted for laws they have broken. This would also be a very significant step in tackling the problems associated with terrorist financing, money laundering, smuggling and capital flight.
- **Having an international agreement on company accounts** that give a detailed breakdown of economic activity, profits and taxes paid in each jurisdiction would make it much harder to avoid and evade taxes and engage in transfer mis-pricing at a large scale.

Some of these measures such as the legislation of a general anti-avoidance principal can be unilateral but most others need to have at least a degree of international co-operation. This is where the G-7 and OECD countries can take a lead and support these issues not just from a development perspective but also as issues that would simultaneously have significant advantages for their own citizens.

Political Feasibility of Action on Tax Justice

Walking down the path of 'international tax co-operation' is in many ways easier and more significant than pushing 'international taxation'. This is especially so as 'international tax co-operation' is a prerequisite to any form of 'international taxation' with a view to developing platforms for implementing such taxes and preventing widespread evasion and avoidance if and when they are implemented.

Also, politically it is much more realistic to expect an agreement or consensus on the need and mechanisms for 'international tax co-operation' than for 'international taxation'. The magnitude of monetary flows that can be mobilized for example by concerted and co-ordinated action against tax havens, are also an order of magnitude higher than the revenue estimates from many of the proposed international taxes such as the 'Tobin Tax'. For example, a combination of measures suggested in the above section could easily result in as much as \$250 billion additional resources becoming available to developing countries in the medium run.

Unlike most other sources of development funding which imply a zero sum game – both ODA and debt cancellation for example imply a transfer of resources from citizens in the OECD countries to citizens in the developing world – money accruing from international tax co-operation is a win-win game. The same issues which are inhibiting development in countries as diverse as Brazil and Kenya are the factors which are leading to an erosion of the welfare state in OECD countries. The interests of a majority of citizens in both the developing and developed world are then aligned, pitting them against the interests of the super rich elite who number a few million at most.

The very structure of the German welfare state, for example, is being threatened by these phenomena of tax avoidance, tax evasion and tax competition. Rich German citizens have put billions of dollars of money into secret bank accounts in Luxembourg and Switzerland to avoid paying taxes. Large companies operating in Germany are able to shift profits out of Germany to low tax locations such as Estonia and to tax havens.

It is easy to get diverse constituencies such as labour unions and religious groups mobilized on the issue, and parties from both the right and left end of the spectrum have much to gain. The left can use the additional monetary flows to increase welfare and infrastructure spending without unpopular tax rate hikes, and the right can cut tax rates without unpopular cuts in the welfare state. Additionally, security issues such as closing down channels which can be used for terrorist financing and money laundering are now a priority in the wake of terrorist attacks in New York, Madrid and London.

In fact, tax avoidance and tax evasion cost OECD governments much more than \$500 billion every year. Co-ordinated action on international co-operation on tax matters could easily net these governments at least about half billion of this money in new income every year. For example, the unpaid income tax on income of the more than \$11.5 trillion dollars of assets held offshore alone is estimated to be about \$255 billion every year. Using even \$50 billion or 10% of these new tax revenues for increasing ODA flows can easily help finance the MDGs. Of course, this action will also help release tens of billions of dollars of developing countries' own money too.

The issue of tackling tax avoidance and tax evasion is thus something that has a lot of latent public support as well as support from both developing and developed country governments. The sheer size of the problem and the positive impacts on both developing and developed countries mean that this is an issue that is likely to be politically feasible in the medium run.

Policy makers and campaigners should push for the tax justice to be included as a financing for development theme because it is so central to the development debate and because the issue has not yet got the kind of attention that it deserves. So short term action can lead to some easy wins (such as the enactment of legislation enshrining the general anti-avoidance principle in law by developing countries) and create the momentum and profile needed to achieve co-ordinated action in the medium term with the potential to generate hundreds of billions of dollars for both developing and developed nations.

The channels that facilitate resource leakage from both developing and developed countries are the very same channels that facilitate terrorist financing networks. The horrible events in London on the 7th of July 2005 lend a fresh urgency to the need for immediate action against tax havens and banking secrecy.

Tony Blair, the British Prime Minister, recently announced plans to crack down on terrorist financing networks using Britain's EU presidency. This provides a unique opportunity for actions that if done right can achieve three goals. These are safeguarding the structure of our welfare state and having a more equitable tax system, helping developing countries plug the leaks and perhaps most urgently make us more secure against terrorist attacks.

