UNTT Working Group on Sustainable Development Financing

Chapter 2

The variety of national, regional and international public sources for development finance

Contents

1. Introduction – the role of public sources of financing for sustainable development

A combination of both private and public sources will be necessary to finance large and growing investment needs associated with sustainable development. These sources should be viewed as complements, not substitutes, especially since in many key areas of sustainable development, private financing is insufficient or entirely absent and public sources of financing are indispensible. Issues and challenges of channelling effectively private resources for development purposes have been covered in a companion paper. This paper looks at the role of public sources of financing for sustainable development.

There are two main areas where public financing is necessary: financing additional economic, social and environmental goals and social needs in particular, and areas that the private sector does not finance sufficiently due to market failures or concerns over the appropriation of returns even when social returns are high. These areas broadly correspond to what is generally considered to fall under the purview of public finance: public financing for equity, allocative efficiency and stabilizing purposes.[1]

The equity or 'distributive' function of public finance is motivated by ethical concerns and solidarity, and aims to foster equity. At the national level, progressive taxation, social safety nets and other measures contribute to a broader development and socially desirable distribution of income. On the global level, one of the aims of official development assistance (ODA) is to help poor countries meet national development goals such as the eradication of poverty. Global development and solidarity has long been an explicit motivation for ODA. The public sector will remain the main provider of financing in this area, through domestic financing and with international support by ODA, notwithstanding the contribution of philanthropic donors and the private sector.

In its allocative function, the role of public finance is to provision of public goods at the national level (national defence and basic infrastructure) but also the provision of global public goods (eradication of diseases, control of illicit drugs, and combating climate change etc.) and financing of the protection of the global commons (atmosphere, oceans, biodiversity and forests). An increasing amount of ODA has been geared towards the provision of such global public goods in recent years, as discussed below. While often entailing large developmental benefits for recipient countries, international public finance used in this manner is nonetheless conceptually different, and should be viewed as such.

In view of the large overall financing needs for sustainable development and the unique role that public finance can play, this paper examines the potential of raising additional public financing at the national, regional and global level.

In a majority of countries, above tasks are largely funded through mobilization of domestic public resources, mainly from national tax systems. Many developing countries have made progress in improving their tax ratios in recent years, but a significant gap in the capacity to raise public revenues persists between developed and developing countries – on average, tax to GDP ratios are 13 per cent in low income countries compared to 35.4 per cent in OECD countries (IMF, 2011). Tapping revenue sources effectively and improving revenue

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[1] This contribution will focus on the former two. The stabilizing role of public finance largely falls to countercyclical fiscal and monetary policies at the national level.

administration for enhanced and fairer mobilization of domestic revenues is therefore critical. Among other factors, there is a need to prevent an erosion of the tax base and illicit financial outflows. While their size is intrinsically difficult to measure, even conservative estimates suggest that illicit flows are very large and exceed the amount of ODA received. The stocktaking of domestic resource mobilization (section I.2) will consider both tax challenges and illicit flows in more detail.

Domestic public resources alone will not suffice. Developing countries and the vulnerable countries among them in particular – including least developed countries, land locked developing countries, small island development states and conflict-affected countries – also rely on international support and external sources to finance public expenditure. In the least developed countries for example, possibilities for mobilising domestic resources and private external investment are limited. ODA represents about half of all external financing available to close the savings gap (UNCTAD, 2012). Domestic resource mobilization needs to be complemented by public resources mobilized at the regional and at the global level, for the purposes of supporting sustainable development efforts at the national level in many developing countries, as well as to provide regional or global public goods.

Financial institutions and development banks, reserve pooling institutions and trade facilitation mechanisms can provide or intermediate additional resources. Regional development banks - closer to recipient countries than global institutions, possessing valuable knowledge specific to the region - are able to allocate resources in line with national priorities and needs (section I.3).

Global public resources (section I.4), prominently including ODA, are critical for developing countries. In recent years, ODA has been overshadowed by private financial flows to developing countries in quantitative terms. Yet, as public resources, ODA flows play a unique role, providing financing for countries and for sectors that do not attract private flows sufficiently. Since the turn of the millennium and the adoption of the Millennium Declaration and the Millennium Development Goals, donors have increased development assistance, and ODA reached a historic high in 2010, at US$ 128.7 billion. However, it has fallen for two consecutive years since, due to fiscal pressures in donor countries in the aftermath of the financial crisis, and it falls far short of international commitments. At the same time, South-South cooperation is gaining in importance, and a range of new and innovative sources of development financing – additional to traditional ODA – is being considered. While implemented only at a small scale so far, they do have the potential to raise significant resources for sustainable development.

2. Stocktaking of Domestic Resource Mobilization[2]

Strengthening the mobilization of domestic resources will make available the much needed funding for wider state building, while serving as a stable source of development finance.. The scope for additional resource mobilization through taxation is significant in developing countries, both at national and subnational levels. Achieving the MDGs alone may require low-income countries to raise their tax-GDP ratios by around 4 percentage points (United Nations, 2005). Yet, despite improvements in recent years, a significant gap between developed and developing countries persists in terms of their capacity to raise public revenues. The median tax-to-GDP ratio in low-income countries remains only about half of the median ratio in high-income countries (IMF, 2011). There is also a significant difference between low-income and middle-income countries. In 2009, tax revenue accounted for 13.6 per cent of GDP in the former, as compared to 19.3 per cent in the latter.[3]

Challenges for developing countries

Developing countries face a range of common challenges in raising resources, particularly pronounced in the most vulnerable countries:[4]

- Dealing with sectors that are ‘hard-to-tax’ everywhere (small businesses, including small farmers, professionals, and in some cases state-owned enterprises), but especially where cash based transaction, weak accounting practices, inadequate administrative capacity and improper compliance habits have limited exploiting the real tax revenue potential. ‘Informality’ is extensive in developing countries. This is not in itself the problem: micro traders may be ‘informal,’ for instance, but are also likely to have income and sales well below any reasonable tax threshold. Much of the most egregious evasion is by qualified professionals. The issue is rather one of avoidance, evasion and noncompliance. Estimates of the extent of non-compliance are scarce however.
- Value-added tax ‘gaps’ have been estimated to be around 50 - 60 per cent in Indonesia and Mozambique, for instance, compared to 13 per cent in the United Kingdom.
- Weak revenue administrations, low taxpayer morale, and poor governance – which are closely linked – though not unique to lower-income countries, are especially entrenched there. Corruption indicators are strongly associated with low revenue (Attali, Chambas, and Combes, 2008). Indeed corruption functions like a tax itself, and likely a particularly regressive one. Governance problems are not unique to revenue administrations and nor can they be fully addressed in isolation from, for example, judicial reform. Nevertheless, the centrality of tax collection in citizen-state relations gives governance issues in tax collection particular importance.
- Heavy reliance on receipts from multinational enterprises, whose adroitness in tax planning poses increasing challenges.

[2] This section is based primarily on section II of the background paper, Domestic resource mobilization in developing countries – a stock taking, prepared by the IMF, incorporating comments and perspectives from other agencies in the UNTT

[3] Source: World Bank, World Development Indicators

[4] Gordon and Li (2009) and Heady (2002) discuss the distinct tax-relevant features of developing countries.

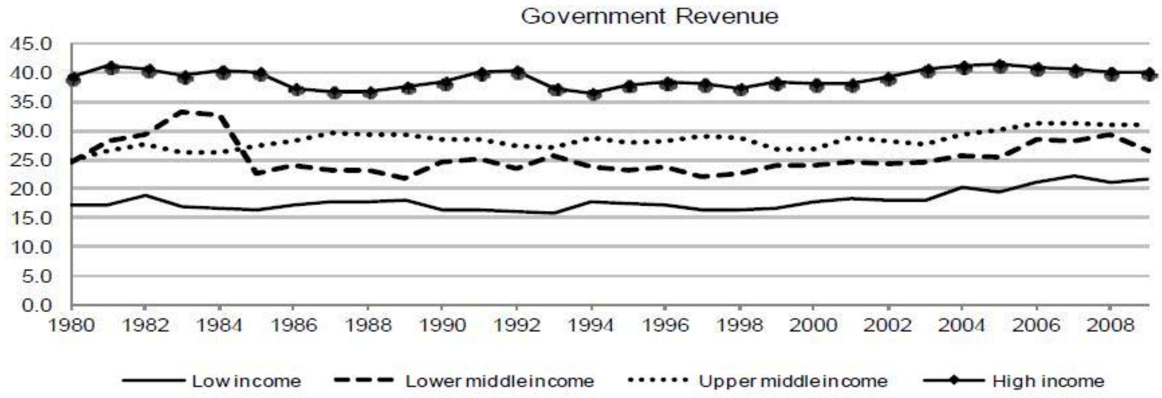
- In many cases, difficulties in dealing with state-owned enterprises that have been known to abuse or simply ignore the tax system.
- A shallow financial sector, potentially a valuable source of tax-relevant information.
- Pressures on revenue from trade liberalization, including regional integration, and from intensifying international tax competition.

