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The State of Finance for Developing Countries, 2014

An assessment of the scale of all sources of finance available to developing countries

By Jesse Griffiths

Introduction

This is a condensed version of a detailed report which provides the most comprehensive review of the quantity of different financing sources available to developing countries, and how they have changed over the past decade. The report finds that developing countries are losing twice as much money as they earn because of issues like illicit financial flows, profits taken out by foreign investors and interest repayments on debt (as demonstrated in the figure above).

We have analysed the best available data produced by international institutions, both from the point of view of developing countries as a whole, and for low-income (LICs), lower-middle-income (LMIC) and upper-middle-income countries (UMICs) separately. In this briefing, we provide figures as percentages of Gross Domestic Product (GDP) – a good indicator of how important they are to the developing country in question.

Unlike other recent analyses, we have not just examined the resources flowing into developing countries, but have also analysed the resources flowing out, identifying the lost resources. We define losses as resources that have either been directly lost by developing countries, such as illicit financial outflows, or resources that represent a lost opportunity, such as lending by developing countries to rich countries.

This has allowed us to examine four very different categories of resources:

- Domestic resources, including domestic investment and government revenue;
- Lost resources, including illicit financial flows, profits taken out by foreign investors, interest payments on foreign debt and lending by developing countries to rich countries.
- Inflows of external resources, including:
  - international public resources (aid and other official flows);
  - for-profit private flows (foreign direct investment and portfolio investments in stocks and shares);
  - not-for-profit private flows (including charitable flows and remittances from migrant workers).
- Debt creating flows, both public and private borrowing by developing countries.

Key findings

One key finding of the report is that losses of financial resources by developing countries have been more than double the inflows of new financial resources since the financial crisis.

Figure 1 shows that lost resources have been close to or above 10% of GDP for developing countries as a whole since 2008 – meaning that for every $100 the country makes, $10 are lost, flowing out of the country. The main drivers of this are illicit financial flows, profits taken out by foreign investors and lending by developing countries to rich countries.

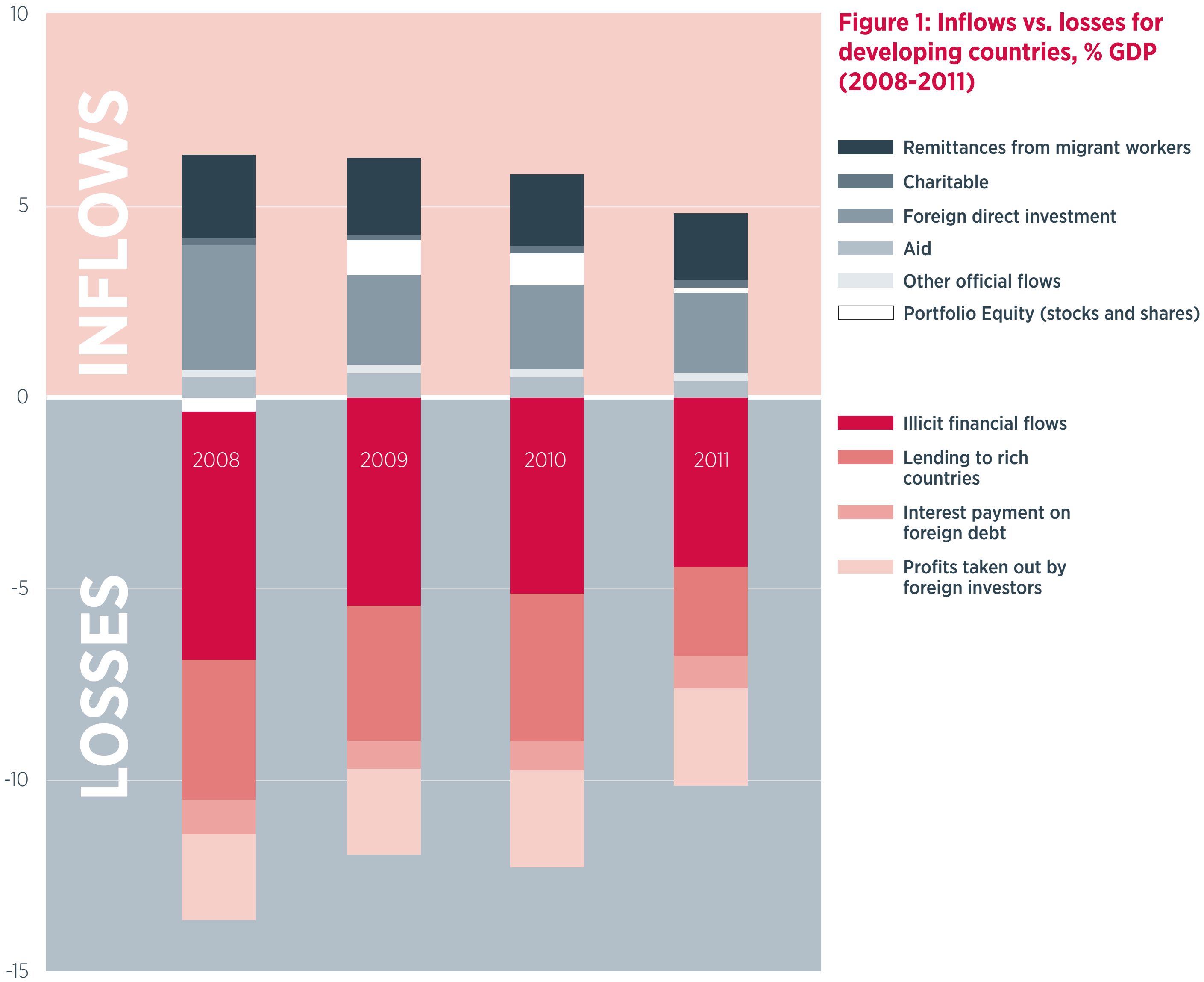


Figure 1: Inflows vs. losses for developing countries, % GDP (2008-2011)

The full report and methodology can be found here: www.eurodad.org/finance_for_developing_countries

Domestic resources

We examined both domestic investment by private firms and the government and the income available to the government. We found that:

- Domestic resources are far larger than all external financing sources for developing countries, with domestic investment reaching over one third of GDP, and government revenue almost one fifth of GDP in 2012.
- The poorest countries (classified as low-income countries) have desperately low levels of investment: only $165 per person per year.

Figure 2: Domestic Investment Trends (%GDP)

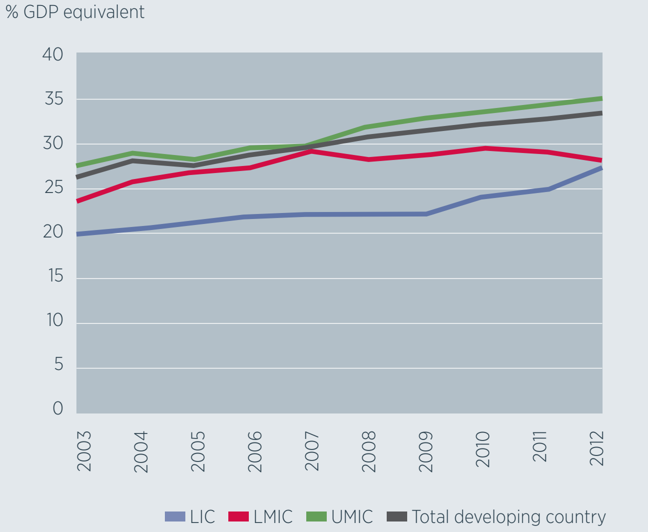
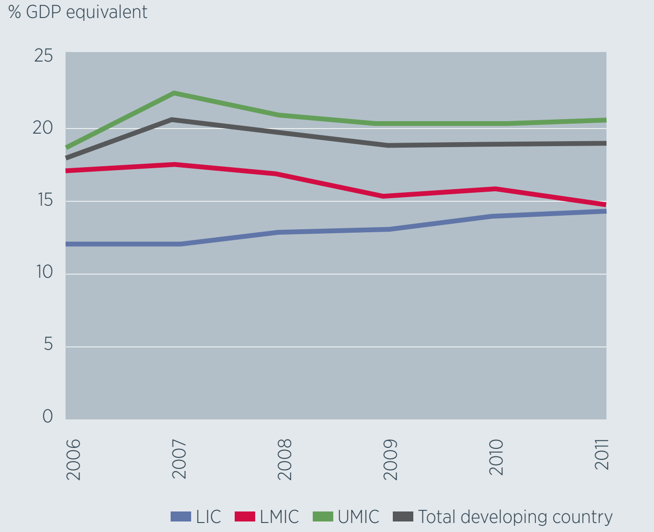


Figure 3: Government Revenue trends (%GDP)



Other important characteristics of available resources

In the report that this briefing is based on, we focus on the scale, distribution among countries and volatility of different financing resources. However, the quality of different resources matters as much as, if not more than, their quantity. We will focus on these issues in future editions of the report. Previous Eurodad research highlighted several of these, as summarised below.

Macro-economic risks

Inflows and outflows of resources affect a countries' exchange rate directly, but also affect the confidence of investors in the country. For example, 'hot money' outflows of short-term investment and lending caused by perceived problems in the host economy, or issues in the home economy, can trigger severe crises in the currency market and financial sector.

Accountability and transparency

All of the resources discussed would benefit from significant improvements in their accountability and transparency. Civil society organisations have often focused on public flows – aid and domestic public resources – precisely because some notion of accountability and transparency is expected of the actors involved, even though they may not live up to those expectations. Efforts made to make private resources more accountable and transparent, such as working on minimum social or environmental standards, have been less successful.

Impacts on domestic politics

The domestic political impacts of resource flows can be extremely important for poverty reduction and sustainable development. For example, the conditionalities attached to lending by International Financial Institutions proved highly controversial. In addition, the strong influence of external actors on domestic policy-making undermines the space for developing countries to set their own policy agendas, and for citizens of those countries to hold their governments to account. The process of international economic liberalisation over recent decades, and the growth in the offshore economy, have provided incentives for governments to engage in a 'race to the bottom' on taxation and standards expected of companies.

Contributions to sustainable development

Ultimately, the impacts of different resources on poverty reduction depend on the overall macro-economic, political and environmental conditions in each individual country. It may be worth distinguishing between two spheres where resources may be needed. In the first sphere of public goods – including basic services, the environment, natural resources and security – there is a greater demand for public sources of finance. However, in the area of productive development – the financing of infrastructure, business expansion and so on – the debate is highly contested.

Losses of domestic resources

Here we have focused on outflows of finance that represent a genuine loss of resources that would have been better invested in the developing country.

- LICs are particularly badly affected, losing more than 18% of GDP in 2011.
- The largest loss was illicit financial flows – money which was illegally earned, transferred or used, mostly linked to commercial tax evasion – which totalled $634 billion in 2011.
- We are not able to estimate the lost resources due to legal, but morally dubious tax avoidance due to lack of data, but indications are that they would also be very significant losses for developing countries.
- The second largest loss was profits repatriated by international investors which totalled $486 billion in 2012. In fact, since 2010, profits taken out of developing countrie have exceeded new inflows of Foreign Direct Investment (FDI), with the poorest countries worst affected.
- The third biggest loss was the $276 billion that was lent by developing countries to rich countries in 2012.
- The fourth biggest loss was $188 billion paid in 2012 by developing countries to service interest on their external debts.

Figure 4: Illicit financial flows (% GDP)

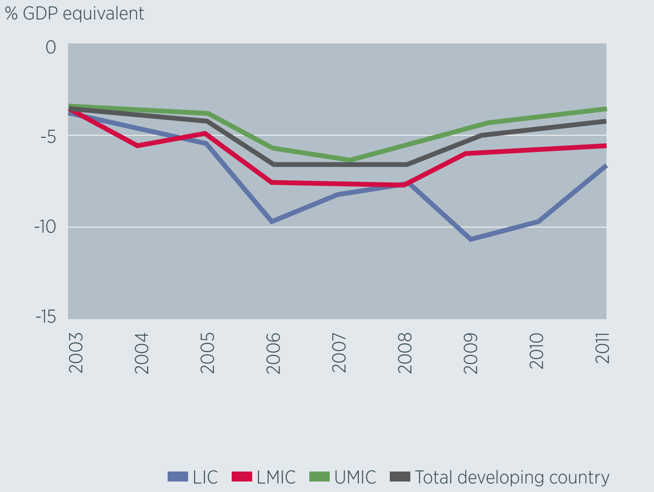


Figure 6: Lending to rich countries by developing country governments (% GDP)