VII. Domestic Resource Mobilization³⁰

Under financial globalization, a significant part of the development effort has focused on raising foreign resources for use in domestic development. Ignoring the enormous potential for raising resources domestically could lead to an overstatement of the need for external resources. This is significant as an excessive dependence on foreign sources of financing can have large associated costs. In particular, excessive foreign borrowing by both governments and private firms has led to a succession of external debt crises in both low and middle income countries with devastating impact on the domestic economies and in particular the poor.

Foreign sources of funds, especially in the form of aid flows, portfolio investments and lending are highly volatile and hence potentially problematic for the purpose of sustainable development. The development impacts of foreign direct investment are also questionable. Reliance on external financing leaves countries vulnerable to the vagaries of the international economy over which they have little control. Interest rates move up or down in response to monetary policy in developed countries, while commodity prices can fluctuate up to 70% one year to the next. For the purpose of sustainable development then, it is essential to tap stable domestic resource flows.

South East Asia, the region, which has had the highest level of investment and growth in the past three decades, has also been the region with the highest reliance on domestic savings and resource mobilization.

It has until recently been assumed that the scope for mobilizing savings in poor countries is extremely limited. It has been argued that when people are living on subsistence incomes, there is little left over for savings once the day-to-day needs have been met. However, it is clear that many developing countries do in fact have the capacity to mobilize substantial amounts of resources domestically. Despite low incomes, many developing countries have high savings rates. In fact, household surveys in a number of poor countries have shown that households can save up to 30% of their assets, although this can often take a non-monetary form, outside of the formal financial system. However, in part due to the poorly developed local financial systems, even the savings that are a part of the formal financial system may not be effectively channelled into domestic investments. Instead, these savings are invested unproductively or worse leave the country in the form of capital flight.

There is thus an urgent need to first, encourage more savings; second, tap into both monetized conventional as well as non-monetized more unconventional savings; and third, ensure that these savings are productively invested to generate sustainable development.

While the Monterrey Consensus was very clear in its ranking of the desirability of development flows, with domestic resource as the most significant source of funding, the development community seems to have largely ignored the issue at least in high profile discussions on the issue. This is very perplexing given that domestic resources are so critical, especially with a sustainable and self sufficient model of development.

Especially in the poorest countries, a large quantity of the economy is non-monetized. For example, the poor in India and in other countries save in the form of

³⁰ See 'Domestic Resource Mobilization; A Literature survey', Sony Kapoor for Oxfam 2003

non-monetary assets such as cattle and gold jewellery. Many times this is due to the non-availability of proper monetary saving instruments in rural areas where banks are usually not present.

Post office savings accounts, which have proven very successful in both India and Japan, could be one way of encouraging and mobilizing monetary savings in some of the poorest economies. Post offices usually have a much more extensive branch network than financial institutions. Other mechanisms of encouraging micro-savings can help large quantities of currently untapped domestic resources to be tapped. Tapping into latent social capital is another way of effectively mobilizing domestic resources for sustainable development.

Tapping Social Capital

A quick look at the resources available to both developed and developing countries makes it obvious that the former are generously endowed with capital and the latter with labour. There then is an obvious case for developing countries to use their main resource (labour) more advantageously.

There is a huge amount of latent social capital and underemployed labour available especially in the rural and agrarian parts of the developing world. There is a sound economic case to be made for tapping this source of labour and capital more effectively for the purpose of local development. Importantly, this source of capital regenerates itself and promotes local and sustainable development. This labour and capital can be used for building and maintaining essential infrastructure in communities with high social capital.

In many primarily agrarian societies in the developing world, there is chronic seasonal underemployment in the agriculture sector in the off-season. At such times, small amount of capital investments in basic tools and planning efforts can be combined with work-for-food programs in the rural sectors to build local critical infrastructure such as canals, wells, schools and primary health care centres etc. in which the local farmers who put their labour have an ownership and interest. Both common sense and practical experience tell us that such facilities are much more likely to be well looked after and maintained as they serve the needs of the local population which builds them.

Within development literature, the subject of harnessing social capital to achieve neighbourhood development has received little attention. If however, developing countries are to accelerate their development efforts, without recourse to unaffordable external debt, they need to significantly increase the mobilization of captive social capital for the purpose of local development. This then needs to be complemented by national level and regional initiatives for infrastructure development.

Many different definitions exist for social capital but what they all have in common is a sense of identity, cohesion and bonding within and across communities. In many cases this extends beyond the immediate community to institutional relationships with say government officials or neighbouring communities etc.