There are, however, significant differences among developing countries. Probably the most important is in natural resource wealth, discussed below. Geography also matters: small islands, for instance, are better able to impose taxes at the border than are landlocked countries. Post-conflict countries face particular difficulties, as do successor states eager to establish investor-friendly reputations.

Achievements and core issues

Even though tax structures vary greatly between developing countries, a common feature is their reliance on a narrow set of taxes and taxpayers to generate revenue. Overall, progress has been made and tax ratios have generally improved between the first halve of the 1990s and the 2000s. Some countries have achieved sustained revenue increases of 4-5 per cent of GDP over just a few years. These developments reflect increased revenue from the VAT, robust receipts from corporate income taxes, and, to a lesser extent, personal income taxes, but also declining trade tax revenues.

Figure 1. Trends in Total Government Revenue in per cent of GDP, 1980–2009



Source: International Monetary Fund, 2011

Value added taxes have spread rapidly in developing countries. Around 150 countries now have a VAT, which typically accounts for around one quarter of all tax revenue. Nonetheless, in many developing countries the potential of a VAT has not been adequately tapped, as its effectiveness is undermined by flawed design and implementation. Common difficulties include low thresholds (pressurizing tax administrations and diverting attention from higher value and riskier taxpayers); extensive exemptions and zero-rating (creating classification disputes and increasing compliance costs); inadequate preparations and public sensitization (making resistance more likely); and piecemeal implementation.

The switch from trade taxes to a VAT has sometimes led to a reduction in total revenues. Concerns have been raised about the distributional impact of value added taxes, as a proportional tax on all consumption is regressive relative to annual income. A number of studies have found relatively benign distributional impacts of a VAT. Some have argued that it can been less regressive than the trade and excise taxes it has replaced, especially if exemptions for major consumption items for poor households are incorporated and can be effective in this regard. However, this may be difficult in developing countries. Overall, studies of the incidence of government taxation and spending programmes are characterized by significant uncertainties, particularly in developing countries. Zolt and Bird (2005) therefore suggest that the available quantitative evidence on tax incidence cannot be considered conclusive.

Emram and Stiglitz (2002) further argue that VAT is really a tax on development in that firms operating in the informal sector may be discouraged to move to the formal sector to avoid VAT, so that the replacement of trade taxes with VAT could reduce welfare. Bird (2008) on the other hand finds that a VAT can act as a presumptive tax on the informal sector as firms will inevitably purchase inputs from the formal sector, but are not eligible for VAT credit.

Corporate income tax revenue is under pressure due to globalization. The revenue challenges that such downward pressures pose are a greater concern for developing than advanced economies: the corporate income tax raises about 17 per cent of total tax in the former, compared to 10 percent (pre-crisis) in the OECD. This may in some cases reflect its use to extract resource rents, absent better targeted instruments. Statutory rates have fallen globally, yet so far revenues raised from this source have been reasonably robust in low-income countries, and have gained in importance in middle-income countries in recent years.

In many developing countries, the extractive industries are a particularly important sector and source of government revenue, often accounting for more than half of total revenue in petroleum-rich countries and for over 20 per cent in mining countries. However, fiscal-regime design for extractive industries is complex. Investments are often characterized by large sunk costs, long time horizons and significant uncertainty over resource prices, rendering the credibility of the investment regime critical to investors. The prominent presence of multinational enterprises in the sector also heightens concerns over tax planning and avoidance in the host country. In addition, the exhaustibility of the resource itself raises issues concerning the time profile of development and extraction. To address these concerns, a wide range of instruments is used in raising revenues from extractive industries. They include production sharing, auctions, various forms of government participation, and others. Revenue administrations can also benefit greatly from capacity development efforts in this area.

Lastly, incomes from personal income taxes are generally low and stagnant in developing countries. They are overwhelmingly raised from wage withholding in large enterprises and from public sector employees, and raise between 1 and 3 per cent of GDP. In this regard, tax evasion and avoidance by the very rich could be addressed more forcefully. Not only is the revenue loss substantial – one estimate is that about $50 billion of tax revenue is foregone annually in developing countries (Tax Justice Network, 2005) – but failure of the elites to pay their fair share also undermines broader trust in the tax system.

Lessons and way ahead

To further improve revenue administration and, along with it, the potential for revenue mobilization, a number of methods, adapted in emphasis to countries' circumstances, can be implemented. They include building more effective administrations to limit opportunities for rent seeking. To this end, incentives faced by tax officials can be improved, their oversight strengthened, and information sharing among different tax departments or tax departments in different regions enhanced (Gordon, 2010). With better risk management and taxpayer segmentation, countries can also achieve greater voluntary compliance to extend the tax base. One example would be to put a greater focus on large taxpayers, which can often secure 60 to 80 per cent of revenues due to the skewed size distribution of firms.

Additional proposals include the

- implementing a broad-based corporate income tax and extending the personal income tax base through measures such as eliminating exemptions and strengthening compliance;
- introducing credible tax regimes for extractive industries
- encouraging the implementation of a broad-based VAT with a fairly high threshold (though distributional impacts would have to be carefully considered).
- Lastly, a careful design of tax rules can protect the domestic tax base. Not least, greater efforts can be made in taxing elites and high-income and high wealth individuals, which is important also for the wider legitimacy of tax systems.

There are also emerging issues requiring greater attention. Challenges in international taxation and from regional integration are intensifying, and closer cooperation on tax matters, including with advanced economies, in both policy and administration, as well as further support for capacity building, will be necessary.

Illicit financial flows[5]

To enhance legitimacy and credibility of taxation system and meet growing investment requirements, broad based national and international initiatives are required to curb illicit outflows of resources. Domestic resource mobilization is being severely undermined by illicit financial flows. Illicit financial flows have recently become a topic of high-level policy discussion, not least due to budgetary constraints in developed countries. A the most recent G8 and G20 Summits, the issue of tax evasion and tax avoidance were firmly on the agenda of the Heads of State.

The issue of illicit financial flows remains unattended despite its featuring in the Monterrey Consensus on Financing for Development of 2002. The Monterrey Consensus committed countries to strengthening international tax cooperation through enhanced dialogue among national tax authorities and greater coordination of the work of the concerned multilateral bodies with a special focus on the needs of developing countries. It also called for enhanced efforts to repatriate funds illicitly acquired to countries of origin.[6] Within the MDG framework, however – and specifically MDG-8 on a global partnership for development – a commitment on coordinated action on illicit financial flows was absent. Despite strong potential as a source of resources and public appeal, a lack of political determination has held back action on this front.

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[5] This sub-section is largely based on section III of the background paper: Illicit financial flows, prepared by UNDP, with additional inputs by FfDO/UN-DESA and comments by task team members.

[6] http://www.un.org/esa/ffd/monterrey/MonterreyConsensus.pdf

There are a range of technical concerns as well. For instance, there is no universally agreed definition of 'illicit financial flows'. The OECD notes that they generally refer 'to a set of methods and practices aimed at transferring financial capital out of a country in contravention of national and international laws' (OECD, 2013). A World Bank study suggests as defining characteristics that '(1) the acts involved are themselves illegal (corruption or tax evasion) in a regime that has some democratic legitimacy, or (2) the funds are indirect fruits of illegal acts' (Reuter, 2012). Moreover, the term capital flight is often and incorrectly used synonymously for illicit financial flows. Capital flight however refers to money flowing out of a country in search for investment opportunities that are both secure and with higher expected returns. It is thus a much broader concept.

Illicit financial flows have different sources. Broadly, two categories can be distinguished – tax-related components such as tax evasion, and proceeds from illegal activities such as the manufacturing, trading and selling of illegal narcotics. Tax evasion is relevant in the context of illicit financial flows when money that was illegally earned through tax evasion is then transferred abroad. Tax avoidance is also often discussed in the context of illicit financial flows. Yet, tax avoidance and the exploitation of gaps in tax systems between countries on the other hand are not illegal per se and it is debatable whether proceeds from such tax planning efforts that are transferred abroad should be considered as illicit flows. They do however equally violate the will of national legislatures and require a policy response.

