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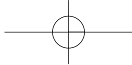
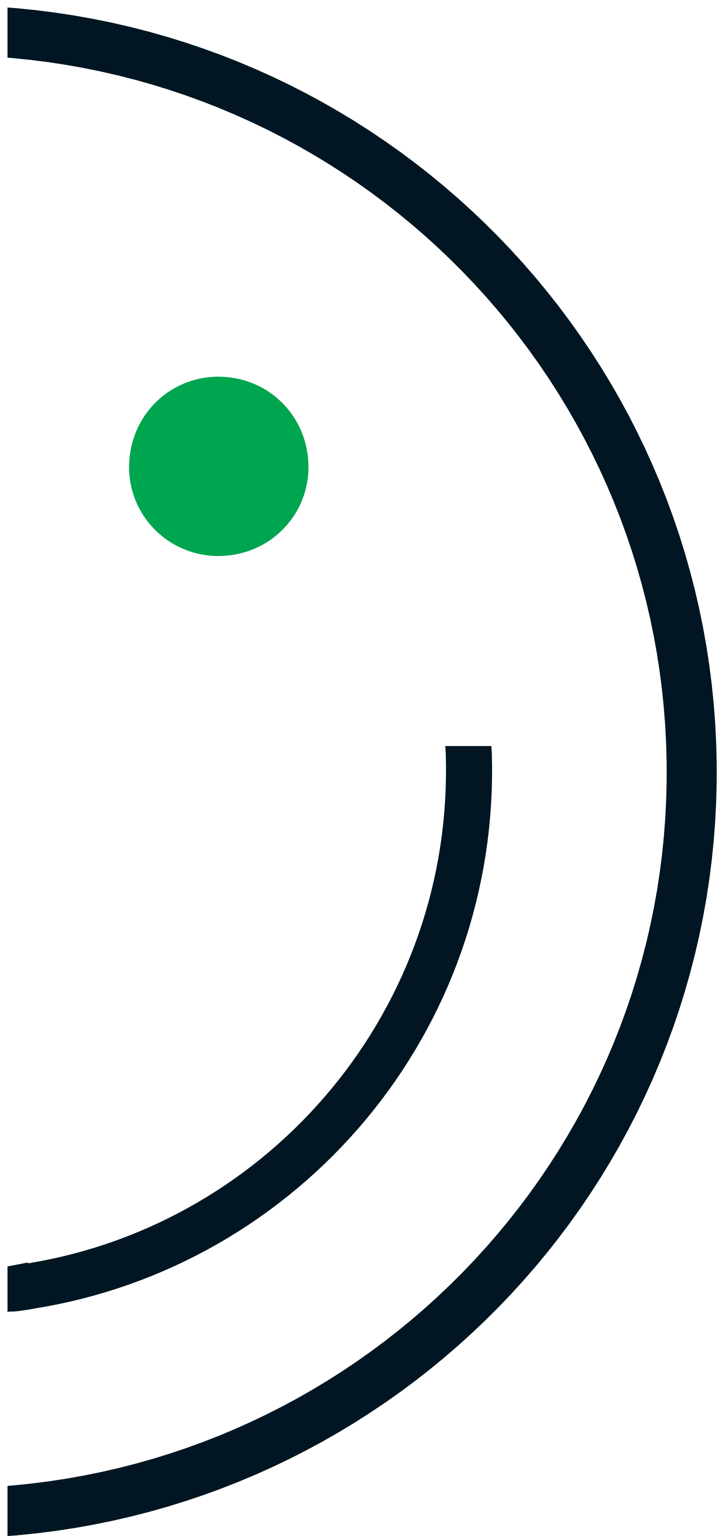
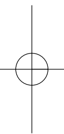
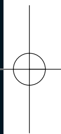


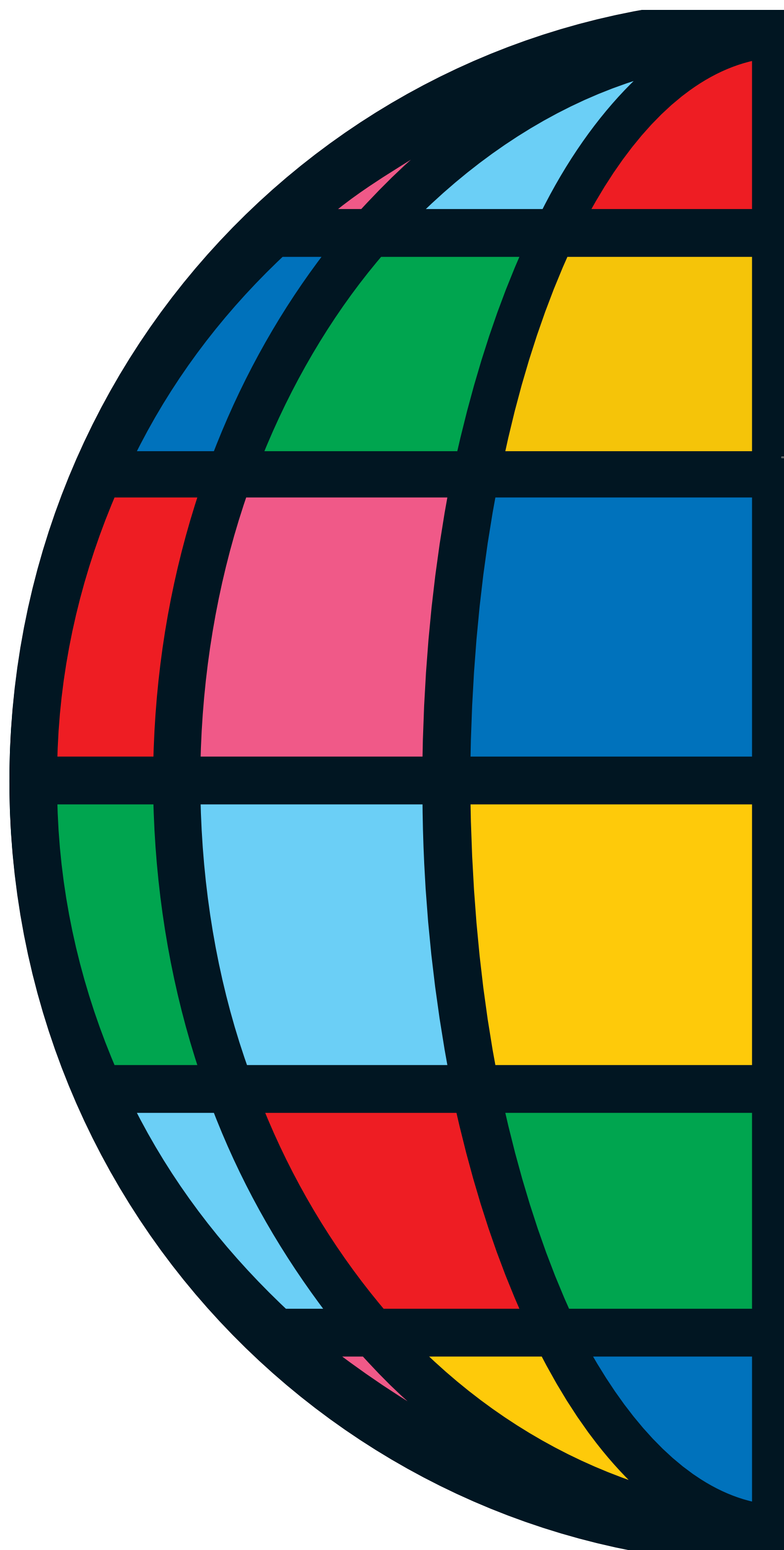


Report of the Technical Group on Innovative Financing Mechanisms

September 2004







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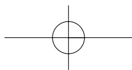

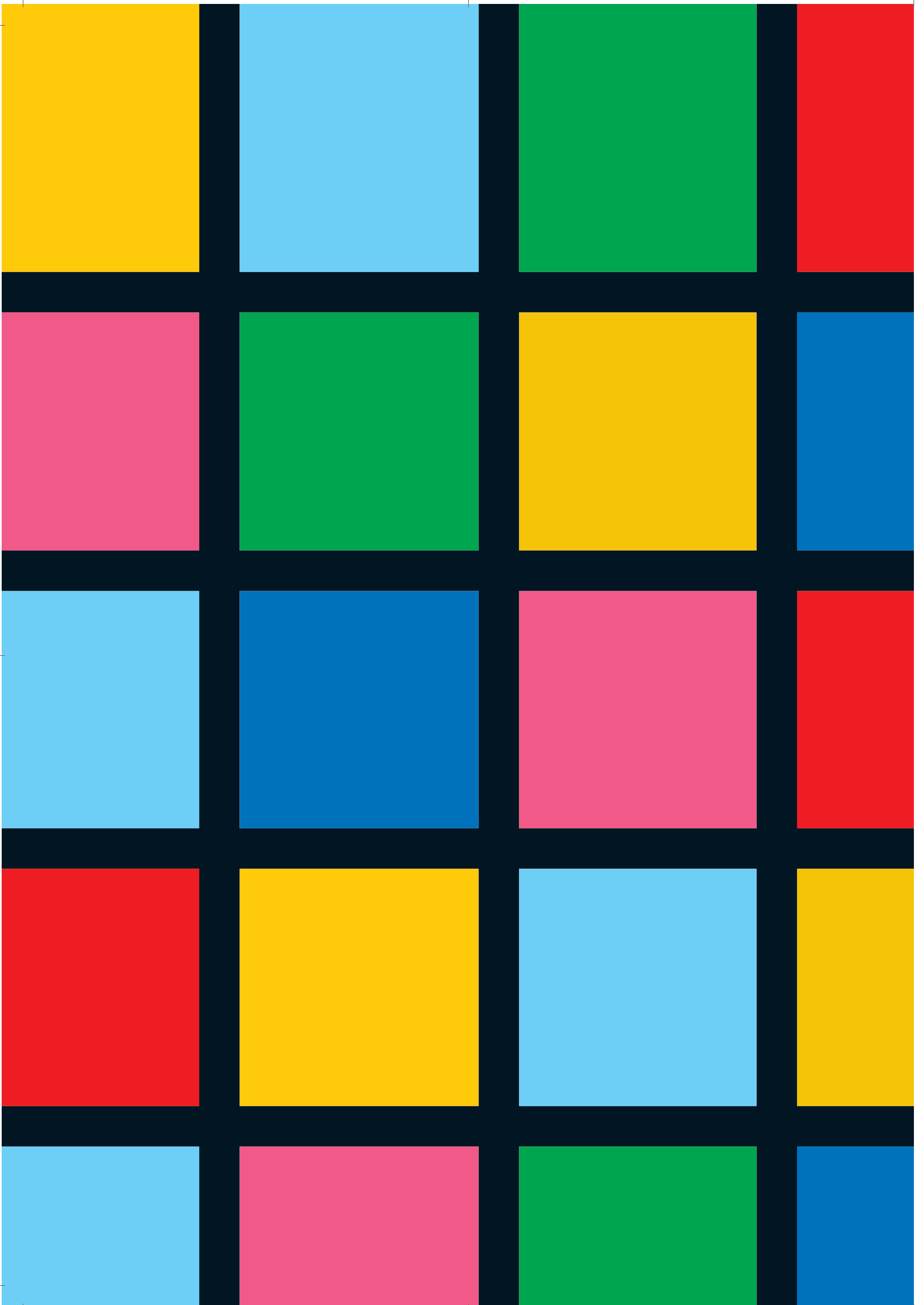

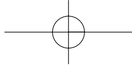

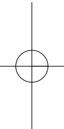

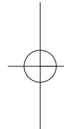

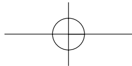

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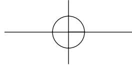

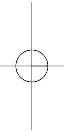

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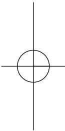

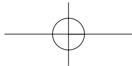

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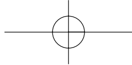

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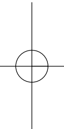

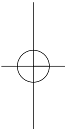

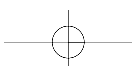

EXECUTIVE SUMMARY

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This report has been prepared by the Technical Group deriving from the 2004 Geneva Declaration, which was subscribed by the Presidents of Brazil, Chile, France and, more recently, Spain, with the support of the UN Secretary General.

The Geneva Declaration states that the fight against hunger and poverty and the promotion of development will not be accomplished unless the gap between political undertaking and development financing is urgently bridged. At the moment, the implementation of financial commitments assumed by all nations remains uneven and slow. On current trends, the agreed goals and target dates will simply not be met.

Consensus runs deep that current aid levels will not suffice to finance the Millennium Development Goals (MDGs). United Nations and World Bank estimates indicate the need to increase the amount of aid currently available by at least US$ 50 billion per year until 2015.

In this perspective, the Group has studied various proposals for innovative ways of financing development.

The Group builds on existing work on the subject, including current efforts led by the United Nations. At its 24th Special Session, the UN General Assembly requested the international community to "conduct a rigorous analysis of the advantages, disadvantages and other implications of proposals for developing new and innovative sources of funding, both public and private, for dedication to social development and poverty eradication".

Why may innovative ways be necessary?

Inflows of Official Development Assistance (ODA) play a valuable role in providing countries with the immediate resources needed to unleash economic growth with social development. Foreign aid can be a decisive factor in improving economic infrastructure as well as education and health indicators.

But ODA today may be in need of a new -supplementary- approach aiming both at increasing the amount of resources available and ensuring better predictability of aid flows. That has been recognized as a particularly important condition for maximizing the impact of ODA. Rapid variations

in the inflow of resources have a very negative incidence on the effectiveness of aid.

Existing sources of financing do not ensure predictability. Aid pledges depend upon internal budget decisions – which, in turn, are conditioned to changeable political circumstances. They lead to the suspension of projects that may never be resumed and may increase macroeconomic instability, especially when some expenses are made before resources are materialized.

The supply of more efficient, focused and predictable flows of aid capable of eradicating poverty in the world is truly a "public good" whose benefits would accrue to all nations. It will also help answering the much-debated question of absorption capacity: if aid were more stable, it could be absorbed and administered more effectively, and in larger amounts. Predictability should also contribute to transparency in the use of aid in recipient countries.

The Group has analyzed a panoply of mechanisms for increasing aid flows – ranging from instruments that would be relatively easier to implement, including voluntary donation schemes, to other tools that would request strong and concerted political action.

All of them have in common, however, the premise on economic rationality. They are technically possible to implement and have already been analyzed, in different degrees of detail, by renowned economists and scholars. They all share some basic principles. They are geared at supplying stable, predictable and substantial development assistance to poor countries. The idea is to make use of existing bilateral and multilateral channels for disbursement of resources. Funding should be made available preferably in the form of grants. Finally, resources raised should be managed in a transparent manner, so as to provide for adequate accountability of their use.

This report does not intend to present an exhaustive analysis of all possible mechanisms, nor to provide definite and prescriptive answers as to which of them should be adopted. It explores various options with their advantages and difficulties, in an attempt to demonstrate that there are indeed viable options to scale-up international action through innovative approaches in parallel to traditional ODA flows, with a view to allowing for a more balanced and inclusive globalization.

In so doing, Brazil, Chile, France and Spain welcome other countries, multilateral

organizations, and the civil society, in particular NGOs, business community, trade unions and academia, to join efforts to implement the proposals.

Taxation of Financial Transactions

Monetary and financial assets are traded in broad, deep and liquid markets, many of which operate across the globe. The resulting volumes are consequently significant, even when measured against the commonest macroeconomic aggregates. Very low rates of taxation could yield high revenues, provided they are levied in a relatively coordinated manner among the major financial centers. Those taxes are examined with the sole purpose of raising funds for development. The level of taxation should be therefore low in order to minimize market distortion and the risk of evasion.

The impact of a transaction tax on investment decisions would be probably negligible, in comparison with that stemming from other measures or prudential regulations surrounding the portfolio decisions of many financial intermediaries and institutions.

For many assets, there are already significant transaction costs compared to which a new, small increase in cost would probably have only a marginal impact. This is not the case in all markets, however, and any eventual taxation should therefore be considered with caution. Overall, a low rate of taxation on financial transactions could prove far less distorting than a higher rate of taxation applied to smaller tax bases.

The report concludes that a tax on foreign exchange transactions is technically feasible on a global level. It recommends that such a tax should be levied at the payment/settlement stage both for practical reasons and to minimize the risk of evasion.

Market making activities would have to be exempted. A tax would cause these activities to be in a state of permanent loss, which could lead either to further concentration among a very

small number of major players, or to the complete demise of these activities, with the market adopting a different model of centralized price quotation. From the point of view of market efficiency and stability, the effect is uncertain. From the point of view of the tax, a sizable fraction of the tax base would definitely disappear.

There is a risk of over taxation of some specific financial instruments (swaps, options). In theory, the tax could be circumvented by the use of derivative products or by swapping liquid securities denominated in two currencies, in place of the currencies themselves. However, these operations are more expensive and riskier than the straight transaction and would probably not be worthwhile if the tax rate were sufficiently low.

Taxation of the Arms Trade

The main rationale for such a taxation is that arms expenditures divert substantive financial, material and human resources that could be otherwise invested in social programs. Taxation would help raising funds to social-oriented projects and could lead to a reduction in acquisitions at least for some categories of weapons. It would also bring greater transparency and accountability in the arms trade, thus contributing to confidence and security building both at regional and international levels.

When devising the tax one should bear in mind that countries, including developing countries, have a right to defend themselves, wheter they do produce or not the weapons they need. Also, the arms trade is both very competitive and highly concentrated, on the producer side. Universal participation is therefore a necessary condition.

For those reasons it is proposed the tax should be levied on all, new or used, heavy conventional weapon transactions, including purchases and donations, whether international or

domestic. The tax levied on domestic transactions could be seen as a contribution to development financing made by arm producers, in direct proportion of their military equipment budget. This would send an important symbolic and political signal to the international development community.

For practical reasons, taxation should start with the seven categories of heavy conventional arms covered by the United Nations Arms Register. At the same time, full support should be given to the work that is being developed in the framework of the United Nations to conclude an international instrument on monitoring and marking of small arms and light weapons.

The greatest challenge is enforcement. Clarification and consultation provisions would need to be foreseen, both in order to check the accuracy of national declarations and as a deterrent to tax evasion. But attention should be also paid to issues such as the scope for the tax (components, technology transfers, immaterial goods, non commercial transactions).

International Financial Facility

The International Financial Facility (IFF) is a development financing mechanism proposed by the UK Government. Its objective is to allow for the frontloading of aid disbursements. It is based on an indebtedness scheme through which participating States securitize their increases in future ODA on the bond markets.

The main and strongest advantage of the IFF is that it does not require universality of participation and thus can be more easily implemented in the short term. It can be established on a regional basis or by a group of countries, since it does not immediately weigh on the economy and hence does not create problems of competitiveness for the contributing countries.

It would generate resources in a stable and predictable manner, the rate of disbursement being disconnected from that of contributions.

Careful attention must be given to the way commitments and the related bond placements are to be considered in national fiscal accounts, so as to forestall the possibility that they would be registered as government liability in domestic accounts and thus result in higher debt to GDP ratios in donor countries. Also, the IFF's governance structure still has to be drafted. It is important to ensure that new organizational costs be the lowest possible, so as not to erode political support for the Facility.

It is not clear whether middle-income countries affected by hunger and poverty problems would also be entitled to benefit from the mechanism. It would be interesting to analyze the possibility of taking into account not only aggregate national statistics, but also regional indicators among the IFF´s eligibility criteria for the destination of resources, thereby not excluding some middle-income countries from the mechanism's scope of application.

As with all borrowing, the IFF transfers the burden of repayment onto future generations and therefore creates a major question mark for the long term future. After 2015, a fraction of developed countries' ODA budgets will be absorbed by IFF repayments. At that point, this could lead to a sharp reduction in net flows toward poor countries. This is a real risk, especially for those countries in Sub-Saharan Africa which, even on strong assumptions for growth and increasing national tax revenues, will still be unable to shoulder the burden of public spending essential to human development. There should be a mechanism guaranteeing that after 2015 aid will still flow on an additional basis and in sufficient amounts to those countries.

The IFF constitutes a creative mechanism that could effectively address the urgent vital need for raising resources to the combat against poverty and hunger. The IFF also has significant complementary features with international taxation schemes outlined in this Report. The mechanism can be used jointly with other instruments when expenditures designed to benefit present and future generations are closely combined within a single program or action.

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SDRs for Financing Development

The idea of issuing new Special Drawing Rights (SDRs) for development purposes was first raised in the 1960's. More recently, the proposal loomed again in the context of international efforts to identify new sources of funding to meet the Millennium Development Goals. New allocations of SDRs would present more than one advantage. While incrementing the amount of resources currently available to the fight against hunger and poverty, new SDRs would significantly address financial volatility and imbalances and contribute to the creation of an international economic environment more conducive for development with social equity.

The IMF's Board of Governors approved a one-time allocation of SDRs in September 1997 through the proposed Fourth Amendment of the Articles of Agreement, the purpose of which is to enable all IMF members (including those who have joined after the date of the last allocation, in 1981) to participate in the SDR system on an equitable basis. The first challenge is therefore to galvanize political support to get the pending Fourth Amendment approved. Then, developed countries could agree to make available their share in this allocation, either to developing countries or to existing multilateral Funds.

The idea is that existing or future SDRs could be used for development purposes, thereby enhancing the efficiency and stability of the world economy.

SDRs could also be issued on a temporary basis during episodes of widespread financial stress and significant drop in commodity prices, and could be cancelled once financial conditions are normalised. Such an approach would provide for a useful counter-cyclical component in world liquidity management. It is known that developing countries, in general, continue to face the long-standing volatility of their export proceeds and private capital inflows. The systematic allocation of new SDRs could help and alleviate this volatility.

One could also consider the possibility of issuing new permanent SDRs, for instance, by an

amount equivalent to a fraction of the annual increase in the demand for international reserves.

Transfers of SDRs, however, raise the issue of interest charges due by recipients, which will have to be dealt with according to individual countries situations.

Tax Evasion and Tax Havens

Tax evasion is a phenomenon of great magnitude that impairs fiscal revenues of governments and is especially detrimental to the domestic efforts to increase tax revenue in developing countries. Tax evasion frequently involves offshore financial centers, as concealment seeks the protection of systems combining zero or low taxation with banking secrecy.

Further joint and concerted international action is necessary to reduce the erosion of national tax bases.

Reducing tax evasion and bringing more transparency to financial operations are international public goods, that additionally can contribute to increase financing to fight poverty and to enhance development. In all, it would increase world welfare.

Given its global nature, the issue of tax evasion must be dealt with in the context of strengthening international cooperation in tax matters. There must be no relaxation of efforts currently underway. If the expected results fail to materialize, States engaged in this process should consider taking coordinated defensive measures, particularly fiscal measures.

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Increasing Remittance's Benefits

Globalization is characterized by the existence of important international flows of workers. The decision to migrate frequently emerges from a family recognition of the need to obtain an additional source of income. Remittances tend to be much less pro-cyclical than other flows, thus providing a more stable and predictable source of financing. They are normally spent in common expenses such as food, housing and utilities, and therefore represent an alternative safety net in developing countries.

The cost of sending remittances should be reduced. Therefore, the first and foremost measure would be for developed countries to facilitate foreign workers' access to financial institutions at an affordable cost. At the same time, the financial systems of many developing countries do not generally reach the majority of their populations. Assistance should be given to developing countries, when needed, to spread the base of the financial sector in order to efficiently channel these flows towards productive activities, including the access to microfinance by families of recipients.

Voluntary Contributions through Credit Cards

Voluntary contributions are also an important dimension of the effort to raise new resources to financing the fight against hunger and poverty. Credit card-based donations, in particular, have already been in place in many parts of the world. The launching of an affinity card identified with the implementation of the Millennium Development Goals could build on existing successful experiences involving banks, credit card companies and individuals.

As with other affinity cards available in many countries, clients would simply agree to

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donate a small percentage of the value of their purchases to the worldwide campaign against hunger and poverty. In addition to contributions focused on individuals, options involving a joint voluntary effort by credit card holders and the major credit card companies and associated banks also deserve consideration. Some of these companies and/or banks could indeed agree to donate a very small percentage of their earnings with annual fees, interests etc. of their contributing clients.

Since it involves the coordination among a relatively small number of actors and builds on existing experiences, the initiative could be implemented in the short run. Benefits would stem not only from the amount of resources raised, but also from the increased publicity of the Millennium Development Goals among consumers and private companies from all parts of the world.

Socially Responsible Investing or "Ethical Funds"

Socially Responsible Investing (SRI) refers to investment decision-making processes that combine the social and environmental dimensions of investments with rigorous financial analysis. Over the past two decades, concerns about global warming, human rights and labor standards have been at the forefront of socially responsible investing. More recently, an important initiative was launched by United Nations Secretary General Kofi Annan – the "UN Global Compact" – congregating today more than 1600 companies from all regions of the world which have agreed to follow a set of common principles on labor standards, environment protection and human rights. SRI encompasses three main investing strategies: shareholder advocacy/activism, community investing and portfolio screening.

The bulk of SRI strategies refers to portfolio screening, i.e., the practice of including or excluding publicly traded securities from investment portfolio or mutual funds according to certain

social or environmental criteria. For instance, investors who stick to positive screening tend to channel their money to companies that follow above average records in terms of pre-established values – like better employer-employee relations, social policies or the safety and social usefulness of their products.

Funds oriented to social values – the so-called “ethical funds” – are becoming very popular among investors. Estimates show that SRI funds have reached the impressive figure of US$ 5.9 trillion all over the world.

However, the fight against poverty and hunger has not so far been explicitly taken as a SRI screen. The constitution of portfolios of securities of companies from different parts of the world that are committed to allocate resources to fighting hunger and poverty in developing countries should be encouraged. Such funds could yield good financial performance while providing an incentive for companies to invest more systematically in social programs for hunger and poverty eradication.

The mechanism would build on existing successful experiences, all of which based on voluntary participation. The initiative is expected to request relatively low administrative costs and relatively low international coordination efforts.

Final Remarks

The list of innovative mechanisms examined in this Report is neither exhaustive, nor prescriptive. The Group kept an open mind with regard to other suggestions analyzed elsewhere. The Group acknowledges that there are political constraints for the adoption of new mechanisms. There is no intention of proposing such mechanisms as the ultimate solution to development financing, in substitution for traditional forms of official assistance, debt relief or trade-related measures that would help promote growth in developing countries.

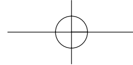
The mechanisms analyzed in this Report are not conceived simply as a provisional measure to address urgent needs of developing countries. Rather, they are designed as means of providing for a predictable and continuous flow of resources over time, so that recipient nations could succeed in the pursuit of long-term development in a more efficient manner.

With regard to modalities of participation, it should be borne in mind that some mechanisms would be compatible with "flexible geometry" coalitions, by bringing together groups of interested parties. Nonetheless, with respect to taxation schemes, the widest possible participation, including by all key players, often seems to be necessary. Although this requirement may represent a serious obstacle to their entry into force, taxation mechanisms would still be worth pursuing. By providing for resources in a stable and predictable manner, taxation schemes would efficiently complement ODA, which suffers from ineffective fluctuation in its level due to donors' domestic budget contingencies. Taxation mechanisms could complement other mechanisms, by offering the possibility of combining different modalities of financing devoted to more immediate, urgent measures and to long-term, structural projects.

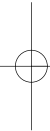
It is crucial that resources raised through innovative mechanisms are truly additional, and do not crowd out current ODA flows. The channeling and use of the resources levied through these innovative mechanisms will be guided by the following general principles: efficiency, accountability, and transparency.

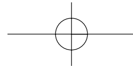
The mechanisms examined should be seen within different timeframes of maturity. In fact, some of the instruments examined would be ripe for adoption in the short term, either because they have sufficient critical mass and in-built financial engineering, or by virtue of their apparently simple conceptualization and implementation, or yet by the fact that they would be based on national successful stories.

We must recognize that it is time to consider the subject of alternative sources of financing as a top priority. The international community cannot afford a wait-and-see attitude. Each year lost represents an increase in resources needed in the run-up to 2015. Let us not waste further time.



INTRODUCTION





Background

The fight against poverty and hunger is not a new issue in the international agenda.

With progress and all the achievements and promises of globalization came a new moral consciousness that it is simply unacceptable to continue to live in a planet where over one billion people cannot enjoy minimally decent life standards.

There is no rational justification for the persistence of hunger and poverty, which claims a severe human toll and puts entire nations and future generations at risk. Hunger and poverty entail the spread of diseases worldwide, contribute to environmental degradation, cause massive displacements of people, exacerbate tensions, prompt arms expenditures, fuel political instability, disrupt trade and investment flows and shrink the potential of markets.

We have witnessed over the last years a change of perceptions, which was reflected in a succession of high-level events purported to draw attention to this cause. The 1996 World Food Summit highlighted the importance of an enabling political, social and economic environment designed to create the conditions to free the world from poverty and hunger.

Four years later, the international community subscribed to the concrete goals and timeframes set by the Millennium Declaration concerning the promotion of development and the fight against poverty and hunger in the world. Governments also committed themselves to promote universal primary education, foster gender equality, combat the spread of diseases, ensure environmental sustainability, among other targets. In particular, governments promised to "spare no efforts to free our fellow men, women and children from the abject and dehumanizing condition of extreme poverty".

In line with the Millennium Declaration, the 2002 International Conference on Financing for Development, held in Monterrey, emphasized the need to build a true partnership for achieving the Millennium Development Goals (MDGs). Developed countries, in particular, were called upon to

support efforts by the developing world, especially by providing increased aid flows, investment, debt relief and open access to their markets.

The 2002 Johannesburg Summit on Sustainable Development reinforced the objective of conceiving "a world free of the indignity and indecency occasioned by poverty, environmental degradation and patterns of unsustainable development". The Johannesburg Plan of Implementation stated that although each country has the primary responsibility for its own sustainable development and poverty eradication, "concerted and concrete measures" should be taken at all levels to help efforts by developing countries.

The fact that the fight against poverty and hunger and the promotion of development were prominent in successive high-level events is in itself indicative of a shared recognition of the imperative to rid the world of the egregious conditions of extreme poverty.

However, the implementation of these commitments assumed by all nations remains uneven and slow. On current trends, the agreed goals and target dates will simply not be met. The pledges are on the table, but the necessary resources are not.

In the period between 1999 and 2001, 842 million people suffered from undernourishment – 798 million of which living in developing countries. Although low-income countries are primarily affected by extreme poverty, middle-income countries host 280 million people living on less than one dollar per day and 870 million living on less than two dollars per day. Compared to the period 1990-92, the number of people suffering from under nutrition fell by only 19 million. If current trends are allowed to persist, 600 million human beings will remain deprived of the most elementary conditions of food security in the developing world by 2015.

The Geneva Declaration – Political Undertaking and Development Financing

The fight against hunger and poverty and the promotion of development will not be accomplished unless the gap between political undertaking and development financing is urgently

bridged. That was precisely the reason why the Presidents of Brazil, Chile, France and, more recently, Spain subscribed to the 2004 Geneva Declaration, with the support of the UN Secretary General.

The Declaration led to the establishment of the present Technical Group with the mandate of exploring innovative financing mechanisms. The objective is to muster political support in an attempt to translate the worldwide consensus on the urgent need to eradicate poverty and foster development into concrete, viable and focused actions. Strong political support for such an initiative could motivate further analysis of new financial mechanisms, with a view to their effective implementation in the short, medium or long terms, according to their different political, economic and technical requirements.

The Group builds on existing work on the subject, including current efforts led by the United Nations. At its 24th Special Session, the UN General Assembly requested the international community to "conduct a rigorous analysis of the advantages, disadvantages and other implications of proposals for developing new and innovative sources of funding, both public and private, for dedication to social development and poverty eradication".

The present report is thus a contribution to an ongoing process, which is part of a renewed effort to galvanize global attention to the imperative of ridding the world of hunger and poverty.

Is Poverty an Impediment to Growth?

Mobilizing countries around the world on such an initiative aimed at identifying new mechanisms to reduce poverty and promote development is a challenging but rewarding task.

Economic growth is critical for lifting people out of poverty. It is, in fact, known that the incidence of poverty – as well as its depth – tends to decrease as economic growth provides people with more job opportunities and better welfare distribution. Experience has shown that countries which have succeeded in tackling poverty have enjoyed higher economic growth rates. However, many countries continue to face structural deficiencies that hamper the normal pace of economic activity.

Developing countries altogether grew by only 1.6% from 2001 to 2003. Latin American countries experienced a 1% fall in their GDP per capita. In Sub-Saharan Africa, the number of poor people has increased from 164 million to 314 million since 1981. Those figures clearly show that a systematic assault on poverty requires strong determination. Estimates indicate that, in order to achieve the MDGs, it would be necessary to have economic growth of at least 3% per year per capita until 2015.

Most of these countries lack adequate infrastructure and human development levels that could pave the ground for steady economic development. In particular, widespread hunger hinders the economic performance of individuals and dramatically reduces their ability to work. Market forces are often unable to foster the eradication of hunger simply because many of the poorest people live beyond the reach of the markets.

It is also clear that hunger, which is both a consequence and a cause of poverty, will not be resolved unless its structural aspects, domestic and external, are genuinely addressed. Investments in health, education, sanitation are desperately needed, as is the expansion of markets and a balanced world trading and financial system, capable of offering opportunities of wealth creation and distribution to all countries participating in it.

Is the Official Development Assistance (ODA) in Need of a New Approach?

Inflows of ODA play a valuable role in providing countries with the immediate resources needed to unleash economic growth with social development. Foreign aid can be a decisive factor in improving economic infrastructure as well as education and health indicators. Its impact is dependant on many factors, among which predictability of flows has been recognized as particularly important. In countries with sound domestic policies, aid flows tend to attract private investment by a ratio of almost US$ 2 to every US$ 1 of aid.

In a sense, it is encouraging to notice that aid flows have been increasing over the past few

years. Nevertheless, the commitments reaffirmed in Monterrey to raise ODA to 0.7% of donors' GDP are not, with a few exceptions, being fully observed.

Consensus runs deep that current aid levels will not suffice to finance the MDGs. United Nations and World Bank estimates indicate the need to increase the amount of aid currently available by at least US$ 50 billion per year until 2015.

Not only are aid levels insufficient, but its effectiveness should be improved. It must be acknowledged, in particular, that ODA figures cover a wide range of developmental expenditures, including debt relief (which accounts for a significant part of recent increases of aid) and administrative costs of donor agencies (which claimed US$ 3 billion in 2002). Only 1/3 of bilateral ODA is actually channeled to programs and project expenditures in benefiting countries. Aid pledges depend upon internal budget decisions – which, in turn, are conditioned to changeable political circumstances. Rapid variations in the inflow of resources have a very negative implication on the effectiveness of aid. They lead to the suspension of projects that may never be resumed, and increase macroeconomic instability, especially when some expenses are made before resources are materialized.

The international community is undergoing various efforts to improve existing aid channels. The need to harmonize donor policies and practices and to combine foreign aid with country-owned development strategies in a more direct and coordinated manner has been widely acknowledged. Aid institutions are intensively working on these issues. These initiatives are aimed at providing greater efficiency in foreign aid.

The supply of more efficient, focused and predictable flows of aid capable of eradicating poverty and promoting growth in the world is truly a "public good" whose benefits would accrue to all nations. As developing countries succeed in achieving higher economic growth rates, they start participating in the global economy in a more active and integrated manner. Donor countries, on their part, could also profit from enlarged markets, new investment opportunities, and business with new trade partners.

Predictable aid flows will also help answering the debated question of absorption capacity: if aid flows were more stable, they could be absorbed and administered more effectively, and in larger amounts. Predictability should also contribute to transparency in the use of aid in recipient countries.

This advocates for the need of a cooperation framework capable of promoting social development and assuring that the gains of globalization are shared by all participants.

Notwithstanding the need to fulfill commitments assumed in terms of raising foreign aid levels, the creation of new mechanisms for financing development and combating poverty could help overcome the under-provision of aid flows to the developing world, in a stable and predictable manner, thereby compensating for current ODA shortcomings.

The New Mechanisms and the Technical Group's Work

The Group has analyzed a panoply of mechanisms for increasing aid flows – ranging from instruments that would be relatively easier to implement, including voluntary donation schemes, to other tools that would request strong and concerted political action.

Many of the proposed mechanisms would indeed require strong political arrangements. Difficulties stem mostly from the fact that countries traditionally cherish the prerogatives of autonomy in fiscal affairs and see with great concern the possibility of engaging in a process of international coordination in this field.

Mechanisms also differ significantly in terms of their functioning – varying from simple donation arrangements through credit cards to complex financial or taxation instruments. Some are envisaged as compulsory, others as voluntary. Some could be more properly described not as mechanisms requiring some sort of international agreement or arrangement, but rather as guidelines for coordinated political action, either to increase international controls, e.g., on financial flows to tax havens, given their negative impact on developing countries, or, on the positive side, to promote socially responsible investments.

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All of them have in common, however, the premise on economic rationality. They are technically possible to implement and have already been analyzed, in different degrees of detail, by renowned economists and scholars. They all share some basic principles.

First, all mechanisms are conceived as a means of incrementing existing flows of aid, rather than providing a substitute for them. It would make no sense to engage the international community on an initiative that, in the end, would lead to the decrease of ODA levels. It is based on the assumption that the resources to be raised would be indeed new and additional to those already committed at the Monterrey and Johannesburg Conferences. It is also based on the premise that innovative financial mechanisms in ODA should not be a replacement to a free and equitable multilateral trading system, which plays a prominent role in fighting hunger and poverty and fostering development.

Second, instruments are geared at supplying stable, predictable and substantial development assistance to developing countries, given the perception that interruption in aid flows strongly reduces their effectiveness. Tackling poverty and promoting economic development must be envisaged as a long-term process, which requires continuous and systematic inflows of aid to assure that projects in various fields – health, education, sanitation, among others – will be integrally accomplished and entail positive outcomes to all.

Third, the idea is to make use of existing bilateral and multilateral channels for disbursement of resources. The Group recognizes the convenience of avoiding, as much as possible, the creation of new bureaucracies and the consequent rise in administrative costs.

Fourth, funding should be made available preferably in the form of grants, since many developing nations have adhered to severe fiscal adjustment programs in order to cope with public indebtedness, tame inflationary pressures, seeking to set the basic economic conditions for growth.

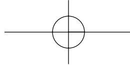
Fifth, resources raised should be managed in a transparent manner, so as to provide for adequate accountability of their use. Since many mechanisms involve strong political and coordinated action, transparency and accountability would be highly important in order to maintain high levels

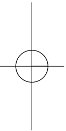
of political domestic support for them over the long run.

Last, but not least, although the search for new financing mechanisms has been driven by a sense of urgency in the face of the dire threats posed by poverty and hunger in the world, the instruments analyzed in this Report are not envisaged as a mere stop-gap measure aimed at providing immediate relief to needy people. Rather, the objective is to mobilize a substantial amount of resources capable of eradicating hunger in the world, by addressing its root causes and structural factors, and providing developing countries with the basic conditions for them to embark on a process of sustained long-term development.

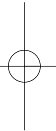
This report does not intend to present an exhaustive analysis of all possible mechanisms, nor to provide definite and prescriptive answers as to which of them should be adopted. It envisages to build on other reflections about innovative financial mechanisms and to analyze their advantages, obstacles and challenges, in an attempt to demonstrate that there are indeed viable options to scale-up international action through innovative approaches in parallel to traditional ODA flows, with a view to allowing for a more balanced and inclusive globalization.

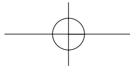
In so doing, Brazil, Chile, France and Spain welcome other countries, multilateral organizations, and the civil society, in particular NGOs, business community, trade unions and the academia, to join efforts to implement the proposals presented in this report. The greater the momentum generated at the highest level, the better the prospects that the September 2005 UN major summit on the implementation of the MDGs will be a successful and result-oriented event.





MANDATORY MECHANISMS





Taxation of Financial Transactions

Introduction

Monetary and financial assets are traded in broad, deep and liquid markets, many of which operate across the globe. The resulting volumes are consequently significant, even when measured against the commonest macroeconomic aggregates.

National and international financial transactions (foreign exchange and securities) hence represent an attractive and highly dynamic tax base. Because these activities are highly competitive and, in some cases, very homogeneous, they form an exceptionally mobile tax base.

Advantages

Very low rates of taxation could yield high revenues, provided they are levied in a relatively coordinated manner among the major financial centers. Moreover, these taxes can help to correct negative externalities if they serve to eliminate transactions deemed not to be useful, or to be harmful, from the standpoint of market efficiency, in the sense of generating excessive price volatility.

The impact of a transactions tax on investment decisions would be probably negligible, in comparison with that of other measures or with that of the prudential regulations surrounding the portfolio decisions of many financial intermediaries and institutions.

For many assets, there are already significant transaction costs compared to which a new, small increase in cost would probably have only a marginal impact. This is not the case in all markets, however, and any eventual taxation should therefore be considered with caution.

Overall, a low rate of taxation on financial transactions could prove far less distorting than a higher rate of taxation applied to smaller tax bases.

Foreign exchange transactions are a special case. Foreign exchange transactions totaled US$ 1,174 billion daily in 2001. The bulk of these transactions involved the main currencies of developed countries (30% euro/dollar, 20% dollar/yen, and 11% dollar/sterling).

One possible objective of a tax on these transactions would be to combat speculation and help to stabilize exchange rates. This objective is not under discussion here. The sole purpose of the tax in question is to raise funds for development, without affecting market efficiency. The level of taxation should therefore be low (around 0.01%) in order to minimize effects on the market and the risk of evasion.

A tax on foreign exchange transactions is technically feasible on a global level. The tax can be levied either on the trading of the transaction, or on settlements to which it gives rise in the payment systems of the currencies traded.

In either case, the transaction would have to be declared. Contrary to what is sometimes supposed, payment systems (with the exception of the Continuous Linked System – CLS, which accounts for approximately 30% of transaction volumes) are not specific to foreign exchange systems, and therefore do not identify the nature of the operations passing through them.

If the tax is levied on the trading of the transaction, there would be a possibility that the back offices move to off-shore jurisdictions. This is less likely to be the case if the tax were levied on front offices (traders), since they benefit, to a greater extent than back offices, from positive externalities in the places where they are presently settled (qualified workforce, access to information, etc).

If the tax is levied on the settlement of the transaction, the risk of evasion is lower. Settlement systems operate with very large-scale infrastructures and require a very secure legal framework. In addition, these systems require access to central bank money and hence to an account with central banks in order to clear the balance on their transactions. Delocalization to “exotic” financial centers is therefore impossible.

Obstacles and Challenges

Taxes on financial transactions are frequently criticized from the standpoint of economic efficiency. It is argued that they raise the costs and reduce the volume of transactions; they artificially modify investors' time horizons at the expense of the short term; they reduce market liquidity and may thus indirectly contribute to increased volatility; they are by nature subject to cascade phenomena. Their real impact is unknown and unpredictable, and may greatly exceed their theoretical rate. Their incidence is, to a large extent, arbitrary and there is a high risk of double taxation (notably with regard to transactions conducted through intermediaries or undertakings for collective investment).

These arguments have greatly contributed to the disfavor with which some economists currently view these taxes.

However, financial assets are already subject to considerable fiscal distortions notably due to the profusion of preferential regimes, to the differential treatment of income and capital gains or losses and to the difficulty of applying this treatment to derivative products (where the distinction between income and capital is blurred); in addition, there are difficulties related to our knowledge of income and stocks of assets held, along with the possibilities of evasion stemming from the increasingly international nature of markets.

Taxation of foreign exchange transactions on a non-worldwide basis would raise many difficulties and would not be advisable.

If the tax is levied at the place of trade, the risks of delocalization are higher if compared to risks associated to a global tax. Even the front offices would be inclined to move away from the tax zone. The foreign exchange market is indeed very concentrated (20 banks representing more than 75 % of the transactions in the United States, the United Kingdom and France) and proximity with the final customer does not matter in the wholesale market.

If this tax is levied at the place of settlement, then there is a very high risk of delocalization

if the main financial centers do not participate. Settlement systems may execute internal clearing transactions outside the taxation zone and settle only net positions in the central bank money. The tax base will then represent only a limited part of the total amount of transactions (for instance, in the CLS system, the daily net settlements represent only 5 % of the wholesale amount of transactions).

Central banks could theoretically thwart this evasion by refusing to open accounts for settlement systems located outside the taxation zone. But this would encourage banks to develop settlement systems requiring less central bank money, which would ultimately diminish the efficiency of monetary policy, which is not advisable.

It would be preferable to exempt market making activities. Banks conduct two types of transactions in the markets, namely transactions on their own account, which are not different from those of other operators, and market making transactions. In the latter, they continuously swap foreign exchange positions in order to balance their net position at a level compatible with the degree of risk they are authorized to accept (which is subject to strict supervision). These are practically zero-cost operations, with estimated daily profits of less than 0.01% of the volumes exchanged.

A tax would cause these activities to be in a state of permanent loss, which could lead either to further concentration among a very small number of major players, or to the complete demise of these activities, with the market adopting a different model of centralized price quotation. From the point of view of market efficiency and stability, the effect is uncertain. From the point of view of the tax, a sizable fraction of the tax base would definitely disappear.

These two considerations argue in favor of the exemption of market making activities. There is no certainty that it would be possible, legally and functionally, to distinguish between a market making transaction and banks' own transactions within the money market. This is a matter for experts to consider. The solution to this problem should not introduce distortions between different categories of transactions and among participants in the market. This may require a

proper adjustment of the tax base.

There is a risk of over-taxation of certain financial instruments. Swaps and options transactions may find themselves taxed several times over.

A swap transaction combines a spot (short leg) transaction with a forward (long leg) transaction. These transactions account for nearly half of daily foreign exchange operations. They would be taxed twice, which perhaps represents an unwarranted penalization since for the most part these are operations designed to optimize cash balances across an array of currencies.

Over-taxation would be further amplified in the case of options, even if the amounts involved are smaller. For the seller of a currency option, managing it over its lifetime implies a continuous stream of spot transactions on a fraction of the underlying amount.

A variety of risks of technical evasion needs to be taken into account. The tax can be circumvented by:

- The use of derivative products, for example by synthetically reconstituting a spot currency position by combining a loan and two options transactions (a call and a put).
- By swapping liquid securities denominated in two currencies, in place of the currencies themselves.

However, these operations are more expensive and riskier than the straight transaction and would probably not be worthwhile if the tax rate were set sufficiently low.

The tax would probably fall entirely on end-customers, i.e. corporations with international operations and fund and asset managers engaged in reallocating portfolios internationally (including the hedge funds, which can play an important role in the foreign exchange markets in certain periods). It would also affect international portfolio diversification, with little economic justification. However, a very low rate would have a negligible effect if the qualifications posed above are taken care of.

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Conclusion

Despite the aforementioned obstacles, the proposal to levy a tax on financial transactions at a very low rate would lead to the collection, on a stable and predictable basis, of a significant amount of resources for development while not interfering with the normal functioning of the market.

Taxation of the Arms Trade

Introduction

At the 2003 G-8 enlarged dialogue in Evian, President Luiz Inácio Lula da Silva, of Brazil, proposed a tax on the arms trade as a possible means to raise funds for hunger and poverty eradication. Such taxation, he argued, would entail benefits from both an economic and ethical point of view.

Advantages

The benefits to which President Lula referred can be grasped intuitively. Although there is a long-standing academic debate regarding the alleged positive economic spin-offs of defense expenditure, there can be no doubt that arms expenditures divert substantive financial, material and human resources that could be otherwise invested in social programs. Consequently, in many countries the question of defense versus social expenditures is a recurrent topic of discussion.

According to the Stockholm International Peace Research Institute (SIPRI) 2004 Report, over the last two years there has been a stark rise in world military spending, which has increased by 18% in real terms and approached the figure of 1 trillion dollars a year. The same Report points

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out that the combined military spending of high-income countries was higher than the aggregate foreign debt of all low-income countries and 10 times higher than their combined levels of official development assistance (ODA) in 2001.

In this prospect, taxation would yield the following benefits:

- It would help raising funds to social-oriented projects and, at the same time, creating disincentives to a trade that is not, at least directly, related to social ends.
- Supposing there is price elasticity for certain categories of weapons, the consequent increase in prices (as producers and exporters would tend to transfer the tax cost to importers and buyers) could lead to a reduction in acquisitions. However, for national security reasons, government spending on goods such as arms might not be significantly diminished. Still, assuming that, in certain circumstances or for certain categories of weapons, there would be some price elasticity, taxation could lead to a reduction in consumption, especially on the part of developing countries situated in regions of low or non-existent political and military tension; it might however also make it even more difficult for the poorest States to buy the minimum quantity of weapons necessary to defend themselves. It might also result in a new balance between equipment and operating spending, within a given and unchanged defense budget. Of course, this would result in a decrease of funds raised for development through taxation. Yet it would be for a good reason.
- Higher prices in arms could give further impetus in some countries to the debate on budget allocation (social programs versus defense programs).
- Taxation can also lead to greater transparency and accountability in the arms trade. The very implementation of a taxation mechanism would require the provision and processing of data, by means of a standardized system of national declarations on exports, imports and national procurement.
- Current international calls on the need to control destabilizing transfers to countries in

conflict, in particular those under UN Security Council arms embargoes, would be reinforced.

- Further data and controls on the arms trade would contribute to confidence and security building among States both at the regional and international levels.

Conditions and Principles

When devising a tax on arms, two paramount considerations should be borne in mind:

- Countries, including developing nations, have the right to defend themselves, whether they do produce or not the weapons they need. Taxation should not be deemed or devised in such a way as to discriminate between producers and non producers, thus creating an undue burden for developing countries whose geographical location put them in a difficult geopolitical environment.
- The arms trade is both very competitive and highly concentrated, on the producer side. Universal participation is therefore a necessary condition for the creation of the tax: otherwise, its only effect would be to encourage free riding and distort trade flows without any impact on the overall amount of arm purchases.

This leads to the two following propositions:

- The tax should be levied on all, new or used, heavy conventional weapon transactions, including purchases and donations, whether domestic or international. The part of the tax levied on domestic sales could, in fact, be seen as a contribution to development financing made by arm producers, in direct proportion of their military equipment budget. This would send an important symbolic and political signal to the international development community as it would really be, in this case, a world-wide tax on weapon equipment dedicated to fighting poverty.
- The tax should only be created when agreement by all producers of heavy conventional weapons has been achieved.

Functioning and Scope

It is worth recalling that we should distinguish among three basic categories: (1) large conventional weapons; (2) small arms and light weapons; and (3) dual-use equipment used in conventional arms or weapons of mass destruction, but also in high technology goods for peaceful purposes. One could be tempted to tax all three categories. However, there may be a need to weigh coverage against effectiveness.

At present, government control over the three categories is not equal. It is much less stringent with regard to small arms and light weapons than in relation to major conventional weapons or dual-use equipment. Estimates indicate the existence of some 600 million small arms and light weapons around the world, being produced by more than 1000 companies in at least 98 countries. Including such a vast universe of enterprises from the outset could overburden the mechanism. Moreover, if small arms and light weapons were to be taxed, the increase in prices would create further incentives to the booming illegal trade, which not only fuels international conflicts and civil wars, but also aggravates law and order enforcement problems faced by many countries.

In this regard, full support should be given to the work that is being developed in the framework of the United Nations to conclude an international instrument on the monitoring and marking of small arms and light weapons, according to the action plan adopted in July 2001 by the UN conference on illicit trafficking of small arms and light weapons.

To start with, the seven categories of heavy conventional arms covered by the United Nations Arms Register could be taken as a basis, namely, battle tanks, armored combat vehicles, large caliber artillery systems, combat aircraft, attack helicopters, warships (including submarines) as well as missiles and missile-launchers. Despite its limitations, the Register has the advantage of utilizing voluntary, official declarations by a considerable number of States (120 provided declarations in 2002, and 164 have done so since its inception in 1992). The last four years have witnessed a significant increase in participation. Incidentally, non-participating countries,

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especially in the developing world, could be encouraged to join, were the taxation mechanism to specify that access to development funds generated by the mechanism would be conditional upon participation. For practical purposes, one could think of a two-stage process, with small arms and light weapons being taken up at a later date, as the mechanism proves to be effective and credible, including in avoiding serious loopholes and tax evasion.

High rates would tend to encourage tax evasion and illegal trade, not to mention even stronger political opposition to the establishment of the mechanism on the part of reluctant governments and arms corporations. Low rates, in turn, would raise questions with respect to the cost effectiveness of the mechanism. It should be borne in mind that there will be a need to put in place a new, and perhaps costly, intergovernmental body to implement the mechanism and monitor compliance, in a reliable manner. Although it could still have a positive moral and political impact, a very low rate e.g. of 1% or less, might not be worth the effort, in terms of raising substantive resources for development goals – after deduction of administrative costs.

Obstacles and Challenges

Attention must be paid to the ultimate incidence of the tax and to the definition of reference values, since many transactions do not follow market prices – if indeed one can speak of market prices when values are agreed by the parties involved. Prices reflect several aspects, including technical specifications and singularities, which – for obvious reasons – cannot always be disclosed. Technical expertise will be required to establish parameters for calculating approximate figures. Much progress has been achieved over the years by respectable research institutes, such as SIPRI, in defining price indexes, purchase power parities and other criteria necessary for consistent methodologies. Although it is purely based on a collection of national declarations, without analysis, the UN standardized instrument for reporting military expenditures – in place since 1980 – could also be useful as a starting point.

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Transactions that do not involve arms systems per se, but rather components or technology for the production of arms under license in another country, will also have to be examined. For tax evasion purposes, some components or sub-systems of certain arms might not be declared as armaments, for example. Another difficult area for defining the value of transactions is the provision of immaterial goods, such as training or technical assistance, which can be part of a deal. Barters, offset arrangements, and other types of transactions would also raise difficulties in terms of values to be declared for taxation.

Non-commercial transactions, such as the ones deriving from military cooperation agreements and donations should not be overlooked. If left untaxed, there is a risk of a proliferation of tax evasion schemes under the guise of transactions of a non-commercial nature. Irrespective of the confidential nature of some of these arrangements, there are strong arguments in favor of taxing all such military cooperation transfers.

The greatest challenge, however, is enforcement. Clarification and consultation provisions would need to be foreseen, both in order to check the accuracy of national declarations and as a deterrent to tax evasion.

At the same time, we should be wary of proposing a burdensome and costly international implementation machinery. An overly ambitious structure could face serious political obstacles – given the large amount of resources required for its implementation – at the expense of the development financing goals invoked for its creation.

Conclusion

While the difficulties to be overcome cannot be underestimated, the possibilities opened up by a mechanism of this sort are well worth serious consideration on the part of the international community as a means of associating development and peace.

International Financial Facility

Introduction

The International Financial Facility (IFF) is a development financing mechanism proposed by the UK Government which would allow to frontload the disbursement of aid thanks to an indebtedness scheme guaranteed by participating States. It aims at doubling existing aid flows and enabling poor countries to achieve the Millennium Development Goals (MDGs) by 2015. The objective is to reach an increase in ODA by US$ 50 billion a year today to US$ 100 billion per year, starting with an additional US$ 15–16 billion a year, and rising by 4% per year in real terms until 2015.

The IFF is an attractive mechanism which provides a new source of stable and predictable financing for development. It also incorporates a trade-off between current and future generations, which has to be examined and dealt with.

Functioning and Scope

The IFF consists of securitizing pledged increases in future ODA through the bond markets. The IFF is a funding platform and performs a treasury function. It periodically collects formal and irrevocable multi-year commitments by member countries to make future contributions. The IFF would issue bonds whose repayment is guaranteed by those commitments. Disbursements to recipient countries are expected to occur up to the year 2015. After that date, IFF´s resources would be channeled for the repayment of bonds. The Facility would be extinguished by the year 2030.

The proceeds of these bonds would be devoted to development financing, mainly in the form of grants. Funds are to be “earmarked”, i.e., directed towards specific recipient countries,

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programs or projects, to be decided upon by donor countries, which would also be entitled to establish conditionalities for the disbursement of resources. Such conditionalities would have to be in accordance with a set of "overarching principles" governing aid policies under the IFF. Those principles might, for instance, include: (1) targeting at low-income countries; (2) assuring that funds are destined to poverty reduction programs or projects; (3) not tying funds to contracts with specific suppliers from donor countries; (4) providing funds through predictable multi-year programs lasting at least 3 years; (5) disbursing funds mainly in the form of grants, with some highly concessional loans; and (6) distributing resources equitably so that no more than 5% of the total amounts of finance raised through the IFF goes to any one country. Funds obtained through the IFF would be disbursed through existing bilateral and multilateral channels.

The whole mechanism is based on the assumption that the creditworthiness of donors, as well as the binding nature of commitments, allows the IFF to issue bonds with the highest rating in the market. The appropriate rating of IFF bonds is also to be guaranteed by the prudential leverage limitation to be observed – around 80% of the net present value of the long-term payment stream pledged by donors. By issuing IFF bonds in volumes of less than 100 percent of donor pledges, the IFF would have sufficient backing to cover risks of non-payment. Failure on the part of donor countries to make payments would be seen as sovereign default.

Advantages

The main and strongest advantage of the IFF is that it does not require universality of participation and thus it can be more easily implemented in the short term. It can be created on a regional basis or by a group of countries, since it does not immediately weigh on the economy and hence does not create problems of competitiveness for the contributing countries.

The mechanism would generate resources in a stable and predictable manner including for actions designed to meet urgent vital needs, the rate of disbursement being

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disconnected from that of contributions. That would stimulate the adoption of policies aimed at attaining sustainable growth and creating an appropriate environment for trade and investment in recipient countries.

Obstacles and Challenges

A first aspect that deserves careful attention refers to the way financial commitments and the related bond placements are to be considered in national fiscal accounts. It is imperative to forestall the possibility that they would be registered as government liability in domestic accounts and consequently result in higher debt to GDP ratios in donor countries – a possibility that would represent a major disincentive for potential donors to make commitments.

Secondly, as with all borrowing, the IFF transfers the burden of repayment onto future generations, with no guarantee as to the return of the investment concerned. A major question mark thus hangs over the long-term future. After 2015, a fraction of developed countries' ODA budgets would be absorbed by IFF repayments. At that point, this could lead to a sharp reduction in net flows toward poor countries. This is a real risk, should future budgetary pressures in countries – the ones with aging populations notably – prevail over the desire to reduce poverty abroad.

Hopefully, over the medium and long terms several countries that now receive aid will no longer need it, having reached a sufficient level of development. Others, clearly, will still be in need of help. That is certainly the case of many countries in Sub-Saharan Africa: even on strong assumptions for growth and increasing national tax revenues, these countries will still be unable to shoulder the burden of public spending essential to human development. There should be a mechanism guaranteeing that after 2015 aid will continue to flow on an additional basis and in sufficient amounts to those countries.

The IFF's governance structure still has to be drafted. It is important to ensure that new organizational costs be the lowest possible, so as not to erode political support for the Facility.

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Since the IFF involves binding commitments, it is necessary that some constituent treaty or arrangement be signed among donor countries. If in many countries the signature of such a treaty or arrangement requires congressional approval, the launching of the mechanism could be delayed, with serious implications for the MDGs´ 2015 target date. This could be circumvented if the IFF agreement allows for its launching irrespective of ratification by all signing countries, or it could specify a very low number of required ratifications.

According to the initial proposal by the UK, funds obtained through the IFF would be destined to low-income countries. It is not clear whether middle-income countries affected by hunger and poverty problems would also be entitled to benefit from the mechanism. It would be interesting to analyze the possibility of taking into account not only aggregate national statistics, but also regional indicators among the IFF´s eligibility criteria for the destination of resources, thereby not excluding some middle-income countries from the mechanism's scope of application.

With regard to the discretionary competence of donor countries to choose the recipient countries and the precise destination of resources, as well as to determine whether conditionalities are being fulfilled, there is always a risk of deviation from purely technical and development-oriented criteria to foreign policy or geopolitical interests. In order to minimize such a risk, the possibility of creating IFF´s own parameters for gauging compliance with conditionalities could be explored. Since existing multilateral instruments and bodies are also to be utilized, their governing bodies also have a pivotal role to play for the best possible allocation of resources.

As it is known, in most of the cases promoting development is not only a matter of providing financial resources. Adequate public policies are indispensable. In this regard, another idea worth exploring is to prioritize loans to countries with sound development and poor-friendly public policies. That would be an incentive for recipient countries to adopt such policies and create positive synergies.

Conclusion

The IFF constitutes a creative mechanism that could effectively address the urgent vital need for raising resources to the combat against poverty and hunger. Far from representing definite impediments to the launching of the Facility, the aforementioned questions and challenges must be seen as elements for further, in-depth discussions aimed at filling the gaps in the original UK proposal and contributing to increased international support to it.

It is also important to note that the IFF has significant complementary features with international taxation schemes outlined in this Report. Firstly, it can be used jointly with other instruments when expenditures designed to benefit present and future generations are closely combined within a single program or action. In healthcare, for example, certain expenditures, such as vaccination, prevention or education, are in fact an investment for the future, whereas others are more a question of immediate solidarity. It must be possible to find suitable funding for both.

Secondly, a fiscal-type resource may serve to secure or consolidate a more sophisticated package based on loans and guarantees. Finally, other instruments may complement the IFF over time. Tax resources would still be available in the long run, when the IFF disbursement period is over, thereby helping to address the question of post-2015 development financing.

SDRs for Financing Development

Introduction

Special Drawing Rights (SDRs) are international reserve assets issued by the IMF to supplement existing official reserves of member countries. Allocated in proportion of members'

quotas in the Fund, SDRs also serve as an international unit of account. Their value is based on a basket of key international currencies – in 2003, the price of one SDR averaged the equivalent of US$ 1.41.

The idea of issuing new SDRs for development purposes was first raised in the 1960's. More recently, the proposal loomed again in the context of international efforts to identify new sources of funding to meet the Millennium Development Goals.

Arguably, new allocations of SDRs would present more than one advantage. While incrementing the amount of resources currently available to the fight against hunger and poverty, new SDRs would significantly address financial volatility and imbalances and contribute to the creation of an international economic environment more conducive for development with social equity.

Functioning and Scope

A SDR is not exactly a currency. Rather, it constitutes potential claims on the freely usable currencies of IMF members. Holders of SDRs can obtain these currencies in exchange for their SDRs in two ways: first, through the arrangement of voluntary exchanges between members; and second, as the IMF designates members with strong external positions to purchase SDRs from members with weak external positions. Only governments, central banks, the IMF, and a few other "official holders" can hold SDRs.

An allocation of SDRs provides each member with a costless asset on which net interest is earned and paid at the same rate. Therefore, if a member's SDR holdings rise above its allocation, it will earn net interest on the excess; conversely, if it holds fewer SDRs than it was allocated, it pays net interest on the shortfall. SDR's interest rate provides the basis for calculating the rate charged to members on regular (non-concessional) IMF loans. It is based on a weighted average of representative interest rates on short-term debt in the money markets of the SDR basket currencies. In 2003, it averaged 1.6%.

General allocations of SDRs are approved by the IMF Board, which every five years analyses

the need to supplement existing reserve assets in the world. The Board also has the mandate to cancel allocations of SDRs. So far, allocations of SDRs occurred on only two occasions, in 1970-72 and 1979-81. Nowadays, the stock of SDRs accounts for 1% of international reserves.

The IMF's Board of Governors approved a one-time allocation of SDRs in September 1997 through the proposed Fourth Amendment of the Articles of Agreement. Such allocation would double cumulative SDR allocations to SDR 42.9 billion. Countries that have joined the Fund after 1981 – which represent one fifth of IMF membership – have never received SDR allocations. This allocation would enable all IMF members, old and new, to participate in the increased stock of SDRs on an equitable basis.

However, the Fourth Amendment has not yet come into force due to the lack of sufficient consensus within the IMF membership. The first challenge is therefore to galvanize political support to get the pending Amendment approved.

After the approval of this Amendment, developed countries – which account for 60% of quotas – could agree to make available their share in this allocation either to developing countries or to existing multilateral Funds capable of providing counter-cyclical loans adapted to developing countries. It must be recalled that the IMF must previously designate any potential recipient of SDRs as a holder of SDRs.

Transfers of SDRs raise the issue of interest charges due by recipients, which will have to be dealt with according to individual countries´ situations.

Furthermore, new allocations of SDRs could contribute to the mobilization of immediate resources to development financing, and also allow for the establishment of an international economic environment more friendly to domestic efforts in fighting poverty and hunger. In this regard, a further reform of IMF's Articles of Agreements could set the possibility of SDRs issuances in two different manners.

First, SDRs could be issued on a temporary basis during episodes of widespread financial stress and significant drop in commodity prices, and could be cancelled once financial conditions

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are normalized. The decision to allocate SDRs should also take into consideration regional liquidity shortages, such as in the cases of the Latin American debt crises and the Asian crises. Allocations could be geared in a more efficient manner to countries that have already reduced domestic demand and begun experiencing a fall in their economic activities. Temporary allotted SDRs would free countries' own reserves to play a role in the reactivation of the domestic economy.

Such an approach would provide for a counter-cyclical component in world liquidity management, as sudden drops in net private lending would be partly compensated by increased official liquidity, and vice-versa. Furthermore, total long-term liquidity would not increase, since normalization of private lending would imply a cancellation of those SDRs. Output in developing countries, sharply affected by shocks from international commodities and financial markets, would be higher than otherwise, and the risk of additional world inflation would be minimal.

Second, one could consider the possibility of issuing new permanent SDRs. A permanent regular allocation of SDRs could be made by an amount equivalent to a fraction of the annual increase in the demand for international reserves; for instance, 1% of the present world stock of reserves. The new allocations could be directed: (1) to all IMF members; (2) only to developing countries, which could have their shares in the allocation progressively adjusted according to their per capita income level; or (3) to an IMF fund or lending facility, that would assist countries with their development objectives. Such allocations would allow developing countries to obtain higher international reserves, without having to borrow from international capital markets or to generate larger trade surpluses. These two sources of reserves are costly, both in financial terms and in terms of real resources.

Advantages

The issuance of new development-focused SDRs would allow for the provision of immediate resources, which could be channeled to recipients either in a direct manner or through existing

multilateral agencies. The initiative would not imply the creation of new institutions to manage the channeling or funding.

In addition, if further changes in the IMF's Articles of Agreements are approved, the initiative would strongly contribute to the creation of more stable international monetary and financial systems. The establishment of predictable rules concerning the creation of liquidity arrangements worldwide would constitute a powerful instrument of crisis prevention and management in developing countries.

Indeed, an appropriate scheme capable of providing developing countries with less costly sources of reserves would be highly beneficial to their domestic economies. As mentioned above, in order to increase their reserve ratios, countries have either to generate a current account surplus or receive net capital inflows that are hoarded at a cost by central banks.

Developing countries, in general, continue to face the long-standing volatility of their export proceeds, which are usually dependent on international prices of primary products. Also, even though flows of private capital to developing countries became much larger since the 1990s than in previous decades, they tend to be sadly pro-cyclical. Needless to say, recessions and macroeconomic imbalances in the developing world – even in very well governed countries – are frequently associated with a fall in export revenues and outflows of private capital, with negative impacts on countries' ability to tackle their urgent social demands. Such a perception points to the imperative of setting an international arrangement to assist developing countries in a more effective manner. The systematic allocation of new SDRs could be an important step in this direction.

Obstacles and Challenges

The most important obstacle to the initiative of allocating new SDRs refers to current political opposition on the part of some countries to the approval of the Fourth Amendment of the IMF's Articles of Agreement. Although the Amendment was proposed almost eight years ago, it has so

far not been possible to reach the consensus necessary to implement the proposal. SDRs are also criticized on the basis of their potential inflationary impact, although that would not be apparent for the amounts currently considered in the present environment.

Critics also argue that new SDR allocations may prevent the adoption of sound policies in developing countries. It must be pointed out, however, that new SDRs would only be channeled towards sound and sustainable programs aimed to reduce poverty and promote development.

Conclusion

The proposal to increment the issuance of SDRs in the IMF would bear important advantages for recipient countries, which would benefit not only from increased flows of resources but also from a more stable international financial environment. With the mobilization of political support, the initiative could be put into practice in the short or medium run and allow for a substantial amount of funding to the fight against hunger and poverty.

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POLITICAL COORDINATION

Tax Evasion and Tax Havens

Tax evasion is a phenomenon of great magnitude that impairs fiscal revenues of governments and is especially detrimental to the domestic efforts to increase tax revenue in developing countries. Yet rebuilding these countries' tax bases is essential to their efforts to finance their fight against poverty, improve social expenditure, support economic development activities and increase productivity levels. Serious efforts made at the domestic level have encountered significant leakages by firms and individuals operating via tax havens. Consequently, there have been lower tax proceeds or higher taxation on non-mobile income earners, sectors that evidently are mostly below the high-income brackets. The tax system tends to loose progressivity.

On this basis, further joint and concerted international action is necessary to reduce the erosion of national tax bases. A strong and reliable tax base is the first source of finance for countries seeking to strengthen their national efforts to reduce hunger and poverty and, more generally, to improve equity. All efforts in this direction are likely to reduce the need to rely on external or special sources of finance. A crucial step in this regard is to intensify domestic efforts related to improving tax administration.

The amount that annually escapes from countries' tax bases exceeds by far the resources needed to finance the Millennium Development Goals. In many cases, efforts undertaken to reconstitute developing countries' tax base are crucial in the fight against poverty and hunger, as a necessary complement to innovative financing mechanisms.

Tax evasion frequently involves offshore financial centers, as concealment seeks the protection of systems combining zero or low taxation with banking secrecy. Fighting tax evasion and elusion via action on tax havens reduces significant distortions in the allocation of resources. It also contributes to diminish the extent of money laundering and financing for terrorism.

The financial sector in tax havens conducts the bulk of its business with non-residents, the

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volume of external claims and commitments being out of proportion to the financial intermediation needs of the domestic economy; most transactions executed or recorded by the financial sector originate elsewhere. These characteristics are not exclusive to offshore financial centers. In particular, banking secrecy is a standard practice in tax matters in many countries, to varying degrees.

Reducing tax evasion and bringing more transparency to financial operations are international public goods. In all, it would increase world welfare. Consequently, effective action in this area could generate enough resources to compensate tax havens (usually countries with small population) that would be negatively affected by that action, with international support for their productive reconversion.

By weakening the tax base of States, tax evasion creates distortions and inequities in the world economy, affecting developed and developing countries. Given its global nature, the issue of tax evasion must be dealt with in the context of strengthening international cooperation in tax matters. Indeed, there is an international consensus to fight tax evasion and the lack of transparency in financial activities. Multilateral programs are currently being carried out in different contexts.

These efforts are expected to produce positive results in addressing tax evasion and the lack of transparency in financial transactions worldwide. All initiatives are conceived as a means of convincing as many jurisdictions, countries and territories as possible, through dialogue and example, to comply with the prescribed guidelines and change their practices. Most of the partners in this drive are in a phase of implementing commitments taken. It is imperative that discussions are translated into action and generate concrete results. Ultimately, these different exercises will serve to fight tax evasion and to redress the lack of transparency in international financial transactions. There must be no relaxation of these efforts.

If the expected results fail to materialize, States engaged in this process should consider taking coordinated defensive measures, particularly fiscal measures.

Increasing Remittance's Benefits

Globalization has been associated with the recent increase in international trade and financial transactions and its consequences over the world economy. However, globalization is also characterized by the existence of important international flows of workers.

The decision to migrate frequently emerges from a family recognition of the need to obtain an additional source of income. These new families, whose head of household is normally abroad, are known as transnational families.

According to different sources, the amount of workers´ remittances to developing countries is in the order of US$ 80 billion annually, which exceeds Official Development Aid flows.

Why are remittances important to fight against poverty and hunger? There are three major reasons.

Firstly, remittances tend to be much less pro-cyclical than other flows, thus providing a more stable and predictable source of financing. Differently from other private external flows, workers´ remittances tend to be quite independent from the economic conjuncture. Research papers from different institutions show that remittances exhibit steady increases in bad times, when other flows fall.

Secondly, remittance incomes are normally spent in common expenses such as food, housing and utilities, and therefore represent an alternative safety net in developing countries.

Thirdly, costs of transfers or intermediation of remittances are notably high. Consequently, any significant reduction in the transfer cost of these flows would have a direct impact in the fight against poverty and hunger.

Some ideas can be proposed to increase the benefits derived form workers´ remittances:

(1) The cost of sending remittances should be reduced. Transaction costs should be lower when remittances are sent through regulated financial institutions (commercial banks and credit unions), especially for immigrants without regular access to these

institutions in host countries. Therefore, the first and foremost measure would be for developed countries to facilitate foreign workers' access to financial institutions at an affordable cost. It is true that in recent years the financial industry has become more transparent and competitive, with a subsequent decline in costs. At the same time, some countries have already been tackling this issue, by favoring measures aimed at reducing these costs. In any case, the costs are still very high and need some further action.

(2) At the same time, the financial systems of many developing countries do not generally reach the majority of their populations. Financial services are concentrated on the richer groups of society. This financial gap is reflected in financial markets that tend to perpetuate inequality, particularly in rural areas. The scale of remittances can be a powerful tool to open up financial systems to poorer sectors of developing countries' population. One strategy to spread out the benefits of remittances is to promote the investment in micro-enterprises and other forms of job-generating initiatives; the flows to the families of emigrants could serve to improve the access of those families to additional financing, at reasonable terms, from the domestic financial system. Obviously, the achievement of this objective is easier if remittances are transferred by banks or credit unions.

Remittances have become a reliable source of international capital flows for developing economies, favoring macroeconomic stability. If properly channeled through the financial system, they can contribute both to the alleviation of poverty and to the strengthening of the local financial system.

It is crucial to reduce the cost of transfers. This should be induced by increasing competition and efficiency in these markets. Corporate social responsibility by the banking sector should also take this issue in consideration.

Assistance should be given to developing countries, when needed, to spread the base of the financial sector in order to efficiently channel these flows towards productive activities, including the access to microfinance by families of recipients.

VOLUNTARY MECHANISMS

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Voluntary Contributions through Credit Cards

Introduction

Voluntary contributions are also an important dimension of the effort to raise new resources to financing the fight against hunger and poverty. Credit card-based donations, in particular, have already been in place in many parts of the world. With low cost and relatively easy implementation, there are still other options worth exploring at the global level, having hunger and poverty eradication and the Millennium Development Goals as strong catalysts for further action.

Functioning and Scope

The launching of an affinity card identified with the implementation of the Millennium Development Goals could build on existing successful experiences involving banks, credit card companies and individuals.

As with other affinity cards available in many countries, clients would simply agree to donate a percentage of the value of their purchases to the worldwide campaign against hunger and poverty. The resources collected would be channeled to a United Nations account, for example.

Like in the use of other co-branded cards – i.e. cards associated with private companies – clients would accumulate points according to the frequency and volume of their purchases. As opposed to co-branded cards, however, points obtained with purchases through affinity cards are not reverted to clients themselves, but transferred to institutions of their choice.

Contributions via credit cards could also be encouraged through the creation of a website exclusively designed for that purpose. Individuals would agree on the donation of a certain amount, and banks would be in charge of the collection and channeling of resources obtained.

Links to the home-page could be inserted in WebPages of banks, major companies, web search tools, and major internet providers.

Finally, in addition to contributions focused on individuals, options involving a joint voluntary effort by credit card holders and the major credit card companies and associated banks also deserve consideration. Some of these companies and/or banks could indeed agree to donate a very small percentage of their earnings with annual fees, interests etc. of their contributing clients. Advertising such contribution would contribute to improving their public image as socially responsible enterprises, apart from other positive externalities, including financial ones, especially if the companies or banks take part in so-called "ethical funds" that are proliferating in many countries (see chapter on SRI).

Advantages

Even though it is not possible to estimate in a precise manner the amount of resources that could be obtained with voluntary contributions via credit cards, some figures suggest that revenues could be significantly high. The volume of annual purchases with credit cards in the world is estimated at US$ 3.2 trillion.

Estimates show that purchases through co-branded and affinity cards are on average 150% higher in volume as compared to purchases with traditional credit cards. In the case of co-branded cards, this is because clients have an additional incentive to concentrate their purchases of goods and services in a single card, as long as they would be granted greater advantages and discounts from the company whose brand is associated with the card. In the case of affinity cards, such an incentive would refer to the moral appeal of doing their part in the eradication of poverty and hunger.

The market for co-branded and affinity cards has been experiencing a boom. These cards already account for more than 50% of all credit cards in the United States.

The creation of a "MDGs Affinity Card" by interested banks and companies would therefore bring about a win-win situation. Banks and credit card companies would benefit from increased use of their products, while helping and fostering clients' contributions to the implementation of the Millennium Development Goals.

Conclusion

The idea of creating an affinity card associated with the combat against poverty and hunger presents a number of advantages and virtually no obstacles. Since it involves the coordination among a relatively small number of actors and builds on existing experiences, the initiative could be implemented in the short run. Benefits would stem not only from the amount of resources raised, but also from the increased publicity of the Millennium Development Goals among consumers and private companies from all parts of the world.

Socially Responsible Investing or "Ethical Funds"

Introduction

The private sector plays a central role in the global economy. As companies began addressing local communities' needs, social concerns appear more prominently among corporate strategies.

Socially Responsible Investing (SRI) refers to investment decision-making processes that combine the social and environmental dimensions of investments with rigorous financial analysis. In essence, it denotes an approach by investors to identifying and investing in companies that

take into consideration standards of corporate social responsibility in their behavior.

The idea underneath SRI is that social and environmental concerns should be increasingly envisaged as an important factor in companies' long-term profitability and sustainability.

The modern roots of social investing date back to the 1960's, when social, pacifist and environmental movements led to an increased consciousness about the social responsibility of companies. Over the past two decades, concerns about global warming, human rights and labor standards have been at the forefront of socially responsible investing.

More recently, an important initiative was launched by United Nations Secretary General Kofi Annan – the "UN Global Compact" – congregating today more than 1600 companies from all regions of the world which have agreed to follow a set of common principles on labor standards, environment protection and human rights. The Global Compact also aims to bring together UN agencies, NGOs and civil society leaders, and to foster partnerships in pursuit of a more sustainable and inclusive world economy.

This chapter presents a suggestion on how socially responsible investing practices could be associated with companies' efforts geared to the eradication of poverty and hunger.

Functioning and Scope

SRI encompasses three main investing strategies: shareholder advocacy/activism, community investing and portfolio screening.

Investors in mutual funds, pension funds and other portfolio are increasingly prone to shareholder activism by filing proposals, voting proxy ballots regarding shareowners, attending annual meetings and discussing with top executives. The objective of enhanced activism on the part of investors is to put pressure on companies to adopt a more responsible stance on specific issues regarding their social or corporate performance.

Other portfolio managers have been willing to channel a certain percentage of their

investments to community development. The idea is to provide local organizations in low-income communities with basic financial services such as community banks, community credit lines, loan funds and micro-enterprise lenders.

At the same time, the bulk of SRI strategies refers to portfolio screening, i.e., the practice of including or excluding publicly traded securities from investment portfolio or mutual funds according to certain social or environmental criteria.

Investors who stick to positive screening tend to channel their money to companies that follow above average records in terms of pre-established values – like better employer-employee relations, social policies or the safety and social usefulness of their products. Participation in public campaigns against poverty and hunger could also constitute a powerful screening criterion to be taken into consideration by investors.

Investors may also adhere to negative screening, and thus avoid investments in companies whose practices and products are considered potentially harmful according to a given set of criteria. Companies that do not follow certain practices regarding environment, labor, human rights and animal welfare are also penalized.

The fight against poverty and hunger has not so far been explicitly taken as a SRI screen. The constitution of portfolios of securities of companies from different parts of the world that are committed to allocating resources to fighting hunger and poverty in developing countries should be encouraged. The use of such positive screen could yield good financial performance while providing an incentive for companies to invest more systematically in social programs for hunger and poverty eradication.

Funds oriented to social values – the so-called "ethical funds" – are becoming very popular among investors. In the United States, screened portfolios accounted for US$ 2.14 trillion in 2003. More than one out of every nine dollars invested under professional management in the United States has gone through some sort of screening. Socially responsible screening is also growing in other parts of the world. A wide array of SRI instruments is currently available in 21 countries. Estimates show that

SRI funds have reached the impressive figure of US$ 5.9 trillion all over the world.

These figures suggest that, although SRI still falls in a sort of niche market, it is increasingly being envisaged as an instrument to be taken into account by mainstream investors.

Socially responsible investing, particularly screened portfolios, could actually perform a significant role in encouraging companies to engage in a worldwide campaign against poverty and hunger. Even though the initiative would require some institutional framework, the mechanism would build on existing successful experiences, all of which based on voluntary participation. The initiative is expected to request relatively low administrative costs and relatively low international coordination efforts.

Conclusion

Despite the fact that revenues stemming from the initiative are, for the moment, difficult to quantify, it is expected that SRI might be able to raise substantive amounts of resources and further associate corporate responsibility with social causes such as the fight against poverty and hunger in the developing world.

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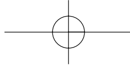
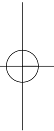
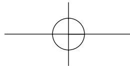


FINAL REMARKS





The list of innovative mechanisms examined in this Report is neither exhaustive, nor prescriptive. The Group´ s intent is to present an overview of the main aspects involved in each of the mechanisms discussed. It owes much to studies recently published or still in draft form by renowned scholars and experts, and has also built on the literature in public economics available, especially with respect to ideas that have been under consideration for a long time. Yet the focus of the Group was oriented by the premise that innovative tools should serve primarily development financing, rather than market regulatory purposes.

Aside from those innovative tools it was specifically mandated to examine, a decision had to be made by the Group on which mechanisms seemed most promising and feasible. In selecting them, the Group kept an open mind with regard to other suggestions analyzed elsewhere. The Group has not addressed, for instance, the issue of a carbon tax to finance development, although it has agreed to discuss it in the future. All ideas indeed deserve attention, inasmuch as the political objective of current international efforts in this field is converging to an accelerated, in-depth analysis of options that might complement each other and, ultimately, bring forward additional resources for the fight against hunger and poverty and the attainment of the Millennium Development Goals.

Not all mechanisms studied will require compulsory or universal participation, or public spending. On the contrary, the report was meant to offer a menu for a wide array of actors – governments, organizations, the private sector and individuals – to choose their preferred means of contribution, in addition to existing modalities of assistance or donation, which, of course, concurrently need to be increased in volume and improved in effectiveness.

In so doing, the Group acknowledges that there are political constraints for the adoption of new mechanisms. At the same time, there is no doubt that changes of perception frequently take time, and so do public awareness and mobilization to global causes whose consequences are not immediately felt or do not attract sufficient domestic attention. Some of the proposals will not necessarily gather universal support and will require some negotiating effort, which is an integral part of the technical and, above all, political work ahead.

There is no intention of proposing such mechanisms as the ultimate solution to development financing, in substitution for traditional forms of official assistance, debt relief or trade-related measures that would help promote growth in developing countries. Even less has the Group wished to favor taxation over other modalities of contribution, or to advocate the rapid launching of mechanisms, irrespective of their different maturity timeframes.

In fact, some of the instruments examined would be ripe for adoption in the short term, either because they have sufficient critical mass and in-built financial engineering, or by virtue of their apparently simple conceptualization and implementation, or yet by the fact that they would be based on national successful stories.

The mechanisms analyzed in this Report are not conceived simply as a provisional measure to address urgent needs of developing countries. Rather, they are designed as a means of providing for a predictable and continuous flow of resources over time, so that recipient nations could succeed in the pursuit of long-term development in a more efficient manner.

With regard to modalities of participation, it should be borne in mind that some mechanisms would be compatible with "flexible geometry" coalitions, by bringing together groups of interested parties. Some could in fact start with pilot projects involving few interested countries. With the assessment of their successes and the correction of their failures, these mechanisms could evolve to full-fledged capacity of financing, including by stimulating other countries to follow suit.

Nonetheless, with respect to taxation schemes, the widest possible participation, including by all key players, seems to be a necessary pre-condition. Although this requirement may represent a serious obstacle to their entry into force, taxation mechanisms would still be worth pursuing. With tax incidence being kept to a minimum, market distortions and tax evasion might be negligible. By providing for resources in a stable and predictable manner, taxation schemes would efficiently complement ODA, which suffers from inefficient fluctuations in its level due to donors' domestic budget contingencies. Taxation mechanisms could complement other mechanisms, by offering the possibility of combining different modalities of financing devoted to more immediate, urgent

measures and to long-term, structural projects.

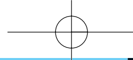
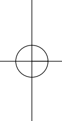
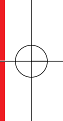
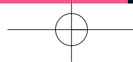
With the exception of voluntary contribution schemes, all other mechanisms examined in the Report would require some sort of agreement or executive arrangement among interested governments. The degree of formality required would have to be decided on a case by case basis. This reinforces the convenience of working, as the Group did, with a menu approach, which includes voluntary and private sector actions, and also steps that would require mostly political coordination among governments.

Finally, another issue that is worth highlighting is the importance of resources raised being truly additional, and not crowding out current ODA flows. There is a risk, indeed, of governments reducing their official assistance once new sources of financing are in place. Engagement and counter-pressure on the part of concerned parties, groups, citizens and, to the extent possible, national and multilateral agencies of development assistance, will be indispensable in order to avoid, or at least minimize, the possibility of replacement of sources of financing.

The channeling and use of the resources levied through these innovative mechanisms will be guided by the following general principles: efficiency, accountability, and transparency.

Effective focusing of resources should contribute to ensure that funds are properly allocated to specific programs or projects. In this sense, visibility and public sensitization are crucial. The association of specific mechanisms with specific social projects would be helpful in convincing public opinion that resources are being spent in causes that have a strong social and developmental appeal.

The Group stresses once again that the mechanisms examined should be seen within different timeframes of maturity. But we must recognize that it is time to consider the subject of alternative sources of financing as a top priority. The international community cannot afford a wait-and-see attitude. Additional resources will not be created spontaneously, and failure to accept this premise only aggravates the current gap between agreed commitments and the necessary financing. Each year lost represents an increase in resources needed in the run-up to 2015. Let us not waste further time.

ACTION AGAINST
HUNGER AND POVERTY