Emma Grant in a study of the La Verbana Guatemala City says that 'the organization in the community provides an example of an outcome of community level social capital, in which social cohesion ... is positively related to collective action.' The community had successfully bargained for land rights and in 1994, through collective community action got water connections. Each family paid a small sum for the water connection, and a local consulting agency contributed the material for the installation of pipes. The water company installed the meters, and the community provided most of the labour. The success of the project strengthened the community and led to other similar projects in basic services and structural improvement in living conditions. In this sense, collective action generates trust that produces the social capital that in turn makes sustained collective action possible.³¹

Studies of community organized irrigation systems in Asia, for example have repeatedly found that systems constructed and operated by the farmers themselves, often without much external assistance, generate a higher level of agricultural productivity than more modern systems constructed by government agencies with substantial external assistance. Examples of such positive outcomes abound.

The Feasibility of Further Action on Domestic Resource Mobilization

There is a tremendous scope for improvement on the domestic resource mobilization front. Developing country governments have a very strong incentive to try and minimize dependence on external sources of financing to help broaden the policy space that is available to them. Concrete actions through stronger support for micro-saving initiatives and the mobilization of non-conventional non-monetary savings especially in rural areas can help mobilize billions of dollars worth of additional resources for development.

Small amounts of capital provision, technical expertise and work-for-food initiatives to help mobilize seasonally underemployed agriculture workers and latent social capital for developing sustainable local infrastructure would also contribute tremendously to the development needs of impoverished communities in developing countries.

Exploring the harnessing of tremendous manpower, technical expertise and equipment of the armed forces in countries such as India where they enjoy a good relationship with the local communities for development projects and support may also be a good idea. Armed forces regularly help in disaster relief efforts in many countries and extending their role to regular development efforts should be explored carefully. However, using the armed forces in such a way is not without risks.

³¹ 'Social Capital and Community Strategies: Neighbourhood Development in Guatemala City,' Emma Grant, Development and Change 2001, Volume 32

VIII. Key Policy Recommendations and Next Steps

The paper has discussed a number of alternatives to help mobilize additional resources for the development effort.

There are four strands of possible actions discussed in the paper. These are:

- 1) Increasing the mobilization of domestic resources
- 2) Stopping the leakage of resources from developing countries
- 3) Increasing the flow of resources through current delivery mechanisms
- 4) Introducing new mechanisms to mobilize additional external resources for developing countries.

Some of the actions aimed at increasing resource availability for development can be taken by developing countries themselves, some need to be taken by donor nations and still others can only happen through international co-operation. We discuss these actions and evaluate which ones are feasible in the short to medium term.

A. Increasing the Mobilization of Domestic Resources

Actions on this front need to be led by developing countries themselves. There needs to be a formal high level recognition of the latent potential of increased mobilization of non-conventional domestic resources. Developing country governments and civil society need to increase the focus on micro-savings and create an enabling environment through specialized initiatives as well as increasing the reach of financial institutions such as rural banks and post offices. There needs to be much more policy thinking and action around encouraging rural dwellers to monetize at least part of current non-monetary savings, which are mostly both unproductive and illiquid.

Tapping latent excess labour and social capital by providing capital, technical and planning assistance to community-owned and community-run infrastructure and development projects can significantly enhance the development effects of even a small injection of external resources, especially into rural areas.

Developing countries which exercise a strong civilian control over armed forces may consider tapping the manpower, equipment and technical expertise of the forces to build and maintain essential services and infrastructure, especially in hard to reach terrain.

While most of the efforts on this front need to be made by developing countries themselves, there is an urgent need for international civil society and donor governments to help educate and share cross-country successes and experiences as a part of mainstream development assistance initiatives.

The authors' analysis indicates that over the medium term, such initiatives can bring about a significant effective increase in development resources even if the envelope of external assistance remains unchanged.

B. Stopping the Leakage of Resources from Developing Countries

Debt servicing and capital flight are two of the most significant sources of the leakage of limited resources from developing countries. Actions to minimize the leakage of resources through both of these channels can be taken by both developing and developed countries.

Debt

As an extreme option, developing countries can unilaterally repudiate or restructure some or all of the debt owed to multilateral institutions, creditor nations and private creditors. There is a good case for at least some of the debt, which is 'illegitimate' in nature to be never repaid. The cases of Nigeria, which by threatening to stop payments on debt got significant debt cancellation and Argentina, which successfully unilaterally restructured its debt and reduced its face value by almost two thirds, highlight that this may be a useful approach.