Transfer mis-pricing is a specific form of tax evasion. Transfer pricing refers to the mechanism by which intra-group transactions within national borders and across borders are priced. Most often, transfer mis-pricing makes use of differences in corporate tax rates by over-invoicing tax-deductible inbound transfers in high-tax countries or under-invoicing taxable outbound transfers from high-tax countries. Some forms of intra-firm transfers such as management fees and payments for intangibles are especially notorious for transfer mis-pricing, as it is difficult to establish comparable market prices (Ritter, 2013).

Estimates on the magnitude of illicit financial flows vary widely. By their very nature, they are clandestine activities. As a consequence, they are poorly captured in official statistics – if at all. Moreover, the methods used to calculate such flows differ in concept, scope and the kind of data that is relied upon. However, in recent years, research has intensified and is arriving at broadly similar conclusions, namely that the problem is enormous. Baker (2005) for instance estimates that more than USD 540 billion flowed out of developing countries each year due to tax evasion, fraud in international trade, drug trafficking, and corruption. Global Financial Integrity (2012) estimates a much higher number. It finds that developing countries, who have a higher presence of multinationals in their countries, lost between USD 858.8 billion and USD 1.138 billion in 2010.

Illicit financial flows impact both developed and developing countries. However, the impact of the flows differs across countries. A few developed countries, especially those hosting financial centres, may enjoy net benefits from illicit flows, despite losses in tax revenues. But even many developed countries are net losers, and illicit flows have a devastating impact on poorer countries. They not only drain resources and tax revenues, but also have a negative impact on economic growth and sustainable development (through lower levels of investment) and impact a country's governance system, by undermining monetary, fiscal and other institutions.

Some progress has been made in recent years in addressing illicit flows, particularly in the area of the extractive industries, which has been identified as a major source of illicit outflows of capital. In the United States, Section 1504 of the Dodd-Frank Wall Street Reform and Consumer Protection Act came into effect in 2012, requiring companies operating in the oil, gas, and mining sectors to publicly report on the payments they make to foreign governments. The measure aims to bring increased stability, accountability, and transparency to the sector, and reduce illicit outflows of capital.

In June 2013, the European Parliament passed landmark transparency provisions for oil, gas, mining, and logging companies. Canada has announced similar intentions. The EU legislation requires large, privately owned European companies and all publicly held European firms operating in the oil, gas, mining, and logging sectors to disclose information on payments made to governments. All firms covered by the rules are required to disclose on a project-by-project basis all payments made to governments above €100,000 (approximately US$131,000) including taxes paid, royalty fees, and license fees. Greater transparency aims to reduce corruption, tax evasion and tax avoidance, as well as boost tax revenues in rich and poor countries alike. It aims to make major multinational companies more accountable.

The G8 also recently made some commitments in this area, although details and a timetable for action are still unclear. The G8 in 2013, pledged to "act to restore confidence in the fairness and effectiveness of our international tax rules and practices, and to ensure that each country is able to collect taxes owing and that developing countries are also able to secure the benefits of progress made on this agenda." It also committed to provide practical support to developing countries' efforts to build capacity to collect the taxes owed to them and to engage in and benefit from automatic exchange of tax information between countries.

The OECD recently prepared an action plan submitted to the G20 aimed at addressing base erosion and profit shifting (BEPS). The G20 has stated its commitment to making automatic exchange of information attainable by all countries and to examining how countries' own domestic laws may contribute to BEPS. The UN Committee of Expert on International Cooperation in Tax Matters has developed a Practical Manual on Transfer Pricing for Developing Countries.

Sovereign debt

Sovereign debt issues have direct implications for the financing of sustainable development, as countries with unsustainable debt burdens spend a large proportion of public resources – resources that could otherwise be spent on development goals – on debt servicing. Currently, debt overhangs are more pronounced in developed countries than in developing countries. Developing countries are currently running historically low public-debt-to-GDP ratios, posing virtually no systemic risks.

In 2012, public debt as a percentage of GDP in developing countries as a whole was 45.9 per cent (United Nations, 2013). Many low-income countries in sub-Saharan Africa have benefited from comprehensive debt relief programmes including the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI) over the past two decades. Nonetheless, sovereign debt challenges remain in some least developed countries, small States and low-income countries. Being granted HIPC debt cancellation does not always eliminate the prospect of debt distress. Of the nine least developed countries that were at a high risk of debt distress, as of February 2013, six had already received debt relief through the Enhanced HIPC Initiative and the Multilateral Debt Relief Initiative.

Public debt as a percentage of GDP in OECD countries jumped from around 70 per cent in the 1990s to almost 110 per cent in 2012. This increase in debt levels has been accompanied by downgrades of credit ratings in some countries, which for years carried AAA ratings. In particular, debt problems in Europe have once again highlighted the interlinkages between sovereign debt problems and the financial sector. Given the size of sovereign debt generally held by the banking system, sovereign debt crises can trigger bank runs and/or banking crises, potentially leading to regional or global contagion.

A central issue for domestic and international economic policy is how to reduce the occurrence of sovereign debt problems in both developing and developed countries. First and foremost, responsible lending and borrowing in order to reduce the chance of debt distress is crucial. At the same time, lenders need to better assess credit risk, to improve credit screening and to reduce irresponsible lending to high-risk countries. Nonetheless, debt distress does occur and can be costly. When debt burdens become excessive, there is a need for an effective mechanism that minimizes economic and social costs, enables countries to restructure their obligations in an effective and fair manner and gives countries a clean slate so that they may resume growth and investment.

For low-income countries, the HIPC Initiative and MDRI, while important initiatives, accounted for debt relief as development assistance, thereby sidestepping the broader issue of how to address issues associated with debt overhang in a comprehensive manner. The international community has agreed to certain broad principles for debt restructuring, including “fair burden-sharing” between debtors and creditors, as per the Monterrey Consensus. However, these principles have yet to be institutionalized in concrete practices. The international community should more actively pursue the development of an agreed rules-based approach to sovereign debt workouts in order to increase predictability and the timely restructuring of debt when required, with fair burden-sharing, including by potentially providing a “safe harbour” for social protection floor outlays in the budget. Such an approach would reduce risk in the global financial system and free up resources for investment in sustainable development.

Domestic resource mobilization in vulnerable countries[7]

The potential for raising domestic resources in the least developed countries (LDCs), land-locked developing countries (LLDCs) and small island developing states (SIDS) is limited - except for major natural resource extraction countries. Average gross domestic savings as a percentage of GDP hovered around 20 per cent, although this mirrors to a large degree high savings rates, particularly government savings in commodity producing countries (United Nations, 2013b).

Government revenues in LDCs are very low and increased only slowly over the past decade from an average of 11.7 per cent of GDP during the period 2001-2009 to 14.9 per cent in 2010. Again, behind this trend was the good performance of resource-rich LDCs, where revenues generated from natural resource extraction rose thanks to the commodity price boom. In some cases, however, revenues derived from other forms of taxation, including

[7] This section is based on a background note prepared by OHRLLS

excise taxes, corporate income taxes on other industries, trade taxes and value added taxes (VAT), stagnated or increased marginally. A small number of taxes therefore accounted for a growing share of government revenues. Such increasing unbalanced tax mix together with a small formal sector contributed to further narrowing the tax base in most LDCs (United Nations, 2013b). Illicit financial flows, such as tax evasion and avoidance, along with the multiplication of tax exemptions and weak administrative capacity, further erode the tax revenue in many of these countries.

UNDP estimates suggest that illicit financial flows from the LDCs have increased from $9.7 billion in 1990 to $26.3 billion in 2008, implying an inflation-adjusted rate of increase of 6.2 per cent per annum. The top ten exporters of illicit capital account for 63 per cent of total outflows from the LDCs while the top 20 account for nearly 83 per cent. Trade mispricing accounts for the bulk (65-70 per cent) of illicit outflows from the LDCs, and the propensity for mispricing has increased along with increasing external trade. Of the top 10 countries with the highest illicit flows to GDP ratio, four are small island countries, two are landlocked, and four are neither. In several LDCs, losses through illicit capital flows outpace resources received in ODA. Although these figures are only indicative they illustrate the magnitude of the issue (UNDP, 2011).

Despite the increased use of the Extractive Industries Transparency Initiative (EITI) to strengthen disclosure standards, African LDCs, LLDCs and SIDS continue loosing revenue through illicit financial outflows. For example between 2010 and 2012, the DRC lost at least $1.36 billion in revenues from the underpricing of mining assets that were sold to offshore companies, which is equivalent to almost double the combined annual budget for health and education in 2012 (Africa Progress Panel, 2013). However LDCs, LLDCs and SIDS have limited capacities to deal with international mining companies and offshore financing institutions. Thus stronger efforts to reduce illicit flows and to repatriate stolen assets could play a significant role in bridging the financing gap, at least in a number of vulnerable countries.