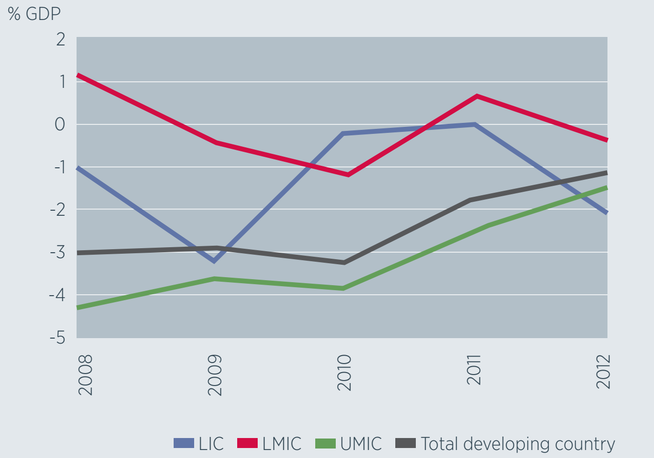


Figure 5: Profits repatriated (%GDP)

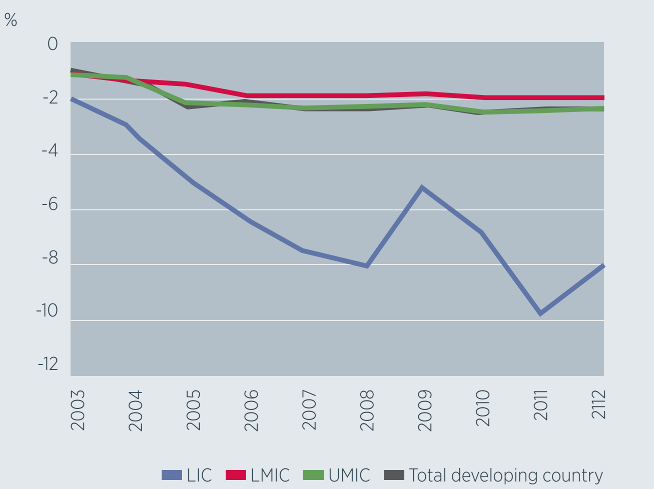
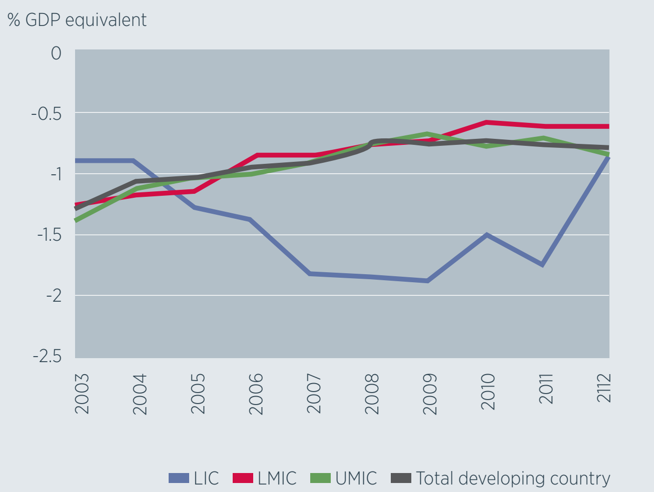


Figure 7: Interest repayments on foreign debt (%GDP)



Inflow of external resources 1

International public resources

- Country Programmable Aid has increased in absolute terms to a high of $96 billion in 2011, but has been falling relative to developing country GDP, which has been growing at a faster rate.
- In the poorest low-income countries, however, aid remains an important resource, accounting for over 7% of GDP in 2012.

Figure 8: Country Programmable Aid (%GDP)

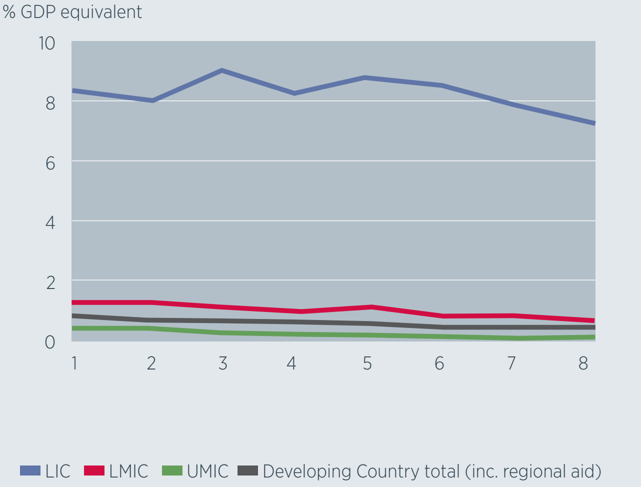
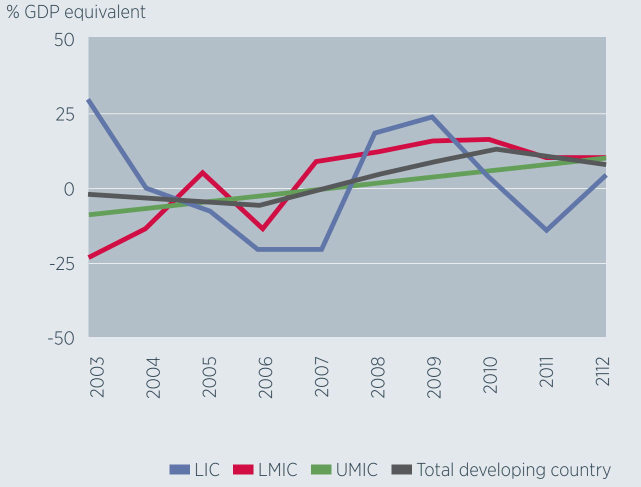


Figure 9: Other Official Flows (%GDP)



'Innovative' public finance

The report that this briefing is based on focuses on the main existing sources of finance. However, considerable efforts have been made in recent years to promote new, additional 'innovative' sources of public finance, some of which are bearing fruit, although totals mobilised so far are very low. Eurodad examined these in detail in a previous report. Below we summarise the findings.

Financial Transaction Taxes

Financial Transaction Taxes (FTTs) are taxes on the trading of shares, bonds, derivatives and foreign exchange. In a sample of just seven G20 countries, the IMF has estimated that FTTs are already raising $15 billion per year, although this is not allocated to development.

A group of 10 European countries have agreed to adopt new FTTs in stages, starting with shares and some derivatives. In 2011, the European Commission estimated that an EU-implemented FTT across all asset classes could raise "between €16.4 billion and €400 billion depending on assumptions on decrease in volume, the scope of products covered and the tax rates (0.01% for the first estimate and 0.1% for the second)."

Carbon and other Environmental Taxes

Airline ticket levy: This is already in existence in nine countries, with the proceeds from most countries earmarked for UNITAID. It has raised over $1 billion for UNITAID since 2006. If expanded to more countries, or increased in scope, the potential raised could increase significantly.

Developed country carbon taxes: A 2011 joint report by the IMF, World Bank and OECD estimated that a tax of $50 per tonne in developed countries would yield about $450 billion per year, or $250 billion ($25 per tonne) or $155 billion ($15 per tonne.) If a tax of $25 per tonne was levied on *aviation and bunker fuels* and taxes paid by developing countries were rebated, the same report estimates that $22 billion per year could be raised, or $14 billion if the rate was $15 per tonne.

New SDR creation

Special Drawing Rights (SDRs) are an international reserve asset held at the IMF by all member governments. The main proposal is to agree regular additional allocations of SDRs – in effect to create new reserve assets. In 2009, a G20 agreement led to the issuance of $250 billion in extra SDRs, showing that such 'global quantitative' easing is possible. UNDESA suggests annual allocations of $100 billion to £250 billion per year and, if the majority of new SDRs went to developing countries this would yield them $100 billion to $167 billion annually.

Inflow of external resources 2
International for-profit private flows

- FDI to developing countries was badly hit by the global crisis and remains below its 2008 peak. Rising GDP means it has fallen as a percentage of GDP from 3.2% in 2008 to 2.1% in 2012.
- For-profit flows can be highly volatile, particularly foreign purchases and sales of stocks and shares, which rose sharply for developing countries before the global financial crisis drove them into negative figures in 2008.

Inflow of external resources 3
International public resources

- Remittances from emigrants from developing countries to their families back home increased from just over $130 billion in 2003 to more than $350 billion in 2012.
- Remittances are particularly important in the poorest countries, where they represented 7% of GDP in LICs in 2012. They are highly concentrated in a small number of countries.
- Charitable flows remain relatively small – around $30 billion in 2012, or 0.13% of developing country GDP.

Figure 10: FDI (%GDP)

% GDP equivalent

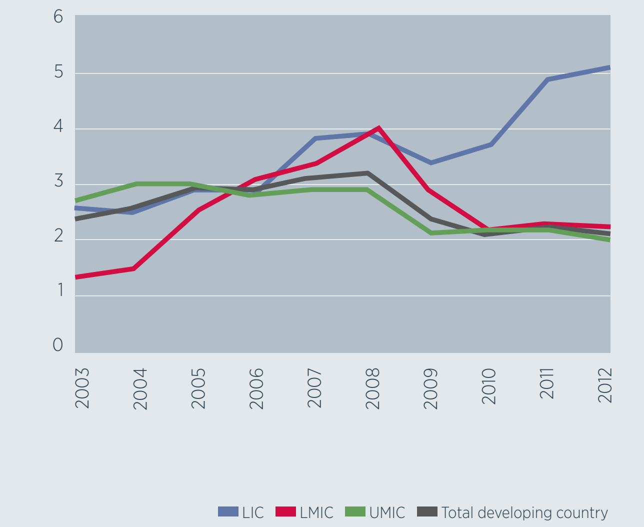


Figure 12: Remittances

% GDP equivalent

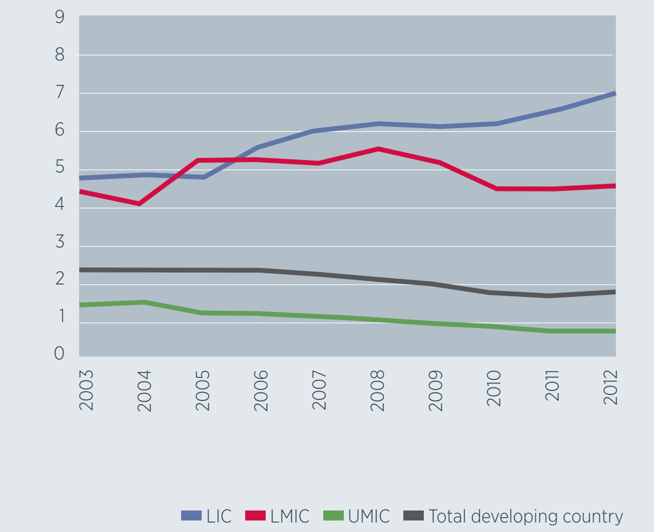


Figure 11: Portfolio Equity (%GDP)

% GDP equivalent

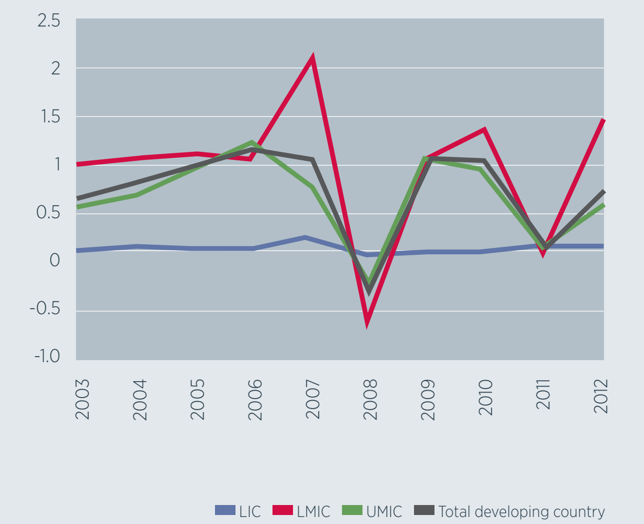
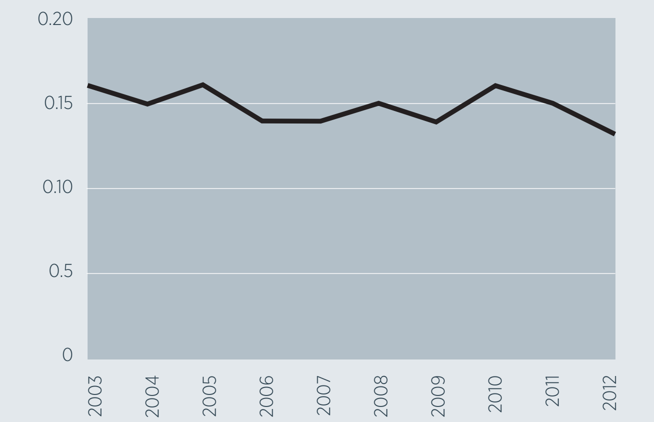


Figure 13: Charitable flows as a percentage of developing country GDP

% GDP



Debt creating flows

Since 2006, there has been a sharp increase in new debt taken on by developing countries, meaning developing country debt stocks reached their highest level ever in 2012 – $4.8 trillion, according to the World Bank – which was largely driven by increases in indebtedness by private actors.

LIC governments have remained heavy net borrowers throughout the period, averaging between 1.3% and 2% of GDP in additional long-term borrowing between 2003 and 2012.

Figure 14: Public external borrowing, long term (%GDP)

% GDP equivalent

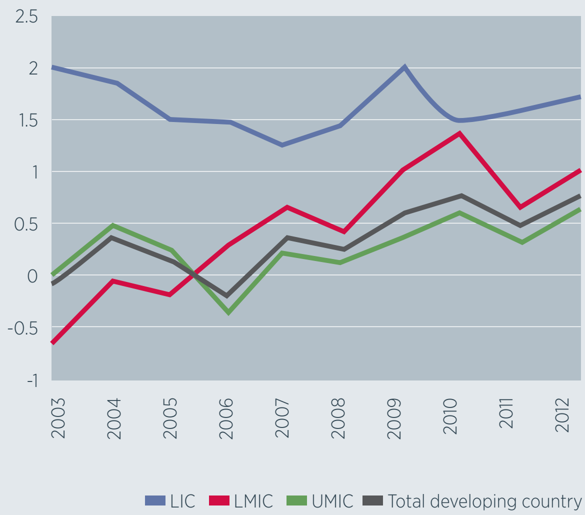


Figure 16: Short-term foreign borrowing (public & private) (%GDP)

% GDP equivalent

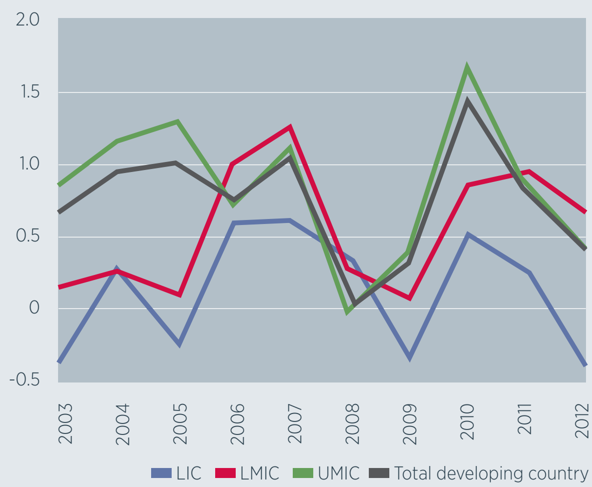
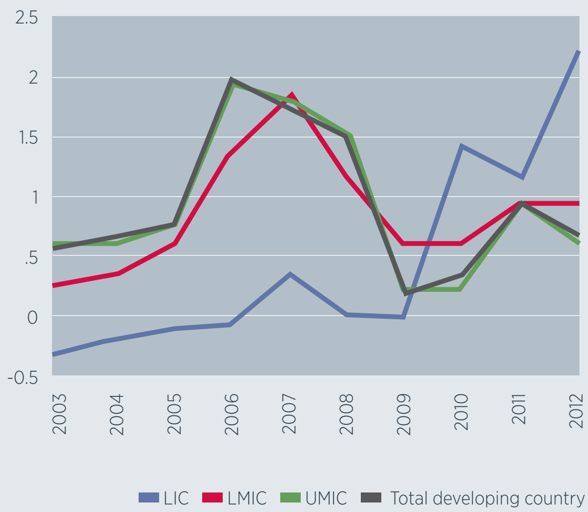


Figure 15: Long term foreign borrowing – private (%GDP)

% GDP equivalent



> “ Developing country debt stocks reached their highest level ever in 2012 – $4.8 trillion, according to the World Bank

Conclusion

This report does not tackle the extremely important issue of the quality of these sources, which will be examined in future editions. Important issues covered in this series will include: macro-economic risks, accountability and transparency; impacts on domestic politics; and contributions to sustainable development.

As the United Nations gears up for its critically important summit on financing for development (FfD) in Addis Ababa in 2015, it will be important to have a clear-eyed view of the current scale of all different financing resources available. It is hoped that this report will make a significant contribution to that understanding.

The full report and methodology can be found here: www.eurodad.org/finance_for_developing_countries

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www.diakonia.se