However, this is a last resort with the potential risk of retaliatory action. The threat of retaliation exists especially for the most impoverished aid-dependant countries that most need debt cancellation. However, one step forward to increase the bargaining power of developing countries would be to club together and form an 'Abuja Club' to increase negotiating power with creditor cartels such as the London and Paris clubs. This would help minimise the threat of retaliatory action in the face of threatening debt repudiation and increase the likelihood of a conciliatory agreement on debt reduction with creditor nations.

Creditor nations should utilize the current political momentum that has been built around multilateral debt cancellation to cancel debt stocks of many more of the most impoverished countries beyond just the 18 that are currently on the list. Additional resources such as those available from the sale of IMF gold or a more efficient use of IBRD reserves can be used to at least part finance this bout of cancellation so developing countries get additional resources.

In the medium term, debt service relief accompanied by the establishment of a fair and transparent arbitration process (FTAP) would seem to be the most politically feasible route forward. This will allow for a fair treatment of the issues of unpayable and illegitimate debt in a manner that is jointly agreed by both creditor and debtor countries. It is likely that any such independent process would conclude that at least a significant chunk of developing country debt is either unpayable or illegitimate or both and hence should be cancelled. Since the establishment of such a mechanism as well as the treatment of debt under this mechanism is likely to be a long drawn out process, the usefulness of such an implementation for developing countries depends to a large extent on how quickly it is done.

There is thus a very strong case for at least some of the more progressive developed countries to take unilateral action to recognize the unpayable and illegitimate debts and wipe them off their books at the same time as encouraging other donor countries to follow suit. The FTAP would still not become redundant but will instead be a mechanism that can be used to address the remaining existing debts as well as resolve disputes that arise over future lending.

Capital Flight

Capital flight can happen through various channels such as tax evasion, tax avoidance and transfer mis-pricing, all of which are facilitated by the existence of tax havens. Extreme tax competition which means that companies and individuals are no longer obliged to pay a fair share of taxes also causes implicit capital flight.

Holding vast amounts of foreign exchange reserves in order to guard against the possibility of speculative attacks on their currencies has a large opportunity cost for developing countries and can also be construed as implicit capital flight. Under-taxed extraction of primary resources is also a form of capital flight.

There is a lot that developing country governments can do to help prevent capital flight or at least minimise it. The enactment of a general anti-avoidance principle which makes most tax reduction strategies illegal is one such action. Specifying an alternate minimum tax regime where a turnover based tax is payable if the profits are underreported is another such measure. Increasing surveillance and stricter penalties for tax evasion and profits laundering are also possible but may be difficult to implement in the face of limited resources.

Large amounts of foreign exchange holdings can be freed up for development purposes through the enactment of a unilateral currency tax regime that makes speculative attacks more difficult and unlikely to succeed. However, the benefits of such a tax are high mostly for emerging economies, and the least developed group of countries which has low stocks of foreign exchange reserves is unlikely to benefit significantly.

Enhanced extraction fees and taxes and higher levies for mining rights for the extractive industry will help most developing countries mobilize more monetary resources in exchange for some of their most precious and non-replenishable natural resources.

Developed country governments also have an interest in clamping down on tax haven activity as they themselves stand to lose hundreds of billions of dollars of potential tax revenue every year because of tax avoidance and evasion.

Developed countries can agree to issue a large quantity of new special drawing rights (SDRs) which they should then undertake to distribute to developing countries. This will allow these countries to then reduce the large amounts of unproductive foreign exchange holding that they currently hold and release billions of dollars for development. It would also help increase the overall stability of the world financial system.

Action against tax havens and actions to reduce 'race to the bottom' tax competition requires both developing and developed countries to act in co-operation to bring about punitive action against countries that continue to engage in bank secrecy and other haven activities.

This would help mitigate at least some of the most extreme examples of transfer mis-pricing that are now common and make the trade regime more fair by allowing developing countries to get a better price on their exports and cheaper imports.

An internationally agreed minimum corporation tax rate, automatic exchange of information between tax authorities and much better rules of disclosure would all help raise hundreds of billions of dollars of additional resources for both developed and developing nations.

C. Increasing the Effectiveness and Amounts of Current Resource Delivery Mechanisms

Migrant remittances account for more than a quarter of the total transfer of external resources to developing countries every year. However, a significant proportion of the transferred amount is lost in transaction costs which can be very high.

Both developing and developed countries need to take immediate steps to help reduce the costs of transferring money to poor countries.