In the short-term, increasing government resources will be achieved mostly through deepening the current tax base, in particular reforming existing exemption regimes and addressing transfer pricing abuses by multinational enterprises and improving the taxation on extractive industries. Looking forward, only if structural transformation and private sector development leads to sustainable and equitable growth will it be possible to significantly increase government revenue in the most vulnerable countries.

Another dimension of the relatively low savings rates is the weak private resource mobilisation. Not only are private savings low but so are financial savings. In a number of LDCs financial markets and institutions lag behind those of other developing countries according to the new Global Financial Development Database of the World Bank. The percentage of people holding bank accounts stands at merely 2 per cent in Burundi and 6 per cent in Tanzania. By the same token, the share of private credit as percentage of GDP and the number of bank accounts per 1000 people are much lower in LDCs than in other developing countries. Furthermore many LDCs, LLDCs and SIDS do not have stock markets or have shallow capital markets.

3. Stocktaking of regional public resources[8]

The regional financing architecture comprises development banks, reserve pooling institutions and mechanisms for trade facilitation. As such, they pool national public funds for regional development goals. Regional development banks place their emphasis on the provision of medium- and long-term resources through investment finance for infrastructure, productive and social development, and for climate change mitigation. They also support countries' counter-cyclical macro mechanisms. Relative to other external sources, regional institutions are believed to provide a sense of ownership of resources, and possess specific knowledge of the region.

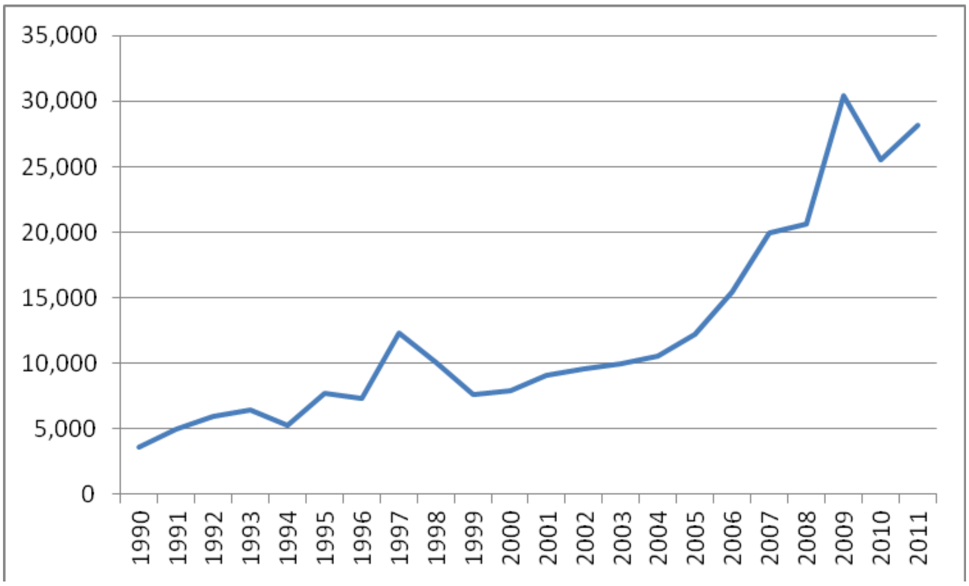
Regional development banks (complemented by multilateral development banks at the global level, i.e. the World Bank, see also Box 1 on development banks) channel resources through direct lending and through indirect lending (through financial intermediaries), both to the public and the private sector. Direct lending most prominently includes lending for infrastructure projects and the strengthening of national development banks. Because of their capacity to distribute risks, they enjoy a higher investment rating than their member countries.

Regional development banks have taken on an increasingly important role in recent decades. Between 1990 and 2011, the combined loan commitments of Latin American and Caribbean Development Banks, the African Development Bank and the Asian Development Bank increased from USD 3 billion to USD 28 billion (see Figure 2). Their lending as a share of GDP in these regions has almost doubled between 1999 and 2011, from just over 1 per cent to 1.9 per cent. In addition, regional development banks have serviced a more diversified set of sectors, and played an important countercyclical role during the financial crisis.

To mitigate external shocks, several regions have set up regional reserve pooling mechanisms. They include the FLAR in Latin America, the Arab Monetary Fund of the Gulf States and the Chiang Mai Initiative in Asia. These institutions provide balance of payments support during a crisis and thus complement global countercyclical mechanisms. They should not, however, be seen as the only defence mechanism for their member countries but rather as one line of defence in addition to other sources of balance-of-payments support. They are a complement to global financial institutions, albeit within a multilevel framework of financial cooperation in keeping with principles of subsidiarity.

Figure 2: Loan commitments of Subregional Development Banks of Latin America and the Caribbean (BCIE and LADB), Asian development Bank and African Development Bank, 1990-2011 (in millions of current USD$)

[8] This section is based on Section IV of the background paper: Stock taking of regional sources of financing, prepared by ECLAC.



Source: ECLAC Financing for Development Division on the basis of official information (2013)

FLAR's financial support to member countries is determined by its coverage and capitalization. Currently FLAR's membership comprise seven countries and a subscribed capital of more than US$ 2,300 million and a paid–up capital representing on average 0.21 per cent and 1.6 per cent of the GDP and international reserves of its members. In the case of the Arab Monetary Fund the size (paid-in capital) of the AMF is US$ 2.75 billion (data as of year-end 2010), which is approximately 0.26 per cent of the average stock of international reserves held by its member States and 0.14% of their GDP. As with FLAR, the relative importance of each State's capital contribution in terms of its stock of reserves and GDP varies. For its part the size of the swap network in the case of the Chiang Mai initiative is US$ 120 billion. This is approximately 2.4 per cent of the average stock of international reserves of the member States and 0.84 per cent of their GDP.

Lastly, regional payment systems such as the Latin America Agreement on Payments and Reciprocal Credits (APRC) contribute to strengthen intra-regional trade flows and cooperation among regional central banks. In turn, greater volumes of trade between member states of regional groups facilitate intra regional investment and growth by creating synergies among firms within regional trading blocs. They have also been, in some cases, a key vehicle for promoting productive inclusion by focusing on enhancing the trading capabilities of Medium and Small Sized Firms (SMEs).

Box 1: Development Banks[9]

Similar to regional development banks, national development banks use public resources to finance investments in sectors and for activities that the private sector is unable or unwilling to serve. Due to the important contribution they make in meeting the purposes of public finance, they are considered here.

[9] This section also draws on the ECLAC contribution to the paper on *Challenges in raising private sector resources for financing sustainable development* and on DESA research

National development banks have historically been used, and continue to be used, to channel public funding to support long-term investment. When managed properly, these institutions have been shown to generate positive externalities. They generally are second-tier banking entities that complement the financial sector by intervening in cases of market failure – to act in those market segments in which commercial banks do not act, or do so only partially. This includes the critical aspect of financing SMEs. Results from a recent survey by the World Bank (De Luna-Martínez and Vicente, 2012), including 90 development banks across 61 countries show that almost all of them (92 per cent) have SMEs as clients they are willing to serve and support. Recent studies have also shown that national development banks have played a valuable counter-cyclical role, especially during crises when private sector entities become highly risk-averse (Brei and Schlarek, 2013).

National development banks are usually created through public funds, but those are often complemented with funding from multilateral institutions, specialized agencies and capital markets. They thus often leverage public resources with private loans. Importantly, provisions -including good governance- should be in place to ensure the efficient administration of the institutions concerned.

They also play an important role in many developed countries and emerging economies (see Table 1 below). Thirteen countries of the G20 have some form of national development bank, with combined assets amounting to more than US$3,000 billion, with United Kingdom being the country that has most recently created a national development bank. A majority of them are State-owned, but within public ownership models the structure varies. Some banks have mixed federal and state ownerships, such as the German Bank of Development Kreditanstalt für Wiederaufbau (KfW). The mandates of NDBs can be 'sectorial', with a focus on sectors, such as agriculture or SMEs; universal, with a focus on a wide range of development banking, such as Brazil's BNDES, which offer a wide array of lending and non-lending services to many sectors of the economy; or export-import banks, which facilitate trade with foreign countries by providing financing or insurance for exports and imports.

Germany's public national bank, KfW, has assets of US$ 640 billion and occupies a wide spectrum of productive project financing, complementing private and cooperative banking on a large scale, as it is the second largest commercial bank in Germany. KfW deals mainly with those business areas that are considered less profitable in the short term, such as renewable energy, environmental and climate protection. Brazil's 55 year-old entity, BNDES, provides domestic long-term industrial credit, with a high participation of credit to large enterprises. Furthermore, for some high risk investments where the market has not provided adequate financing, such as in innovation, BNDES has begun to use structures based on equity investments. This has the advantage of allowing taxpayers to profit from the upside, rewarding the risk assumed by them.

