Financing for Development: What can be achieved at the 2018 FfD Forum?

Key tests for policy makers

A Eurodad position paper

December 2017

Contents

BACKGROUND: FINANCING FOR DEVELOPMENT AND THE UN 2

TEST 1: INCLUDE ALL COUNTRIES IN GLOBAL EFFORTS TO CRACK DOWN ON TAX DODGING TO FILL THE PUBLIC FINANCING GAP 3

TEST 2: ENSURE FULL TRANSPARENCY FOR EFFORTS TO FILL FINANCING GAPS TO AVOID PROMOTING THE WRONG SOLUTIONS 5

TEST 3: SHOW COMMITMENT TO ENDING DESTRUCTIVE CRISES BY SUPPORTING A DEBT WORKOUT MECHANISM 8

THE WAY FORWARD: RECOMMENDATIONS 10
Background: Financing for Development and the UN

The latest conference of the United Nations Financing for Development (FfD) process, held in Addis Ababa in July 2015, agreed the Addis Ababa Agenda for Action (AAAA), which was supposed to provide the framework for how the world would finance the Sustainable Development Goals (SDGs).

When they adopted the SDGs in 2015, the world’s governments committed themselves to eradicating extreme poverty and hunger, reducing global inequality, ensuring free quality education for all children, universal access to safe drinking water, sanitation, reproductive health-care, safe and affordable housing, as well as preventing the extinction of threatened plants and animals – all within the next 15 years. Additionally, through the Paris Climate Agreement, they have committed to strengthening the global response to climate change.

The annual FfD Forum at the UN is supposed to “follow-up and review ... the financing for development outcomes” agreed in Addis Ababa, and also the “means of implementation” for the SDGs. The Forum is therefore a space for UN member governments to draw conclusions and agree further actions reform the global financial and economic system in order to meet the ambition of the SDGs.

Last year’s FfD Forum was disappointing, with few concrete outcomes achieved. It is clear - as the FfD Forum outcome document highlighted - that current policies are not delivering the economic step-change needed to achieve the SDGs. As the Inter-agency Task force on Financing for Development notes, “since the [global economic] crisis, global growth has been sluggish, trade and investment growth have decelerated and financial flows have remained volatile.”

This raises expectations that more must be achieved at the 2018 FfD Forum: specific tangible improvements must be made to the way the global financial and economic system is run if we are not to slip further behind. This paper highlights key issues, and suggests three key tests that the 2018 Forum must meet if it is to be regarded a success.

However it has become apparent that the scale of changes that can be achieved through annual Forums is restricted, which is why we propose a limited number of concrete reforms. Given the slow rate of reform since Addis, it is clear that global leaders need to work towards a major new set of concrete actions on financing for development: an FfD heads of state summit should be planned for 2020, at the latest, with an ambitious agenda.
Test 1: Include all countries in global efforts to crack down on tax dodging to fill the public financing gap

Agree to set up a global intergovernmental tax commission, under the auspices of the UN, to ensure that all countries have a say, with the mandate and resources to combat international tax dodging, which drains the vital public financing needed to achieve the SDGs.

Domestic public finance is by far the largest development finance resource for developing countries. Though they have significantly improved tax collection in recent years, the structure of developing countries’ economies means they rely far less than developed countries on income tax, and more on corporate income tax (middle-income countries) and trade taxes (Least Developed Countries).

However, significant resources and tax revenues are lost due to the use of offshore financial centres, intra-company operations within transnational corporations, and financial secrecy to transfer financial resources out of developing countries. The scale of the problem is, by its nature, impossible to quantify precisely, but all available figures suggest there is a significant loss of resources by developing countries: both in terms of lost resources for investment or consumption expenditure in developing countries, and lost tax revenues. For example:

- The Report of the High Level Panel on Illicit Financial Flows from Africa found that the “amount lost annually by Africa through illicit financial flows is ... likely to exceed $50 billion by a significant amount.”