A good policy step which would help deliver resources to recipient country governments would be to share the tax revenue from migrant incomes with the governments of their country of origin. This could be done wither by a sharing of tax or through making part matching transfers to the countries and could result in as much as a 10% or higher increase in resource flow to developing countries for a 50% to 75% tax sharing arrangement.

Overseas development assistance (ODA), a large chunk of which is usually tied to the purchase of goods and services from the donor countries, needs to be immediately untied. Even under a constant resource envelope, this can result in an increase of as much as 10% of the resources made available for development by ODA flows.

By signing up to an international financing facility, donor country governments can help frontload aid delivery especially in the areas of development such as immunization where a development effort made now is much more effective than the same development intervention ten years down the line. However, this is most effective only under a regime of increasing aid budgets.

D. Introduction of New Mechanisms to Mobilize Additional External Resources for Developing Countries

The onus to act to increase external resource delivery to developing countries lies mostly with donor countries. The simplest step to achieve an increase in resources would be to increase aid budgets. However, this seems unlikely to happen at a scale large enough to cover the deficit that exists to finance the MDGs.

The enactment of a host of environmental taxes could be a step forward in this direction. It is of course very important to ring fence the funds raised from such taxes to finance the international development effort. From the outset, it should be clear to policy makers that the introduction of such taxes is mostly a revenue raising tool and at the low tax rates being discussed by policy makers such taxes would do little to minimise environmental damage.

A tax on aviation tickets or an increase in airport taxes is the easiest way forward. However, in order to align the incentive structure with environmental protection the tax needs to be moved to emissions or fuel in the medium term.

Taxes on other non-replenishable natural resource or public good consumption can be major sources of revenue at least part of which can be allocated to development.

The introduction of a tax on currency transactions has the advantage of being unilaterally feasible and the introduction of such a tax by progressive countries that have their own currencies can raise billions of dollars of new money for development every year.

Conclusion

In aggregate, action on all of the measures discussed in the previous section can easily mobilize as much as \$ 500 billion of additional resources for development every year. However, the distribution of resources would be uneven with the major benefits accruing to a select few developing countries such as India and China etc.

But in reality, it is unlikely that there will be progress on all but a handful of the policy measures discussed above. So, the need to continue to pressure policy makers and call for a greater redistribution of resources will not go away.

This paper highlights a series of realistic and politically feasible policy options that civil society campaigners and progressive thinkers can rally round to put pressure on their governments. The forthcoming UN summit in New York in September provides a good opportunity to see at least some of these proposals being implemented.

Appendix: Financing Requirements for Meeting MDGs – The Case Studies

Assumptions and Methodology

Sources of Data

In writing this paper we have used inputs from the World Bank (HIPC Decision Point and Completion point documents, MDG related papers, Global Development Finance, World Development Indicators), UNDP (MDG papers and country level costing analysis), New Economics Foundation (MDG related papers) and the Economist Intelligence Unit.

Time Period Used

Throughout, we have used the period 2000-2015 for consistency. It is significant from a methodological perspective as many of the World Bank projections (from completion and decision point perspectives) date back to 2000. The ensuing period also gives us a chance to evaluate and try and eliminate any biases in these projections.

Annual Resources

Over the last three year period, none of these countries have been able to mobilize the resources they need in order to meet the MDGs. On current trends, barring a significant additional external injection of resources, none of these countries would be able to meet the MDGs. The fact that we now need to look at resources going forward from 2005 does not change the actual amount of resources required significantly. (Even though they are listed as an annual flows.) This is because the annual investment needed to achieve the MDGs under a tighter time constraint (as we have now) increases at least proportionately. This method perhaps leads to a slight underestimation of the total resources required.

Currency

We have denominated all costs and revenue estimates and projections in millions of US dollars for both consistency and comparability.

GDP Growth

For the years that they are available, we have used actual GDP estimates from the online version of the World Development Indices. For GDP growth projections going out to 2015, we have taken data from the UNDP country studies (where available), the Economist Intelligence Unit (mostly till 2007) and most important the World Bank (Country completion and decision point documents). Where none of these estimates have appeared to be realistic (given recent history and structural constraints), we have made our own projections.

Domestic Revenue

For domestic revenue, we have used actual figures where available. (Mostly from UNDP and World Bank documents) For domestic revenue projections going out to 2015, we have taken data from the UNDP country studies (where available), the Economist Intelligence Unit and most important the World Bank (Country completion and decision point documents). Where, none of these estimates have appeared to be realistic (given recent history and structural constraints), we have made our own projections.