Table 1: Financial indicators for National Development Banks in G20 countries

Country	Institution	Total assets	Total loans	Credit rating (Foreign, Long-term)		
		USD billions circa 2011		MOODY'S	STANDARD & POOR'S	Fitch
Brazil	BNDES	336.1		Baa1	BBB	
Canada	BDC	16.8	14.4	Aaa	AAA	
China	CDB	992.3	877.0	Aa3	AA-	A+
Germany	KfW	640.3	472.4	Aaa	AAA	AAA
India	IDBI	546.1	340.1	Baa3	BBB-	
Italy	Cassa depositi e prestiti	354.0	127.6	Baa2	BBB+	A-
Japan	DBJ	189.6	166.0	Aa3	AA-	
Mexico	BANOBRAS	23.2	12.2	Baa1	BBB	BBB
Russia	Vnesheconombank	71.3		Baa1	BBB	BBB
South Africa	IDC of South Africa	13.8	2.0	Baa1		
South Korea	KDB Financial Group	149.3	74.5	Aa3	A	AA-
Turkey	Kalkinma	1.5	981.9			BBB-
United States	Ex-Im Bank of the US	13.7	11.8	AAA	AA+	AAA

Source: UN DESA calculations based on Annual Reports.

Regional and multilateral development banks play a similar role at an international level. They assist countries and firms in mobilizing financing for productive investments that are not financed by the private sector. Their importance was reemphasized during the global economic and financial crisis, when it became more difficult for many borrowers to access long-term financing. Multilateral development banks were able to play a countercyclical role by expanding their lending significantly in 2009 and 2010.

4. Stock-taking of global public resources[10]

At the global level, ODA remains an important source of public financing for developing countries, particularly for those that do not have sufficient access to other financing flows. For many of the most vulnerable countries, including least developed countries, small island developing states and landlocked developing countries, ODA remains the largest source of external financing. In the least developed countries, ODA represents about half of all external financing available to close their savings gap (UNCTAD, 2012), and 7 per cent of GNI. For sub-Saharan Africa, net official flows are estimated at US$ 36 billion for 2013, while net private financial flows amount to US$ 22 billion.[11] In middle income countries on the other hand, ODA amounts to less than 1 per cent of GNI.

One of the primary stated goals of ODA is to assist developing countries in overcoming internal problems, most prominently the eradication of poverty. In this sense, ODA aims to foster equity and help poor countries meet national development goals. In addition, over time, ODA has increasingly been used to finance global issues, such as the eradication of diseases and combating climate change, in line with the ‘allocative function’ of international public finance.[12]

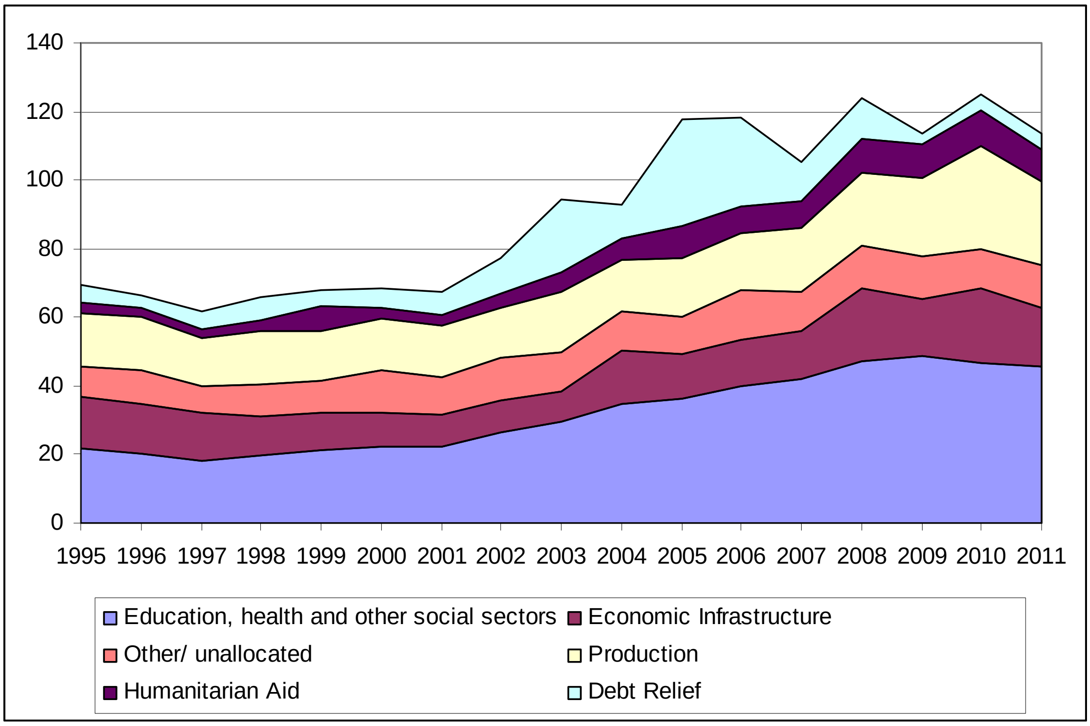
[10] This section is based on Section V of the background paper: Official Development Assistance, prepared by FfDO/UN-DESA, and a background note by OHRLLS on Financing needs of LDCs
[11] International Monetary Fund, World Economic Outlook Database, April 2013
[12] In practice, ODA has also often served additional purposes – responding to strategic, political, economic and military considerations of donors.

ODA trends

Overall, ODA has been rising since the adoption of the Millennium Declaration and the MDGs in 2000. The focus of the MDGs on social development has led some donors to increase aid to social sectors and to the health sector in particular. Within the health sector, the largest increase in ODA was dedicated to the fight of HIV/AIDS and, to a lesser extent, malaria, tuberculosis and other infectious diseases which pose cross-border risks, and are therefore of international concern (see Figure 3). In addition, as concerns about environmental degradation and climate change have grown, aid targeting environmental sustainability has seen a particularly strong increase. Between 1997 and 2009-2010, aid that had environmental sustainability as a principal objective has grown more than threefold, reaching US$ 11.3 billion in 2010.

However, since 2010, when it reached its peak, ODA from OECD DAC member countries has fallen for two consecutive years, by a total of 6 per cent in real terms, to $125.6 billion in 2012 (OECD, 2013). Reductions in aid budgets have largely been due to post-crisis austerity policies in a number of donor countries. These negative developments represent a clear retreat from the internationally agreed aid targets. OECD DAC donors' ODA represents 0.29 per cent of their gross national income (GNI), well short of the United Nations target of 0.7 percent. So far only Denmark, Luxembourg, the Netherlands, Norway and Sweden continue to exceed the target, and the United Kingdom is expected to reach the 0.7 percent target in 2013.

Figure 3: Total bilateral aid by OECD-DAC members, in billions of US$



Source: OECD International Development Statistics

Looking forward, ODA is expected to stagnate over the medium-term. The most recent Survey on Donors' Forward Spending Plans (OECD, 2013b) suggests an increase of 9 per cent in ODA in 2013, mainly due to planned increases in country-programmable aid (CPA) in a few major donor countries and in soft loans from multilateral agencies. However, ODA growth is expected to stagnate from 2014 to 2016, particularly for the poorest countries with the largest MDG implementation gaps. Major increases in CPA are projected only for middle-income countries in Far East and South and Central Asia.

Development assistance to vulnerable countries

LDCs, LLDCs and SIDS face different conditions with respect to financing options as compared to other developing countries. Most LDCs, LLDCs and SIDS are still highly aid dependent with respect to the share of ODA in government expenditure and in terms of to the source of foreign exchange earnings. For LDCs the share of ODA in recipient country GNI was 7 per cent, for LLDCs this share was 4 per cent and for SIDS 5 per cent in 2010 (United Nations, 2012c). Average ODA per capita in 2011 was $52 in LDCs, whereas for middle income countries it was only $10.