- UNCTAD found “an estimated $100 billion annual tax revenue loss for developing countries is related to inward investment stocks directly linked to offshore investment hubs” – only one aspect of the problem of tax losses through opaque multinational corporate structures.

- In a study published in 2017, Alex Cobham and Petr Jansky estimated that governments worldwide lose $500 billion annually due to corporate tax avoidance. According to the study, Pakistan, for example, loses the equivalent of 40 per cent of the country’s overall tax revenue to corporate tax avoidance.

Developing countries inevitably have limited tax bases compared to developed countries, but this has been made worse by a ‘race to the bottom,’ led by OECD countries, to reduce taxes on multinationals. The average global corporate tax rate has been falling since the early 1980s, dropping from above 40 per cent to below 25 per cent in less than 35 years. The OECD noted in 2016 that ‘The trend of corporate tax rate reductions, which had slowed down after the crisis, seems to be gaining renewed momentum’. Since then, things have got worse, with, for example, Hungary slashing its corporation tax rate to just 9% and the US proposing large cuts.

Many countries are using harmful tax practices and sweetheart deals with multinationals which have further eroded the tax base of other countries. Harmful tax practices can help multinational corporations avoid paying the official corporate income tax rate in the countries where they do business. These practices include providing ‘patent boxes’ and other generous tax incentives, often cemented through secret tax deals between governments and corporations. In addition, advance pricing agreements – secret tax deals signed between multinational corporations and tax administrations which are also known as ‘sweetheart deals’ – are being promoted. Such deals have become controversial after several scandals revealed how multinational corporations have used them to avoid paying taxes.
Developing countries are also feeling pressure to join in this ‘race to the bottom’ through granting multinationals tax incentives which significantly erode the corporate income tax base. For example, ActionAid estimates that statutory corporate tax exemptions alone cost developing countries $138 billion per year. However a report by the IMF, OECD, World Bank and UN found that “tax incentives generally rank low in investment climate surveys in low-income countries, and there are many examples in which they are reported to be redundant—that is, investment would have been undertaken even without them.” Another IMF study found that “taxation is not a significant driver for the location of foreign firms in SSA [sub-Saharan Africa], while other investment climate factors, such as infrastructure, human capital, and institutions are.” In other words, public investment is a far more important driver of longer-term foreign direct investment (FDI) than lower taxes, but this investment is itself harmed by lower tax revenues.

As a result of low tax bases, tax losses due to the race to the bottom, and tax avoidance and evasion, there are significant public resource shortfalls for basic services, social protection and infrastructure, particularly in least developed countries. Public expenditure is vital for delivering basic social services, including health and education for all. However the range of public goods that require public expenditure is broader than this. The 2030 Agenda for Sustainable Development includes the provision of social protection floors, including, for example, pensions, unemployment and disability payments, and as the Task Force report notes, “financing social protection generally comes from the budget: thus tax revenues are first and foremost the basis of financing.” These shortfalls have gendered implications, as women’s health needs and socially constructed caring roles mean they are particularly reliant on public services and social protection. Infrastructure should be added to this list. In developing countries “three quarters of infrastructure is financed by the public sector.”

The AAAA committed governments to addressing these problems, but in practice most UN members have been excluded from relevant decision-making processes. Instead of a truly global negotiating forum to deliver strong and truly global solutions to combat international tax dodging and the race to the bottom, developing countries are encouraged to join the OECD’s Inclusive Framework. Membership of the forum requires developing countries to pay a membership fee to the OECD and commit to implementing the standard on Base Erosion and Profit Shifting (BEPS). This BEPS package, which runs to nearly 2,000 pages, was negotiated through a process where over 100 developing countries were excluded from participating. Its content is both inadequate and, in some cases, highly problematic. This dominance of the OECD – which is largely a grouping of developed countries – is replicated in discussions on ODA rules, which take place in the OECD Development Assistance Committee (DAC), a donor country grouping.