Costs of Meeting MDGs

Most existing estimates for the costs of the MDGs look at global costs of achieving the MDGs. The Zedillo report, the World Bank and the New Economics Foundation have all estimated these global costs to be in the range of \$45- \$76 billion.

Year	Malawi		Mozambique		Tanzania		Uganda	
	GDP	Revenue	GDP	Revenue	GDP	Revenue	GDP	Revenue
2005	1,964	393	4,734	625	11,768	1,483	7,232	911
2010	2,229	446	6,486	921	15,748	2,142	9,363	1,273
2015	2,509	502	8,886	1,351	21,074	3,077	12,306	1,797

However, for the purpose of this report, we need to look at country level costings. The UNDP has done some MDG costings for Malawi, Tanzania and Uganda as a part of a pilot project. Both the Millennium Commission and the World Bank are also working on country level MDG costings but have not completed or published most of their estimates yet. In the event, the only country level estimates that exist for Mozambique are the estimates made by the New Economics Foundation (nef) in 'The Unbreakable Link - Debt Relief and the Millennium Development Goals', 2002. For Tanzania, the UNDP, nef, and the World Bank have all estimated the costs of meeting the MDGs.

The UNDP country models focus on six MDG targets: income poverty, primary education, child mortality, maternal health, HIV/AIDS and water. They do not cover all sectors and deliver only a partial idea of the interventions needed to achieve the MDGs. The country studies did not aim at estimating the total cost of achieving the MDGs and hence do not reflect the total costs. Also, the methodology used was not standard and differed between targets and countries.

The UNDP estimates of the total costs are on average about 20% less than nef estimates. However early indications from the detailed MDG costing work in progress under the Millennium Project points to estimates that are significantly higher than the New Economics Foundation estimates.

Hence, while the estimates made in 'The Unbreakable Link - Debt Relief and the Millennium Development Goals' (New Economics Foundation, 2002) also suffer from serious limitations, we use them as they provide both consistency and a 'balance of opinion' between the UNDP and the Millennium Project.

The table shows the total costs of meeting the MDGs between 2000 and 2015

In US\$ million	Malawi	Mozambique	Tanzania	Uganda	Total
MDG Costs	8,864	15,632	29,440	18,448	72,384

Non MDG Spending

Next we calculate the non MDG related public expenditure needed for each country. This includes statutory and state functions other than debt servicing. Where an estimate of the current and future expected levels of such expenditure is possible by looking at recent budgetary allocations, we make our own projections. The data for this is mainly derived from various documents including UNDP country studies, World Bank Decision point & Completion point documents and Poverty Reduction Strategy Papers.

Where such data is not available, we follow Jeffrey Sachs in arguing that the HIPC countries need to spend at least 10% of GDP on other essential expenditures. (This is broken down into 2% on public administration; 3% on police and defence; and 5% on essential infrastructures such as roads.)

Debt Servicing

As we are looking to the future, we look at the debt servicing numbers after maximum debt relief under the Enhanced HIPC initiative and any additional bilateral debt relief pledged by donor nations. We are hopeful (though not necessarily optimistic), that all the HIPC countries would get to the point where they will be able to get this debt relief. However, we need to look beyond this and towards mobilizing resources needed to meet the MDGs.

From a methodological perspective, we wanted to establish the total amount of external resources (irrespective of source) that the countries in question would need in order to meet the MDGs. For this purpose, in our calculations we have systematically removed any resources already mobilized through additional (post 2000) borrowing. We then take a fresh look at the various sources of funds (of which new debt is one) that can be used to plug the MDG resource gap.

The data for this is derived mostly from the World Bank HIPC Completion and Decision point documents for the respective countries. The table shows the total debt service between 2000 and 2015 on debt that was contracted before the cut off dates. This does not include the debt service due on more recent debt.

<i>In US\$ million</i>	Malawi	Mozambique	Tanzania	Uganda	Total
Debt Service	587	615	718	1,059	2,979

Expected Grant Flows

These projections of grants are taken from the World Bank Completion point and Decision point documents. They are critical as they provide one very important source of funds to plug the resource gap to meet the MDGs. Once these are factored in, it allows us to calculate the additional commitments needed from donor countries towards meeting the MDGs.

It is important here to point out that these projected grant flows may not materialize in full. This is so because grant flows are notoriously volatile and hence difficult to predict with any accuracy. The amount of grant flows are sometimes influenced more by the geopolitical priorities and the domestic situation of the donor country (institution) rather than by the needs of the recipient country.