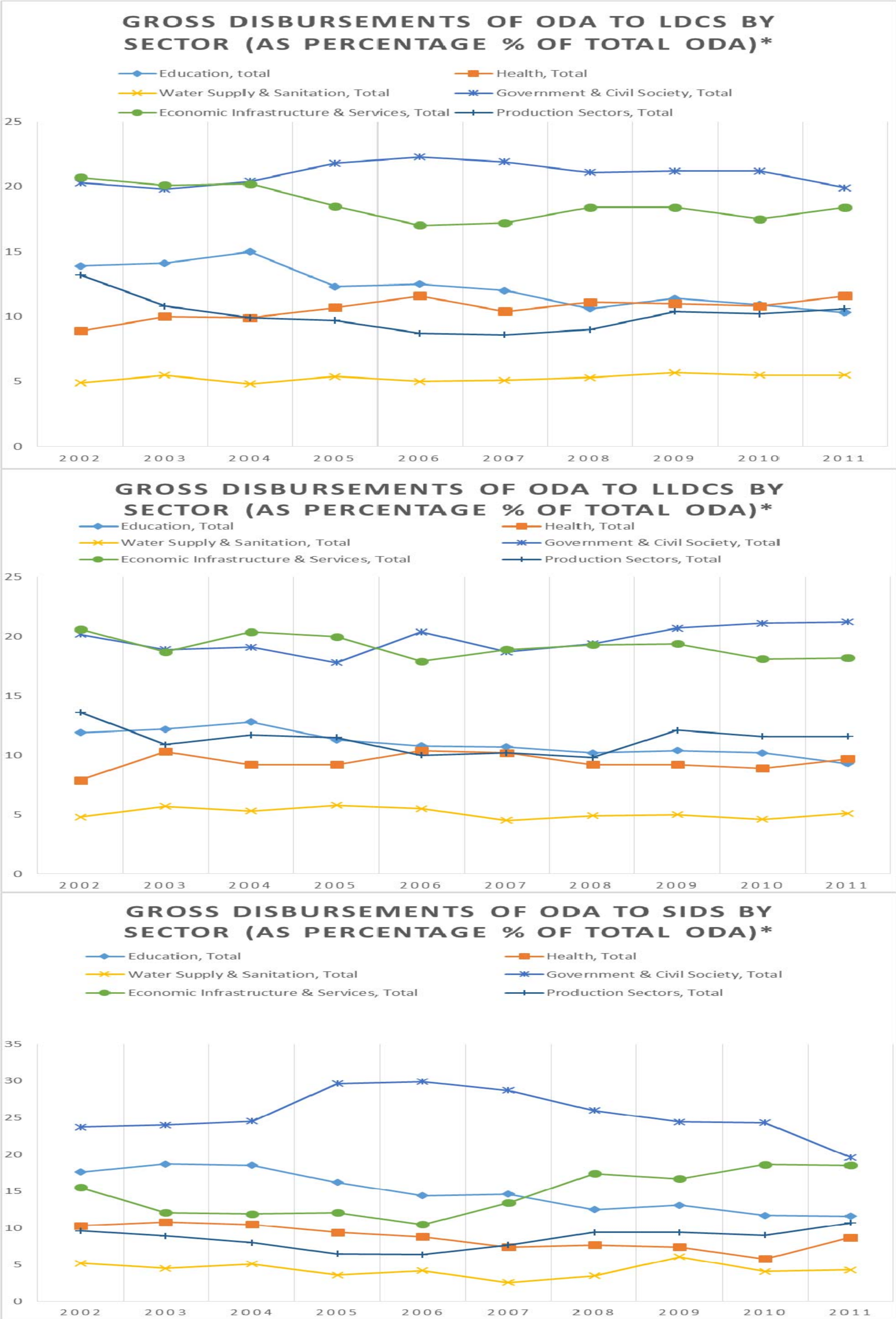
This has been acknowledged in the Monterrey Declaration, which states that ODA to LDCs, LLDCs and SIDS is critical to the achievement of the MDGs (A/CONF.198/11). This situation has not changed much over the past decade. For example, in 2011 ODA to LDCs stood at $44.6 billion, whereas FDI amounted to $21 billion and remittances to $27 billion. All of these flows are also highly concentrated with large shares going to a small number of countries. Also, ODA per capita to LDCs differed widely ranging from $8 in Myanmar to $4332 in Tuvalu.

Despite their high dependency, LDCs were disproportionally affected by the decline in ODA in 2011 and 2012 (the year of the Istanbul Conference), with their share in total ODA declining from 34 per cent in 2010 to 33 per cent in 2011. ODA as a percentage of donors' GNI fell to 0.10 per cent in 2011, despite the 0.15 to 0.2 per cent ODA targets that are reaffirmed in the Istanbul Plan of Action (IPoA) (OECD, 2012a and 2013). ODA to LLDCs also declined in real terms from $25.2 billion in 2009 to $25.1 billion and $24.3 billion in 2010 and 2011 respectively.

With respect to aid allocation both needs and performance need to be taken into account. Most aid orphans – i.e. countries that are under-aided relative to others – are LDCs (United Nations, 2012). Furthermore, providers of aid do not determine their aid allocations in a coordinated manner. Aid allocation to the LDCs should take into account national development priorities, as expressed at the 2011 United Nations Conference on the Least Developed Countries. Aid allocation practices need to better take into account the vulnerabilities and special needs of LDCs and should be based on expected outcomes of development interventions. The decision of the General Assembly (A/RES/67/221) to promote the consideration of least developed country indicators, GNIpc, HAI and EVI, as part of their criteria for allocating official development assistance is an important step in this context.

Access to finance also varies by sector in vulnerable countries. While the MDGs were successful in focusing attention on the poor and have contributed to a greater focus on results, there are also challenges related to allocation of a large proportion of ODA towards social sectors at the expense of productive capacity, including in agriculture.

Figure 6: Gross disbursements of ODA by sector in LDCs, LLDCs and SIDS from 2002 to 2011



Source: OECD DAC Statistical Database, accessed April 2013.
Note: * ODA total from all donors

Figure 4 above show the sectoral allocation of total programmable ODA for LDCs, LLDCs and SIDS over the last decade. For all three groups, ODA allocated to government and civil society accounts for the largest share. The share of ODA for economic infrastructure and production sectors started to increase somewhat since 2006, coinciding with the establishment of Aid for Trade (AfT). AfT is crucial for the building of productive capacity in LDCs, LLDCs and SIDS, which would in turn allow them to benefit from their integration in the world economy and reduce their exposure to commodity price fluctuation. However, the share of AfT going to LDCs has stagnated around 30 per cent As AfT can play a role in helping LDC companies entering global value chains, it can make a substantial contribution to the development of productive capacity.

South-South cooperation

While aid from traditional donors is decreasing, several non-DAC donors have dramatically scaled up aid in recent years. South-South cooperation is taking an increasingly important role in global development cooperation. It is estimated that South-South development cooperation – concessional loans, grants and technical cooperation – has reached between $12.9 billion and $14.8 billion by 2010 and it is expected to increase further, with major increases planned by China, India and Venezuela. The largest donors from the South in absolute terms are Saudi Arabia, China, and Venezuela. Together, they accounted for more than three quarters of all South-South cooperation in 2008. Most of the resources are delivered through bilateral programmes, but Southern providers also contribute significantly to the United Nations and other multilateral organizations, as well as to South-South multilateral organizations. (United Nations, 2012).

However, the term South-South cooperation is often understood more broadly to cover other forms of exchange and cooperation between developing countries, including trade, loans, technology sharing and direct investment. South-South cooperation lays emphasis on national sovereignty, common interests, and usually does not contain explicit policy conditions. It is typically delivered as project finance, and due to the prevalence of large infrastructure financing, these projects are larger than those by traditional aid providers. As a result, South-South cooperation is less fragmented than traditional ODA (United Nations, 2010). Furthermore, South-south cooperation is generally based on an integrated approach that packages commercial transactions in trade, investment and loans at non-concessional interest rates, with an expectation of earning returns on the investment. Expanding South-South cooperation may help to cushion the fall in aid receipts from traditional donors, but nonetheless should not be seen as a substitute for traditional aid flows.

Aid effectiveness

In addition to increasing the volume of aid flows, many developed countries, together with many developing countries, have also committed themselves to increasing the effectiveness of aid. High transaction costs, fragmentation and lack of coordination associated with project-based aid, and the lack of policy change induced by conditionality were commonly blamed for ODA’s limited impact (Dijkstra, 2010). It is, however, difficult to establish a simple metric to measure aid effectiveness, not least because the view of effectiveness can differ based on whether it is from the donor or recipient perspective. Nonetheless, the Paris Declaration on Aid Effectiveness, endorsed by over 100 donors and developing countries in 2005, and reaffirmed in the 2008 Accra Agenda for Action and in the Busan Declaration of 2011, committed both signatory donors and aid recipients to adhere to several principles of aid effectiveness, including country ownership, alignment of donor support with national development strategies, harmonization of donor arrangements and procedures, a focus on results, mutual accountability, predictability and transparency. The Busan Declaration also endorsed efforts to increase the effectiveness of South-south cooperation on a voluntary basis.

To date, progress in implementing the aid effectiveness agenda is slow. Out of 13 targets established at 2005 Paris Declaration to be reached by 2010, only one has been met, even though progress has been made towards achieving many of the remaining targets (OECD, 2011). For example, ownership of the development policies by partner countries is the core principle of the aid effectiveness agenda. The aid modality that best embodies this principle is budget support. Yet, ODA continues to be delivered as projects to a very large degree. In 2010, budget support represented only 3.2 per cent of bilateral aid, which fell to 2.2 per cent in 2011 (OECD database), and 18.2 per cent of multilateral aid (United Nations, 2012).

Signatories to the Paris Declaration also commit to ensure results-based aid delivery, based on “measurable outputs”. “Measurable outputs” are important from the donors’ perspective, as programmes with a results focus tend to get parliamentary approval more easily. Yet, there are several challenges associated with using measurable indicators, which need to be addressed. First, a too strong insistence on demonstrating visible results in the short term may cause limitations in the monitoring capacity of public management systems in recipient countries to be overlooked. Second, measurable short-term indicators are not necessarily indicative of development effectiveness over the medium and long-term, which can cause public finance to be short-term oriented.

For aid recipients, the stability of aid disbursements, including its predictability for their development planning, is particularly important. Indeed, the Paris Declaration committed donors to provide aid over a multi-year horizon and disburse it according to schedule, making use of partner countries’ systems for planning as much as possible. The follow-up 2008 Accra Agenda for Action mandated immediate actions to improve the availability of information to support medium-term planning, including three to five year forward expenditure and implementation plans. Yet, the Busan commitment to improve aid predictability by halving the proportion of development cooperation funding not covered by indicative forward-spending plans is unlikely to be met by the target year of 2013. Budget cuts in donor countries have also had a negative impact on aid predictability. The OECD-DAC report on predictability finds that donors disbursed 5 per cent less aid than planned in 2010 and 8 per cent less in 2011. This is a marked deterioration from 2009 (OECD, 2012b).

Another important issue is tied aid. In 2011 untied aid was recorded at 84.6 per cent of bilateral aid in 2011, excluding technical cooperation, in-door refugees and administrative costs, still lower than the peak of 91.4 per cent recorded in 2005. However, this is still a marked improvement from earlier decades, when around 50 per cent of aid was tied. A number of donors, including Canada, have gradually untied aid over the past decade, while others, such as Austria, Italy and Spain, reversed earlier progress (United Nations, 2013).

ODA and public private partnerships

In line with the broader rethinking of public policy and the role of the state in the economy, partnerships between public and private actors have become increasingly prominent in the delivery of ODA. Kaul (2006) estimates that such partnerships, which involve governments, business, civil society and other stakeholders, have increased from around 50 initiatives in the mid-1980s to more than 400 in 2005. In the health sector for example, purpose-specific or vertical funds such as the Global Fund to Fight HIV/AIDS, Tuberculosis and Malaria and the GAVI Alliance are prominent examples that have successfully brought together donor and recipient governments, philanthropists, the research community, the private sector and civil society. They have succeeded in steering resources to their set purposes on a very large scale, yet it is important to note that these are overwhelmingly public resources (UNTT, 2013).

The strength of such vertical funds lies in leveraging the comparative advantages of all participating stakeholders. Furthermore, the earmarking of funds to the specific and narrow purposes of vertical funds can help build political support and attract funds. By establishing a clear link between fundraising and spending on initiatives and programmes with strong political consensus in donor countries, such as the health and climate sectors, it proved easier to approve public funding and to attract philanthropic donors (United Nations, 2012b). In addition, many funds are considered to be more efficient than bilateral delivery mechanisms. The disbursement of aid through vertical funds has, however, in some instances given rise to tensions between the programmes, which have been effective on an individual basis, and the international commitment to development effectiveness more broadly, which emphasizes country responsibility for decision-making on national policies. For example, in the health sector, while vertical approaches allow results to be achieved more quickly in particular areas, there have been concerns about their impact on the development of effective health systems capable of meeting the needs of the populations they serve, in particular as they have been set up and operated in parallel to the many, often much smaller, bilateral programmes. Such fragmentation runs counter to aid effectiveness principles.

There are several policy options to approach global governance of these funds, ranging from a completely centralized approach to full dispersion. On one extreme, all funds could be channelled through a central institution, which would be in charge of allocating financing. However, it is unlikely that there is political support for such a centralized approach. In addition, there are benefits to decentralization, including greater representation and competition. In a less centralized approach, funds could be centralized by sector, with an overarching health fund, climate fund, etc. Alternatively, there could be some merging of existing funds and efforts, combined with increased coordination and cooperation. Nonetheless, in this scenario, appropriate institutional arrangements should be designed to encourage greater cooperation and coordination of effort.

Innovative source of development finance[13]

Vertical funds have also been pioneers in the use of innovative financing mechanisms. Innovative sources of development finance have been increasingly discussed in view of shortfalls in ODA, the perceived lack of stability and reliability of aid flows, and the large financing needs for sustainable development.

There is no universally agreed definition of innovative development financing. IDF proposals have usually shared two main objectives – to raise significant additional resources for development, and that they would do so in a stable and predictable manner (Herman, 2012).

[13] This section is based on Section VI of the background paper: Stock taking of innovative international sources of financing, prepared by FfDO/UN-DESA and UNDP.

The Leading Group describes IDF as 'comprising mechanisms for raising funds for development that are complementary to official development assistance, predictable and stable, and closely linked to the idea of global public goods'. The World Bank employs a more expansive definition, including South-South cooperation and local currency bonds, whereas the OECD considers new approaches for pooling private and public revenue streams, new revenue streams earmarked for development on a multiyear basis, and new incentives to address market failures as IDF (for an overview, see UNDP, 2012).

The World Economic and Social Survey 2012 (United Nations, 2012b) considers as innovative development finance mechanisms that are in the realm of international public finance and that have the following characteristics: (i) official sector involvement; (ii) international cooperation and cross-border resource flows to developing countries; (iii) an element of innovation in the nature of resources, their collection or governance structures; and (iv) as a desirable characteristic that resources are additional to traditional ODA. This definition is also adopted here.

Innovative development financing mechanisms can be categorized intro three groups: those that raise new resources, those that intermediate existing resources, and those that disburse traditionally raised funds in innovative ways. The latter consist mainly of vertical funds discussed above. A significant number of mechanisms of all types have been implemented over the last two decades. Yet, they have so far raised or intermediated only a modest amount of resources - $5.8 billion for health and $2.6 billion for climate and other environmental programmes. Moreover, donors count almost all of this funding – more than 90 per cent in the case of health – as ODA.

The international solidarity levy for airline tickets is by far the largest resource-raising IDF mechanism operational at this point. Introduced in 2006, it is currently levied on airline tickets in 9 countries, and then coordinated internationally for allocation. The levy is paid by passengers and imposed on all flights leaving a country. Airlines are responsible for collecting and declaring the tax. Rates vary between countries and within countries, depending on ticket classes and destination. As of December 2012, it has raised around $1.2 billion, overwhelmingly from France, for the international drug purchasing facility UNITAID (UNITAID, 2013).

The Solidarity Levy also has potential for scaling up. Keen and Strand (2007) showed that a worldwide ticket tax of 2.5 percent (which would amount to $4 on average for economy class tickets and $25 for business class tickets on average) could raise $10 billion annually. These estimates assume that because the tax is relatively small per traveller, the behavioural response in terms of travel volume will be equally small. Updating this with projected revenues of the airline industry in 2012, it is estimated that such a tax could raise $15 billion in 2012.[14] Although the revenues from the tax would vary based on travel volumes, and thus be somewhat linked to economic cycles, the goal of the program is for revenues to be allocated directly to development. As such, revenues would be outside the political budget process and likely raise resources for their set purpose in a more predictable and sustainable manner. The predictability of resource flows at the recipient level – arguably much more important for aid effectiveness – would entirely depend on the distribution mechanism however.

[14] Projected total revenue of airline industry in 2012 by IATA: http://www.iata.org/pressroom/facts_figures/fact_sheets/Documents/industry-stats-dec2011.pdf

In terms of its political feasibility, earmarking the proceeds of the tax for UNITAID facilitated its adoption in national parliaments, as the tax is linked directly to a specific and popular public good, the fight against HIV/Aids and other global diseases. The tax is counted in the ODA budgets of those donor countries that have implemented the tax. As such, it is difficult to discern if the funds raised are additional to what would have been the level of ODA without the resources raised by the tax.

There are a numerous other proposals of IDF that are both technically feasible and have significant potential to raise revenues, even though coordinated international implementation is likely to face substantial political difficulties. They include international taxes such as financial and currency transaction taxes or a carbon tax, and non-tax revenues such as the use of the IMF's special drawing rights for development finance. A currency transaction tax could raise around USD 40 billion annually if levied on all trading in the four major currencies (United Nations, 2012b). Potential global revenues for a broader financial transaction tax are much larger. The new European financial transaction tax alone (agreed to by 11 countries in the European Union, to enter into force some time in 2014) is estimated to raise between € 30 and 35 billion annually. Lastly, if developed countries collectively agreed to implement a carbon tax of $25 per ton, they could mobilize an estimated $250 billion annually by 2020 (World Bank and others, 2011).

Existing 'intermediate' mechanisms of innovative development finance are designed to restructure existing flows to better match financing with needs, reduce risk, pool philanthropic funds with official resources, or leverage official flows with private resources. While to date these mechanisms have been of relatively small size, they have often been effective at the task they had set themselves, and have shown potential for scaling up and for replication in other areas, albeit to varying degrees.

The largest intermediate mechanism is the International Finance Facility for Immunization (IFFIm), which uses securitization, a mechanism developed in the private sector, to front-load aid flows. Established in 2006, IFFIm securitizes long-term pledges from donor governments and issues vaccine bonds in the capital markets backed by aid. The revenue from the bond issues provides upfront financing for vaccination programmes by the GAVI Alliance. Securitization is valuable when upfront financing is needed, but a steady flow of future payments is not necessary. The transferability of this model is thus limited to programmes where there are benefits of large upfront investments. This could include infrastructure investment, particularly green investments.

A second group of intermediate mechanisms are those that seek to mitigate risk and change incentives, with the particular purpose of spurring innovation. For example, Advance Market Commitments (AMC) aim to overcome the failure of the private sector to develop vaccines needed in developing countries due to insufficient demand at high market prices of medicines. It provides a commitment by donors to purchase vaccines once they have been developed, providing vaccine makers with incentives to invest in manufacturing plants needed to develop vaccines and produce them on a large scale.

These types of mechanisms – aiming primarily at spurring innovation – could conceivably be replicated in other areas of innovation, in particular with regard to clean energy and low carbon products. Other projects currently under consideration include assistance in rolling out mini-grids in remote areas with limited access to the central electricity grid, large-scale gridconnected renewable energy projects, the development of new technologies to deal with problems of land and water scarcity, climate change, and declining crop yields, and medium-scale deployment of biogas for schools and hospitals. Additional applicability to social sectors is less clear, but it is possible to envisage the use of similar structures to promote education and health services such as ICT or web based applications adapted for isolated and poor communities, for example in Africa.

A third type of mechanism, also borrowed from the private sector, is catastrophe risk insurance. The Caribbean Catastrophe Risk Insurance Facility (CCRIF) is the first multi-country catastrophe insurance pool. It is capitalized through a donor trust fund, while the premiums are paid by the 16 participating countries and territories. It provides insurance against earthquake or hurricane risk for Caribbean countries. By pooling risks among member countries, CCRIF provides insurance at about half the cost that would be incurred if each country sought insurance separately (United Nations, 2012). Such risk-pooling and insurance are of particular importance to small countries, especially in regions prone to natural disasters.

Replicability in other regions or for other risks depends primarily on the correlation of risks – the Caribbean Islands are sufficiently wide spread for risks to be localized, but for other groups of countries, or other risks (e.g. a Tsunami), this may not be the case. Risk insurance facilities that cover a diverse set of countries, regions or products would, however, provide greater diversification and help lower costs further. In addition, well-structured insurance pools could be sold to the private sector as catastrophe bonds.

Overall, existing intermediate mechanisms of innovative development finance have been quite successful at the tasks they have set themselves, and have shown potential for scaling up and replication in other areas, albeit to varying degrees. Yet, they have so far created only limited additional resources, in large part due to the decision by donors to count revenues raised by most mechanisms as ODA.

Accounting issues

As most IDF mechanisms are counted in donor budgets as ODA, it is therefore difficult to assess how much of it can be considered additional to traditional aid (United Nations, 2012b). Given these issues and other major changes in development assistance since the current definition of ODA was adopted in 1972, there is an ongoing debate – in particular within the OECD DAC - on the need to modernize the concept of ODA.[15]

The current accounting of ODA is based on flows of cross-border transfers of resources. On the one hand, this accounting is seen as being too broad, in that it has come to include items that are not actually transferred across borders, such as private consultancies, spending on students and refugees in donor countries, or are based on donor country interests not necessarily related to development or poverty alleviation, such as aid tied to foreign policy objectives and companies from donor countries (see for example ActionAid, 2011). Similarly there have been debates on the extent that debt relief should be counted as ODA. Most recently, there has also been a discussion on how to separate support for development needs

[15] See: http://search.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=DCD/DAC%282012%2948/REV2&docLanguage=En

and support for other global objectives, as discussed above. A recent report by the OECD acknowledged this with respect to commitments made on climate financing, and suggested that "monitoring resource flows in support of the eventual post-2015 development framework may necessitate a review of the statistical methods to track financing targeted to global objectives, such as climate change mitigation and adaptation, for which financial commitments have already been made."[16]

On the other hand, the accounting of ODA is also seen as being too narrow, as it doesn't include mechanisms that could be used to leverage private finance, which could be a disincentive to implementing mechanisms to leverage private sector resources. In particular, mechanisms that do not generate immediate resource flows are not included in calculations of ODA, such as guarantees. As many guarantees are never triggered, they are not included in assistance statistics. At the same time, guarantees cannot be counted at face value since there is a significant probability they will not be exercised.[17]

Given this dichotomy, the OECD suggests that the DAC investigate the feasibility "of alternative/complementary accounting methods that would better reflect contemporary budget and balance-of-payments accounting standards." The complementary roles of public finance discussed above could provide a framework for this. Such a framework would distinguish between the role of ODA to help poor countries meet national development goals such as the eradication of poverty (which will likely continue to be financed by public resources, with contributions from philanthropy), and addressing other global concerns (which will incorporate more innovative measures to leverage private resources.)

While this is necessarily complex given overlaps between development and other global goals, this discussion could help clarify the alternative roles of public finance, while incorporating new mechanisms and techniques, yet still ensuring sufficient financing for national development goals and poverty eradication, especially for poor countries that lack resources domestically. At the same time, the rising prominence of South-south cooperation may warrant a global discussion of these issues in more inclusive fora in the future.

4. Conclusion

In light of the large financing needs and the unique role and purposes of public finance, securing sufficient public sources of finance, both domestic and public, will be critical for achieving sustainable development.

At the national level, significant additional revenue can be raised in many developing countries. Measures to achieve this include the building of effective administrations that limit incentives and opportunities for rent-seeking, adopting and implementing strong taxpayer protection, and careful design of international tax rules as well closer international cooperation to protect the domestic tax base. Some progress has already been made in the area of extractive industries, through greater transparency requirements for multinational companies.

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[16] Ibid

[17] Valuation could be based on the probability of the event, as in the private sector, but major difficulties in quantifying would arise.

To improve domestic resource mobilization in vulnerable countries, rationalizing exemption schemes, dealing with transfer pricing and designing fairer and more transparent taxation systems on natural resources-based industries will be some important steps towards deepening tax bases.

Even if major progress is made in domestic resource mobilization however, external public sources of financing will nonetheless remain important, both to support developing countries, especially low income countries, and for the provision of global public goods. If developing countries are to meet their sustainable development goals, they will rely on a range of external resources. In light of the diversity of needs – financing for social needs, financing for long-term investments or risky investments, and others – these will include investment financing from regional and multilateral development banks, traditional ODA, and innovative mechanisms. It is particularly important that donors fulfil their ODA commitments and that innovative development financing mechanisms raise resources additional to traditional ODA, rather than replacing it.

There is also a growing consensus that ODA will have to be more focused on countries with limited access to other sources of financing, especially LDCs, LLDCs and SIDS. The current trend of disproportionally cutting ODA to LDCs needs to be reversed.

Sustainable development financing will also need to provide sufficient resources for financing global public goods and the protection of the global commons. ODA is increasingly used for this purpose. There is a risk that a rising share of financing for global public goods would divert ODA flows from the least developed countries and low income countries, to financing of global goods in middle income countries. This raises questions on how to ensure that ODA goes to those most in need, and how to define eligibility and graduation criteria. For this reason, it is critical that financing flows for global public goods are accurately and separately accounted for, and that they are additional to existing ODA commitments.

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