A truly global commission on tax to combat international tax dodging was nearly achieved at Addis Ababa, but a minority of countries, many of them sponsors of tax havens, blocked it. The 2018 FfD Forum is a vital moment for governments to complete this unfinished agenda by committing to setting up a global intergovernmental tax commission. This commission must be under the auspices of the UN, to ensure that all countries have a say, and must have the mandate and resources to tackle these serious problems.
Test 2: Ensure full transparency for efforts to fill financing gaps to avoid promoting the wrong solutions

Agree to abide by the Open Contracting Global Principles, as the first step in a process to ensure full transparency and prevent bad decisions arising from government efforts to mobilise additional resources through PPPs.

Mandate the Development Cooperation Forum to examine the interaction between international public finance and private sector development, which examines both the impact of international public finance on the local private sector, including how best to tackle informal tying of ODA to firms in provider countries; and the knock-on impacts and opportunity costs for public services in the global south if international public finance is used to support the private sector.

International public financial flows that could help fill the public financing gap have been lower than stated, less than promised, and proven volatile and subject to changing priorities in developed countries. This is largely due to developed countries’ failures to meet the UN target of 0.7% of GDP to be given as Overseas Development Assistance (ODA, or ‘aid’). In 2016, members of the OECD Development Assistance Committee (DAC) reached less than half of this figure. ODA figures are being brought into disrepute by increasingly large proportions that never leave the donor country, driven in recent years by increasing expenditure on in-donor refugee costs.

ODA is also seriously undermined by the continued practice of many countries of ‘tying’ ODA – using ODA to support firms from the donor country. This not only subverts the sustainable development focus of ODA, it also increases the costs of projects by 15–30%. LDCs are understandably more dependent on ODA, as other public finance sources are constricted: tax collection rates are low, and opportunities to borrow are also limited. Worryingly, ODA to LDCs fell in real terms in 2016. Forthcoming changes to the ODA rules, that would allow more support to the private sector to be counted as ODA, are deeply troubling from this regard, as these are instruments poorly suited to LDCs. Unless there is a step change in the amount of ODA provided, spending more ODA on private sector support is likely to come at the expense of grants for public investments.

While private finance is vitally important for development, it is a mistake to suggest that it can be a substitute for these shortfalls in public expenditure, including for infrastructure. In fact, as we have seen, insufficient public expenditure is a significant barrier for investment. As the Task Force put it, “... public investments in basic infrastructure, health and education, and many other areas provide the preconditions without which markets cannot function.”

The link between international public finance and the impacts on both public and private sectors in developing countries needs much more careful examination, recognising risks as well as potential rewards. One step forward would be to mandate the Development Cooperation Forum to examine the interaction between international public finance and private sector development, which examines both the impact of international public finance on the local private sector, including how best to tackle informal tying of ODA to firms in provider countries; and the knock-on impacts and opportunity costs for public services in the global south if international public finance is used to support the private sector.

International private capital has been flowing out of developing countries, in net terms, since 2015. International private capital flows are made up of FDI, portfolio investment (buying and selling stocks and shares), and other investment - mainly international bank claims. These flows had been net positive until 2014, but swung dramatically negative in 2015 and 2016. According to the UN, this multi-year reversal in flows has not been seen since they started collecting relevant records in 1990.
As the report of the Task Force summarises, “to date, private international capital flows have been subject to volatility, driven by trends in the global economy and by short-term investment horizons.” The main explanatory factors for the switch in net private capital flows noted above are external: a collapse in commodity prices in 2015, and “monetary conditions and interest rates in major advanced economies and the strength of the dollar.”  

Protecting themselves from external shocks transmitted through the international financial system has very high costs for developing countries. Developing countries have been lending to developed countries on an enormous scale, to protect themselves against future crises by building reserves. This has largely taken the form of buying assets in developed countries, and “in the first quarter of 2016, 64 per cent of official reported reserves were held in assets denominated in US dollars.” A far better alternative to this diversion of scarce resources is the UN’s proposals to issue new Special Drawing Rights (SDRs, a kind of global reserve asset) and to allocate these to developing countries. The UN proposes annual allocations of new SDRs, with $100-167 billion allocated to developing countries.