<i>In US\$ million</i>	Malawi	Mozambique	Tanzania	Uganda	Total
Expected Grants	2,032	6,652	13,139	5,637	27,460

Model

We follow a very simple model where we calculate the resources available to countries to spend on achieving the MDGs and compare these with the estimates of the approximate costs of achieving these MDGs to highlight the resource gap.

For this purpose, we first project the GDP out to 2015 and then estimate the revenues that can be mobilized domestically (mostly as a percentage of GDP). From these revenues we then deduct the debt service (on existing debt after E-HIPC and additional bilateral debt relief), the non-MDG spending (actual projections from documents or calculated as a percentage of GDP) and then finally the required MDG spending to arrive at the total financing gap.

We then assume a 100% debt cancellation scenario (hence we add back the debt service we deducted previously) and also add expected grant flows to arrive at a financing gap that needs to be financed through additional external grants or loans.

In order to plug the resource gap, we examine the relative merits of the different sources of funds.

Results, Discussion and Caveats

It is important to interpret the country numbers in the context of the assumptions and methodology used in this paper.

Economic Shocks

We do not account for any shocks to the economies. However, these and other Sub-Saharan African countries are especially vulnerable to both weather (mostly drought and sometimes flooding) as well as commodity price shocks. Such shocks can undo what it has taken years of steady economic growth to achieve. There would need to be significant additional external support in terms of emergency relief and additional grants and aid in order to help these countries tide over such shocks without derailing their progress towards the MDGs.

Given the past frequency of shocks experienced by these countries, it is highly unlikely that they would not suffer any more such shocks now till 2015. Yet, due to the uncertainties involved and limitations in modelling, this is the assumption we have based our analysis on. Such shocks would serve to increase the resources these countries need to meet the MDGs.

Additional resources

There are additional channels other than just debt cancellation through which the domestic resources available for MDG spending can be increased significantly. However, most of these are beyond the control of the HIPC countries and hence almost impossible to predict accurately. So these do not form a part of our simple model and any additional resources arising would reduce the need for additional grants and loans.

Some of these channels are:

- Higher domestic reinvestment and lower remittances by foreign companies
- Lower patent and copyright fees charged by multinational corporations for using technology and medicines
- Repatriation of the overseas savings of wealthy residents
- Improved terms of trade and higher export revenues as a result of reduced protectionism and lowering of subsidies in the developed world.
- Increased inward remittances due to lowering of barriers to the free movement of people.
- Cracking down on widespread tax avoidance, tax evasion, capital flight and transfer mis-pricing

Debt Cancellation, Concessional and Non Concessional Loans

Concessional loans from the IDA typically have zero interest rates, forty years maturity; and a grace period of ten years. There is however a small upfront commitment fee. PRGF loans from the IMF typically have much less generous terms.

For our model, we assume that all concessional borrowing undertaken to fill the resource gap happens at these terms. However, this assumption is highly optimistic as non-IDA concessional loans have less generous terms and the amount of concessional loans available to these countries currently is limited. So this underestimates the amount of debt service and overestimates the amount of concessional loans available.

However, under the assumption that such loans are available as needed, the cash flows from these would be nearly indistinguishable from grants for the period till 2015 (because of the ten year grace period on repayment) Nevertheless, given that the countries in question would still have significant resource gaps in 2015 and that they should be expected to stay on course (in terms of improving the targets set under the MDGs) even after they meet the MDGs in 2015, this would lead to a serious external debt burden.

In case all the additional resources needed to meet the MDGs are raised in the form of concessional loans, the debt burden of all the countries would quickly go to unsustainable levels. The following table illustrates this scenario and the 'minimum-debt-to-GDP ratio' does not include existing (both pre HIPC and post HIPC) debt.

<i>In US\$ million</i>	Malawi	Mozambique	Tanzania	Uganda
Total MDG Resource Gap	6,935	11,966	21,908	16,702
Expected GDP in 2015	2,509	8,886	21,074	12,306
Minimum Debt to GDP Ratio	276.4%	134.7%	104.0%	135.7%

Malawi would then already have a debt burden of at least 276% of GDP in 2015. In other countries too this debt burden would go on increasing after 2015 at least for the foreseeable future. This would in essence defeat the very spirit of the HIPC initiative which was to reduce the debt burden of these countries to sustainable levels.

Such levels of indebtedness would cause serious problems even to the most advanced economies even though they have access to substantial domestic resources and export revenues. It is well known that HIPC countries have a much lower level of sustainable debt burden. We do not want to use a single cut-off point, but firmly believe that HIPC countries should only build up debt as a very last resort and even then keep the debt stock levels as a fraction of GDP.

Due to the very low creditworthiness of these countries (they have all restructured debt under the HIPC initiative); they would find it next to impossible to raise any money in the markets. This is especially true given the recent defaults by other large sovereign states (Argentina, Russia).

To illustrate the unsuitability of market borrowing for financing the MDGs we use the example of Malawi. We assume that Malawi is able to get the terms on private credit that it had in the past (average of 1970,1980,1990,1996); namely a 10% interest, a maturity of 7 years, and a grace period of 2 years.

If Malawi financed the MDG cost gap through such borrowing, it would be completely unsustainable. Our calculations show that on these terms Malawi would already be borrowing \$1 billion by 2009 (50% of its GDP) of which less than a fifth would go towards financing the MDGs and the rest would be used for debt servicing. Clearly, such a scenario is completely unaffordable.

In case we consider a more realistic possibility of the net resource gap (after factoring in expected aid flows) being financed exclusively through concessional lending, we find that both Malawi and Uganda will still have very high debt burdens in 2015. The following table illustrates this point.

<i>In US\$ million</i>	Malawi	Mozambique	Tanzania	Uganda
Net MDG Resource Gap	5,490	5,928	9,488	12,124
Expected GDP in 2015	2,509	8,886	21,074	12,306
Minimum Debt to GDP Ratio	218.8%	66.7%	45.0%	98.5%

Given the potential problems posed by both concessional and non concessional debt discussed above, we believe that the resource gap should be plugged mainly through 100% debt cancellation and additional grant flows.

Debt Cancellation and Grant Flows

Throughout the paper, we have based our calculations on debt service on the assumption that all debt relief promised under the enhanced HIPC initiative and additional bilateral debt relief will be forthcoming; however given the slow progress of the HIPC initiative this can by no means be taken for granted. We have looked beyond that to the financing need for the MDGs and firmly establish that as a first step, total debt cancellation is urgently needed.

Debt cancellation is the most efficient form of aid delivery as it has minimal administrative costs and provides direct budget support (that may be ring fenced for social and health related expenditure) so the government can target the funds as per local priorities.

However, as we have established, this is by no means sufficient. A multiple of the resources released by debt relief would actually be required to achieve the MDGs.

We have shown in the last section, debt is not a good way to finance the MDGs. So we are just left with grants.

As we show in the country section, the donor community is already expected to give significant (though by no means enough) grants in the run up to 2015. However, historically up to 30% of all grant revenues are used for tied aid, administration, foreign consultants etc. Given this, grants are not the most efficient way of mobilizing resources for the MDGs. However, there is now an increased recognition of these limitations of current donor financing, and we are optimistic that future grants would be less 'tied' and would increasingly be given in the form of direct budgetary support.

To the extent that this does not happen over the next ten years or so, our calculations underestimate the actual amounts of grants needed to achieve the MDGs.

Domestic Resources

Most of the HIPCs are faced with serious constraints on domestic resource mobilization. These result from the combined existence of (usually) low savings and investment rates and a mainly subsistence based, highly informal economy. This and the fact that income levels in HIPCs are so low that a significant part (more than 50% in many countries) of the population lives below the poverty line means that personal income tax revenues are abysmally low.

The lack of a well organized corporate sector (most firms are run by small family entrepreneurs as a part of the informal economy) severely constrains the amount of corporate tax revenue that these countries can raise. Multinationals firms, where they operate, have sometimes been attracted through tax breaks and in some other instances have used transfer pricing to minimise tax liabilities.

As a part of the structural reforms package being pushed by the IMF and the World Bank, a number of these countries are being asked to introduce consumption based taxes such as value added taxes. Given that aggregate consumption levels are so low and that the government has severely limited resources to enforce and collect such as tax, the total revenues raised from this are also low.

Customs duties are one of the easier taxes to administer. However, under the WTO agreements and structural reforms being pushed through by the Bank and the Fund, most HIPCs are being forced to lower these tariffs. This is another reason why domestic revenue growth is expected to be low.

User based fees for essential services are yet another potential source of revenue. However, this can only be applied in a very limited number of cases on a 'capacity-to-pay' basis and is not expected to bring in large revenues due to the low prevailing income levels.

Finally, there exist other more unconventional non-monetary ways of mobilising resources domestically. Community-based initiatives represent one such example that seems to be promising. However, these measures will take time to develop roots and are complementary to rather than substitutes for increased monetary financing. Such initiatives could prove very effective in increasing the efficiency of monetary investments.