By contrast, domestic private investment has been a high share of GDP, particularly in middle-income countries, and has not suffered from volatility. Domestic investment is far larger than all external financing sources combined, in all categories of developing countries. There is a significant difference between middle-income countries, which have reached more than 30 percent of GDP as domestic investment (of which around two-thirds is private investment) compared to low-income countries (LICs), which have reached around 25 percent of GDP. Most of this difference is explained by lower levels of public investment in LICs. In addition to proving more stable, domestic investment in developing countries does not appear to be greatly affected by external shocks, having increased as a percentage of GDP for developing countries in the years following the global financial crisis.

Successful developing countries have directed domestic investment into productive sectors, while carefully managing international private finance: their ability to do this now is significantly curtailed by the international trading system and by international rules. A host of strategies that successful developing countries have deployed in the past are becoming increasingly difficult or even prohibited by international agreements or WTO rules. For example, the WTO does not allow companies to apply subsidies linked to sourcing domestically or on export performance; the proliferation of bilateral trade and investment agreements restrict the use of procurement and competition policy to promote domestic industries; and the increasing power of investor-state dispute provisions in these treaties give multinationals the power to challenge governments’ efforts to promote domestic industry and protect basic human rights.

The ‘billions to trillions’ narrative that promotes massive increases in international private capital flows assumes that private finance can substitute for public finance in key areas such as infrastructure – which is rarely the case - and does not consider the major increase in risks of such an approach. There is widespread agreement that infrastructure has historically been primarily financed by the public sector, though there are country variations. In China, for example “…almost all infrastructure financing is undertaken by the public sector, with private financing as a proportion of GDP close to zero.” The IMF finds that “…the public sector was and continues to be [the] main provider” of the stock of infrastructure across the world. There are good reasons for this, as the IMF’s 2014 World Economic Outlook pointed out:

- Infrastructure investments are often large, capital-intensive projects that tend to be ‘natural monopolies’ meaning extensive state regulation is necessary.
- They often have major up-front costs, but the benefits accrue over long periods of time, often many decades, meaning private actors find them hard to finance.
• The total benefit of the infrastructure investments is often far larger than the commercial benefit that can be captured by the provider.

Rather than supporting policy space for developing countries to manage private finance, many international institutions – particularly the World Bank Group (WBG) – have been promoting greater involvement of private finance in delivering public services through public private partnerships (PPPs). PPPs are increasingly being promoted as a way to finance development projects. To pave the way for PPPs, donor governments and financial institutions have set up multiple donor initiatives to promote changes in national regulatory frameworks, to provide advice and to finance PPP projects. In particular the WBG has played a leading role in shaping the rules in developing countries which allow PPPs to flourish, and has increased its support to PPPs more than threefold, from US$0.9 billion to US$2.9 billion, over the period 2002-2012.

However, all too often PPPs prove to have significant hidden fiscal costs, frequently for the simple reason that most public services, including infrastructure, cannot be delivered on a for-profit basis. A recent study by Eurodad found that:

• The fiscal costs of PPPs can impose large burdens on the public purse. Some of these arise from ‘explicit costs’ where the government guarantees payments to private providers to make up for the fact that the project may not be commercially viable or very risky. However, there are often major hidden costs, including contingent liabilities, which the government has to pay to prevent public services from collapsing if the private provider runs into trouble.

• PPPs typically suffer from a lack of transparency and limited public scrutiny, which creates greater opportunities for poor decision-making and corrupt behaviour.

• The way governments record the costs of PPPs in financial statements and budgets creates a false incentive in favour of PPPs.

A change of approach is needed. The contract value and long term implications of each project must be included in national accounts, rather than being off-balance sheet. Full details of guarantees and contingent liabilities associated with PPPs, and the conditions that will trigger them, and all PPP-related documents should be publicly disclosed. These will allow citizens to have a clear understanding of the fiscal risks involved and will increase democratic accountability.

To prevent bad decisions arising from the hidden debts of PPPs, a key first step would be for governments to agree at the FfD Forum to abide by the Open Contracting Global Principles, and the proactive disclosure of documents and information related to public contracting. According to the Principles, this should be done in a manner that enables meaningful understanding, effective monitoring, efficient performance, and accountability of outcomes. This would mean proactive disclosure of:

• Contracts, including licenses, concessions, permits, and grants

• Related pre-studies, bid documents, performance evaluations, guarantees, and auditing reports.

• All information concerning contract formation, including the planning process.

• Ongoing information on performance and completion of public contracts.
Test 3: Show commitment to ending destructive crises by supporting a debt workout mechanism

Agree to create a transparent and accountable Debt Workout Institution, independent of creditors and debtors, to reduce and resolve debt crises and to comprehensively, rapidly and fairly restructure debt.

As we have seen, the global financial system increases the vulnerability of developing countries to crises. In the twenty first century, private capital flows to developing countries have been driven by the external economic situation and the policies of other countries. For example, the increased capital inflows following the global economic crisis were driven by low interest rates in developed countries leading to a ‘search for yield’ and bolstered by higher commodity prices at the time. At the same time, “widespread liberalization of international capital flows and greater openness to foreign financial institutions in [developing countries]” have “resulted in a significant increase in the presence of foreign investors and lenders in domestic financial markets of [developing countries] as well as the presence of their residents in international financial markets, rendering them highly vulnerable to global boom-bust cycles generated by policy shifts in major financial centres.”

Globally, debt of the non-financial sector stood at 225 percent of global GDP in 2015, two-thirds of which were private sector liabilities.

The global monetary system has also increased the tendency for crises. Since the collapse of the Bretton Woods system in the 1970s, the international monetary system has been prone to significant swings in exchange rates. This creates enormous risks for small or poor countries with a high proportion of external debt denominated in a foreign currency, and makes them extremely vulnerable to swings in their exchange rates.

Debilitating sovereign debt crises continue to be a major feature of the international system, and debt risks have been rising in developing countries. Thanks to economic growth and international debt relief initiatives, debt levels of developing countries had fallen but has increased significantly since the global financial crisis. In absolute terms, the debt of developing countries has now reached the highest level ever seen. On average, sovereign debt as a share of GDP in emerging markets and developing countries has increased by 12 percentage points since 2007, and by 2016 these economies on average had government debt equivalent to 47 percent of GDP. Sovereign debt crises continue to be a major feature of the international system, with debilitating effects on the countries that experience them. The nature of developing country debt has also changed significantly, with an increasingly high percentage borrowed from private sources, external as well as domestic. This commercial debt has higher interest rates, and is more difficult to restructure than debt owed to public creditors if it becomes unsustainable, for example when a crisis hits.

The architecture of global economic governance has been slow to change, and there are no effective ways of dealing with unsustainable debt. For example, despite the fact that since the 1950s, there have been more than 600 cases where unsustainable sovereign debt has had to be restructured, there is still no bankruptcy regime or ‘debt workout mechanism’ for governments that face unsustainable debt levels. The Heavily Indebted Poor Countries initiative (HIPC) provided a limited, ad hoc process to deal with the debts of some developing countries, but this process is no longer available for future cases.
Political commitments to pursue this agenda have been bolstered in recent years by several UN initiatives. At the three international conferences on Financing for Development in Monterrey, Doha and Addis, the international community made political commitments to prevent debt crises or resolve them quickly where prevention failed. These commitments include promoting responsible lending and borrowing, producing better data on and assessment of debt and debt sustainability, and protecting developing countries against litigation by predatory vulture funds. In recent years, UN bodies have significantly stepped up efforts to prepare the ground for an effective and fair debt workout mechanism:

• In 2015, UNCTAD released its Roadmap and Guide for Sovereign Debt Workouts which was the culmination of proposals worked on since the beginning of the global financial crisis, and reflected the work of a multi-stakeholder expert group. The Guide establishes principles for debt workouts and proposes a Debt Workout Institution (DWI).35
• In 2014, the UN General Assembly passed a resolution that mandated an ad hoc committee to negotiate a multilateral legal framework for sovereign debt restructuring.36 The General Assembly process could build on numerous political mandates to create a new debt workout mechanism, in particular the agreements made at the international conferences on Financing for Development in Monterrey (2002) and Doha (2008).
• In 2015, the UN GA adopted Basic principles on Sovereign Debt Restructuring Processes37 that build on principles defined earlier by the UNCTAD. The Resolution also contains a mandate for a follow-up process.

The next step for the UN is to complete the job and create a Debt Workout Institution (DWI), independent of creditors and debtors, to facilitate debt restructuring processes. Such work must be guided by good practice in insolvency procedures, the sovereigns’ obligations to comply with international human rights law, and by the internationally agreed 2030 development agenda and its financing needs. The DWI should:

• Prevent debt crises by promoting compliance with responsible lending and borrowing principles, and be mandated to monitor such compliance and sanction non-compliance.
• Deal with the whole sovereign debt stock of a country in one single and comprehensive process, and ensure fair burden sharing among different creditor categories.
• Be able to invoke an automatic standstill on debt payments in times of crises or overhangs, and ensure sufficient legal protection from vulture funds.
• Ensure that debt sustainability analyses based on financing needed to meet sustainable development goals and international human rights obligations guide decision-making throughout the whole debt restructuring process.
• Act in a transparent and accountable manner, make all relevant information public, and give all relevant stakeholders the right to be heard.
The way forward: Recommendations

It is clear that current policies are not delivering the economic step-change needed if we are to achieve the SDGs. The annual FfD Forum is a key space for UN member governments to draw conclusions and agree further actions to reform the global financial and economic system in order to meet the ambition of the SDGs.

This paper has highlighted key issues and suggested key tests that the 2018 Forum must meet if it is to be regarded a success, with the following five recommendations:

1. **Agree to set up a global intergovernmental tax commission**, under the auspices of the UN, to ensure that all countries have a say, with the mandate and resources to combat international tax dodging, which drains the vital public financing needed to achieve the SDGs.

2. **Agree to abide by the Open Contracting Global Principles**, as the first step in a process to ensure full transparency to prevent bad decisions arising from government efforts to mobilise additional resources through PPPs.

3. **Mandate the Development Cooperation Forum to examine the interaction between international public finance and private sector development**, which examines both the impact of international public finance on the local private sector (including how best to tackle informal tying of ODA to firms in provider countries), and the knock-on impacts and opportunity costs for public services in the global south if international public finance is used to support the private sector.

4. **Agree to create a transparent and accountable Debt Workout Institution**, independent of creditors and debtors, to reduce and resolve debt crises and to comprehensively, rapidly and fairly restructure debt.

5. **Plan an FfD heads of state summit for 2020**, to recognise that far more needs to be done given the slow rate of reform since Addis, so that global leaders can work towards ensuring the implementation of previous commitments, as well as agree a major new set of ambitious actions on financing for development.

2. Ibid., 31.

3. Ibid., 32.


7. Data received by Eurodad from IMF


United Nations General Assembly, Towards the establishment of a multilateral legal framework for sovereign debt restructuring processes, A/68/304, (17 September 2014)

Eurodad

Eurodad (the European Network on Debt and Development) is a network of 46 civil society organisations (CSOs) from 19 European countries, which works for transformative yet specific changes to global and European policies, institutions, rules and structures to ensure a democratically controlled, environmentally sustainable financial and economic system that works to eradicate poverty and ensure human rights for all.

Our focus is on strengthening the power of European CSOs, working as part of a global movement to push governments and powerful institutions to adopt transformative changes to the global economic and financial system.

More information and recent briefings are at:
www.eurodad.org

EURODAD Information Updates:
Subscribe free to EURODAD’s newsletter
“Development Finance Watch”: