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On the  
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**MOVING FORWARD  
FINANCING MODALITIES TOWARD THE MDGs**

Background document

Attached for the April 17, 2005, Development Committee Meeting is a report entitled "Moving Forward: Financing Modalities Toward the MDGs," prepared by the staff of the World Bank and the International Monetary Fund. The report is a background document for the Committee's consideration of Item II of the Provisional Agenda.

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Prepared by the staff of the World Bank and IMF

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## Moving Forward: Financing Modalities Toward the MDGs

### Background

1. At the 2004 Annual Meetings of the Bank and the Fund, the Development Committee emphasized the importance of providing “additional, predictable and timely financial assistance to countries committed to sound policies, . . . particularly for sub-Saharan Africa.”<sup>1</sup> In that context, the Development Committee reviewed proposals to complement increased aid flows and commitments with innovative mechanisms, and asked the Bank and the Fund to continue their work and report at the next meeting on how to take such options forward. In addition, the Development Committee encouraged the Bank to explore the potential for increasing leverage through blending aid with other flows, including MDB lending. The International Monetary and Financial Committee also encouraged “further analysis by the World Bank and IMF of . . . financing modalities and mechanisms to augment aid flows, such as the International Finance Facility, global taxes, and other innovative mechanisms, and [looked] forward to a further report.”<sup>2</sup>

2. A key conclusion of the Global Monitoring Report 2005 is that official development assistance (ODA) remains well short of what poor countries need and can use effectively given recent and prospective progress on policy and institutional reform in many countries. While the recent recovery in aid flows is encouraging, at least a doubling of ODA will be needed within the next five years to support adequate progress toward the MDGs. Further increases would likely be needed beyond that period as countries strengthen further their absorptive capacity.<sup>3</sup>

3. Given the need to scale up funding where it can be used effectively, the most important priority is to deliver on aid commitments already made. The Development Committee also urged donors who have not yet done so to make concrete efforts toward the ODA target of 0.7 percent of GNP. Yet existing commitments, along with efforts to increase aid levels, will take time to materialize, lending merit to focusing on additional ways, beyond increasing traditional ODA, to mobilize aid flows. This focus has been reflected in work by the Bank and Fund on innovative financing, notably Aid Effectiveness and Financing Modalities (the Fall paper).<sup>4</sup> Other recent work on innovative financing mechanisms, including the UNU-WIDER study New Sources of Development Finance, the Report of the Technical Group on Innovative Financing Mechanisms and the Landau Report (2004), discusses some proposals that are different in

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<sup>1</sup> Development Committee Communiqué, October 2, 2004, para. 8.

<sup>2</sup> Communiqué of the International Monetary and Financial Committee (IMFC) of the Board of Governors of the International Monetary Fund, October 2, 2004, para. 17.

<sup>3</sup> Global Monitoring Report 2005 Millennium Development Goals: From Consensus to Momentum.

<sup>4</sup> Financing Modalities Towards the Millennium Development Goals, Spring 2004; and Aid Effectiveness and Financing Modalities, Fall 2004.

nature from those considered here. Remittances, and the Soros proposal regarding the SDR, are taken up in Appendices 1 and 2 to this paper. In addition, the new U.S. bilateral mechanism, the Millennium Challenge Account, is described in Appendix 3.

4. The task at hand is to focus, among the array of proposed mechanisms, on those with the greatest potential to generate needed funds whether in the short or longer term. Accordingly, this paper concentrates on work in progress with respect to the pilot International Finance Facility for Immunization, and on the more promising global tax mechanisms. As many have pointed out, these two financing mechanisms can potentially complement each other, with the purpose of the International Finance Facility to provide short-term, frontloaded funding while global tax mechanisms may have the potential to provide medium- to long-term funding for recurrent needs. Further work will also be useful with respect to voluntary contributions and blending arrangements. Taken together, these approaches provide a menu of financing alternatives that can augment as well as improve the stability and predictability of development financing. Specific mechanisms can be taken up and moved forward as agreements are reached among coalitions of interested governments.

#### **I. International Finance Facility**

5. The International Finance Facility, or IFF, was proposed by the UK Treasury as a way to frontload aid flows in the short term to help reach the MDGs. The frontloading of aid makes sense where there are immediate needs, taking into account absorptive capacity, and ways to improve it, country by country. The IFF would generate funding that is higher cost than traditional aid financing – and indeed higher cost than sovereign bond issuance. Accordingly, IFF funds should be used in support of sectors, programs and projects in which increased flows can be used rapidly and effectively, and where development investment returns are expected to be higher than the IFF's cost of funds.

6. Under the IFF proposal, donors would make off-budget pledges, contingent on a high-level financing condition, of future increases in their aid commitments. The pledges would be used as backing to issue AAA-rated bonds. Bond proceeds would be channeled through existing aid programs. Over time, the IFF would draw down the donor pledges to pay off its bonds. Future aid budgets would thus be used to support aid commitments and disbursements as and when they are needed in the short term.

7. Each component of the IFF structure carries issues that need to be resolved. At the first stage – government backing of an IFF – the feasibility of using conditional donor support to raise funding now needs to be established for countries interested in participating. For this, the level and breadth of donor participation, as well as determining the specific nature of government pledges that can be at once off-budget and legally binding, and accepted as such by capital markets, need to be specified.

8. Second, the IFF itself will need to be structured and established as a treasury platform that can issue AAA bonds. For this component, the focus should be on ensuring the efficiency and reasonable cost of the IFF mechanism and IFF funds.

9. Third, the governance structure of the IFF needs to be both inclusive and efficiently aligned with existing structures to avoid contributing to a proliferation of separate aid funds and facilities. The IFF's contribution to development results will turn on how effectively and efficiently IFF funds are allocated, an outcome of its governance arrangements.

10. Fourth, IFF bond repayments will need to be managed to ensure that aid flows frontloaded through the IFF result in a short-term increase in aid – and then a continuing steady flow of baseline aid funds after 2015, when the need for development funding will remain.

### **The IFF for Immunization**

11. Technical aspects of the IFF proposal are being worked through in a pilot IFF for Immunization, sponsored by the Global Alliance for Vaccines and Immunization (GAVI) and the Vaccine Fund.<sup>5</sup> The "IFFIm" would seek to raise frontloaded, reliable funding to expand the global immunization effort to help achieve the child health MDG. The IFFIm is intended to be a small IFF, serving as a proof of concept for the larger IFF. Focused work on all aspects of the IFFIm has been ongoing over the past year, looking towards it being up and running in 2005.

#### **A. Government Backing**

12. IFFIm donors would make legally binding pledges of future aid flows to an affiliate of the Vaccine Fund, which would assign the pledges to the IFFIm. These pledges would be contingent liabilities, subject to the high-level financing condition described below, so that only annual expenditures made under the multi-year pledges would be treated as expenditures in the donor's fiscal accounts.

13. IFFIm pledges would be contingent in nature, subject to a high-level financing condition. For such a condition to function in the framework of an entity issuing AAA bonds, it must be clearly defined, reasonably predictable and, whether or not it has been triggered, must be easily and objectively ascertainable by bondholders. For the IFFIm, a number of possible conditions were explored. Options that related directly to immunization coverage were considered closely but not chosen due to absence of reliable data, and limited market understanding of immunization indicators. The high-level financing condition for the IFFIm, as endorsed by the GAVI Board, will be that originally set out in the UK IFF proposal: protracted arrears to the International Monetary Fund. The condition would be triggered when a recipient country is six months or more overdue in settling its financial obligations to the Fund. In that case, donor obligations to make

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<sup>5</sup> GAVI is a public-private partnership between governments in developing and industrialized countries, established and emerging vaccine manufacturers, NGOs, research institutes, UNICEF, WHO, the Bill & Melinda Gates Foundation, The Vaccine Fund and the World Bank. Its purpose is to save children's lives and protect people's health through the widespread use of vaccines. The Vaccine Fund is GAVI's financing arm, and provides financing for immunization services and the purchase of vaccines in countries with a per capita GNI below \$1000.

future payments to the IFFIm would be reduced in proportion to that country's expected share of the IFFIm portfolio until it cleared its arrears to the Fund.<sup>6</sup> Where IFFIm funds have already been committed to existing country-level immunization programs, those commitments are unlikely to be affected. Countries that are now or become ineligible for IFFIm funding on account of the high-level financing condition would remain eligible for regular Vaccine Fund financing. The IFFIm would be managed to avoid having the high-level financing condition impact bond payments, by issuing bonds at levels lower than total pledge amounts.

14. Requirements for an aid pledge to be given off-budget fiscal treatment vary under the laws of individual countries.<sup>7</sup> The IFFIm structure, like the original IFF proposal, is based on Eurostat requirements. Supporters of the IFFIm are in the process of clarifying the status of IFFIm pledges for European donors. An application is expected to be submitted shortly to Eurostat with respect to the IFFIm's institutional nature and the fiscal treatment of IFFIm donor pledges; Eurostat's decision would follow in due course.

15. Donor participation: Negotiations are in process to establish a core group of donors interested in funding the IFFIm. In January, the United Kingdom announced that it would pledge £960 million to the IFFIm over the next 15 years, based on an IFFIm program of at least \$4 billion over ten years. In early February, France and Germany issued a joint statement of support for the IFFIm, and other European donors including Sweden have also expressed support.<sup>8</sup> A positive ruling by Eurostat on the fiscal treatment of IFFIm pledges would resolve important concerns for some possible donors.

## **B. Bond Issuance/Treasury Platform**

16. The IFFIm would be established as a UK charitable entity, essentially as a special purpose vehicle for the Vaccine Fund. It is expected that the World Bank would be asked to provide treasury management services to run the IFFIm treasury platform, on a full cost-recovery basis. These services would likely include managing donor pledges and drawdowns, issuing bonds on behalf of the IFFIm and dealing with rating and qualification issues, managing IFFIm liquidity, disbursing funds to implementing agencies, implementing an asset-liability management strategy, and reporting.

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<sup>6</sup> Four countries are now in protracted arrears to the Fund: Liberia, Somalia, Sudan, and Zimbabwe.

<sup>7</sup> The Statistics Department of the IMF has concluded that donor pledges to an IFF initially would be a contingent liability, but at the time the IFF issues bonds a liability equivalent to the amount of bonds issued should be recognized in the accounting records of donor countries to ensure consistency with the principles of fiscal transparency in the *Government Financial Statistics Manual 2001*.

<sup>8</sup> There have been broader expressions of support for a full-fledged IFF from a wide range of countries; it is not yet clear how many countries would make financial commitments to such an instrument.

17. Transactional and structural aspects of the IFFIm are still being negotiated, so that the final cost of IFFIm funds, both in terms of expected rates on its bonds and setup and management costs, cannot yet be estimated with certainty. Given the fundamental premise of an IFF structure – that the returns on frontloaded funding for development investment will exceed the cost of its funding – careful upfront estimation of the cost of IFFIm funds, and continuing scrutiny of how they are used, will be necessary to support appropriate assessments of the IFFIm’s costs and benefits.

### **C. Governance**

18. A key concern in the establishment of an IFF is to avoid proliferation of aid institutions, and to avoid a vertical approach to aid – earmarking aid for specific tasks. For that reason, the original UK proposal emphasized avoiding the creation of new institutions but using existing structures for implementation.

19. The IFFIm’s functions would mostly be undertaken by existing aid agencies. In particular, the IFFIm would rely largely on the existing governance structure and country programs of the GAVI and the Vaccine Fund. While the IFFIm would support a specific development purpose, its funds for immunization would not be earmarked to be spent in a top-down manner. Rather, they would be allocated through the existing country application and monitoring process overseen by the GAVI Board, under the direction of the Vaccine Fund, assuring country ownership.

20. The programmatic proposal for the IFFIm proposal focuses on using the frontloaded resources to provide two principal funding streams:

- (1) accelerating increased production of new and existing vaccines – using IFFIm funds to increase the development and supply of new vaccines such as those against severe diarrhea and acute respiratory diseases (which account for over 2 million deaths yearly) and for the existing combination vaccines against diphtheria, tetanus, pertussis, hepatitis B and Hib; and
- (2) strengthening the capacity to deliver vaccines – increasing investments in country health systems and the vaccine delivery pipeline.

21. These funding streams appear to be a sensible use of frontloaded funds. Using the IFFIm funds to purchase existing vaccines and to guarantee the purchase of new vaccines will increase supply in developing country markets by reducing core risks to manufacturers. This, in turn, should stimulate private sector investment and competition, reducing costs and thus prices more rapidly than if there were no scale-up, accelerating developing country access to vaccines, and increasing planning predictability for them and for manufacturers.

22. As for the second funding stream, delivery capacity is frequently a weakness in countries’ health infrastructure. Strengthening it saves children’s lives immediately, reduces disease incidence, and builds delivery systems to reach children with other

interventions and future priority vaccines such as malaria. While the precise programs supported by IFFIm funds should be carefully evaluated from a cost-benefit perspective, the return on investment in immunization is generally high.

#### **D. Bond Repayments**

23. An important concern about the IFF structure is the risk of a detrimental drop-off in aid flows after the frontloading period. The anticipated uses of IFFIm funds are appropriate for frontloading, as noted above. Accordingly, one would expect only minimal adverse effects at the end of the IFFIm disbursement period. The first funding stream is explicitly intended, in time, to drive down the cost of vaccines, enabling countries to afford them using domestic sources of funds. The second stream would fund system-building programs, not provide recurrent cost funding. Baseline aid, domestic and other flows supporting health programs are expected to continue, and to fund ongoing recurrent costs that will remain after IFFIm funding is spent.

24. Over time, donor payments to the IFFIm will increasingly be used to repay bonds. As payments of principal and interest are made to IFFIm bondholders out of aid budgets, donors may face considerable political pressures relating to the use of their funds.

25. In sum, a range of issues around the IFFIm remain, and many details need to be settled. If successful, the IFFIm would offer assurance of the feasibility of several aspects of the proposed larger IFF: the capacity to garner donor support for such a mechanism; obtaining off-budget treatment for donor pledges; and acceptance by the rating agencies and capital markets of the IFFIm's bonds at AAA rates. In particular, the IFFIm will be a test case for the feasibility of obtaining donor pledges of future support that are both legally binding and off-budget. This key underpinning of the IFF will likely be resolved, one way or the other, for European donors with the consideration of the IFFIm proposal by Eurostat.

#### **Moving Forward**

26. If the IFFIm moves forward in the near term, concerns will remain about the viability of a full-fledged IFF. Among these, key considerations would include the following:

- The pilot relies on the existing governance structure of GAVI/Vaccine Fund. Establishing an efficient IFF governance structure remains a challenging issue, by contrast, since it will reflect competing considerations of participating donors and other interested entities. There is broad reluctance to create anything new, and a strong desire to avoid elaborate decision-making or institutional structures. However, governance and allocation decisions by the IFF (its policy framework and operating principles, as well as funding levels and allocations) will be of great interest to donors, recipients, aid organizations, and international civil society. As noted earlier, the IFF's impact on ODA flows must be carefully managed to avoid inefficiency and support aid predictability – that is, they must flow where they can

be absorbed effectively and where they will enhance donor alignment as well as country ownership. At the same time, however, IFF flows will be disbursed through existing delivery channels, so its policy framework must be consistent with those of implementing agencies.

- IFF planning and management must ensure that donor flows will not drop off, post-2015, from needed levels as donor pledges are drawn down to pay IFF bonds, a concern raised by Ministers in previous discussions. The IFF, if substantial and successful, could lower needed aid volumes over the long term – but substantial needs will remain even if the MDGs are achieved by 2015. Thus, the IFF must tap truly additional resources, consistent with the original assumption that donor pledges to an IFF would come out of incremental commitments as aid levels increase toward the 0.7 percent of GDP target ODA level, while still ensuring a continuing level of baseline flows.
- It will also be important to ensure the benefits of frontloading flows. The virtue of IFF funds is that they can respond to immediate needs and also provide assurance of funding predictability over a sustained period. Yet they would be relatively expensive resources whose cost would be borne in future, underlining the importance of good selection and implementation of IFF-funded programs.

## **II. Global Taxes**

27. The last few months have seen substantial discussion of the potential introduction of global tax instruments to provide additional finance for development expenditures. The case for such innovation has been made, and the main candidates reviewed – without arriving at firm proposals – in both the Landau Report prepared for President Chirac, and the Report of the Technical Group (2004) prepared by Brazil, Chile, France and Spain.<sup>9</sup> A major research project on the issue, examining many of the candidate instruments in some detail, has been undertaken at UNU-WIDER.<sup>10</sup>

28. This section draws on this and other work underway to advance the debate by providing a ranking of the main candidates in terms of criteria presented in the Fall paper to the Development Committee, raising some general administrative considerations that have received little attention, and addressing the key issues of earmarking and additionality.

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<sup>9</sup> Report of the Technical Group on Innovative Financing Mechanisms (2004). The group has now been joined by Germany.

<sup>10</sup> Atkinson (2005). Other important contributions include UN (2001), Kaul et al (2002) and Reisen (2004).

## A. Criteria

29. It is a basic canon of public finance that any tax should be judged by the adequacy of its revenue yield, its impact on equity and efficiency in the wider economy, and the ease of its collection. These same criteria continue to apply to global taxes – that are levied, with some degree of coordination, by several countries – but some distinctive considerations arise in an international context and from the desire to finance development. These led the Fall paper to set out the following criteria in particular:

- **Revenue adequacy and stability:** the instrument should raise a significant amount of money, be relatively stable (so capable of mitigating the volatility of conventional aid flows), and be likely to grow over time (in part, to complement the front-loading of IFF and other innovative schemes). It should be borne in mind, however, that the net revenue available for development purposes may be reduced not only by the costs of ensuring proper collection (discussed below) but also by pressures to return part of the revenues to the countries that pay the tax as partial compensation for the burden they bear.
- **Efficiency:** a tax is more desirable, all else equal, the less it worsens – preferably, the more it improves – the global allocation of resources. There are three main ways in which by expanding the set of instruments deployed such a tax might improve, or at least not reduce, the efficiency of the overall tax system:<sup>11</sup>
  - By dealing with some cross-border market failure that individual nations are unable to address unilaterally, the most obvious of these being environmental damage of various kinds.
  - By redressing mutually damaging international tax competition, as countries pursue beggar-thy-neighbor policies in order to attract or retain an internationally mobile tax base – though the case for tax coordination on these grounds is by no means clear-cut, since some would argue that competition imposes a healthy discipline against government waste.
  - By levying tax on economic rent (and so having no impact on decision-making), an especially attractive form in this context being rents that accrue to the world as a whole rather than to any nation in particular (such as those from mineral resources in international waters or Antarctica).
- **Equity:** the tax should be seen as fair, both in its treatment of different groups within any country and in the distribution of the burden across countries.
- **Ease of collection:** this is in part a matter of the simple feasibility of collecting the tax, of broadly the same kind as arise with any purely national tax, but more fundamental incentive issues arise whenever – as would surely be the preferred

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<sup>11</sup> The gain arises from governments' ability to reoptimize their overall tax system, and expenditures, in the face of a common tax initiative.

option – collection is delegated to national tax administrations. These issues have received relatively little attention in the discussion so far, and are taken up further below.

- **Minimum coalition size:** while it is in many cases technically preferable if all countries participate, and levy the common tax at common rate, this is by no means always a strict requirement. The smaller the group needed to implement a tax effectively – without excessive additional distortion or undermining by evasion or avoidance – the greater its chances of being implemented. Indeed a key reason many of these candidate taxes are not imposed already is because of a fear that domestic producers will be placed at some competitive disadvantage in world markets, in which case countries will need to be assured that their competitors – actual and potential – will also participate. The question becomes that of how large and cohesive is that minimal set of key participants.

30. There are important complementarities and trade-offs between these criteria. Taxes that are perceived as unfair, for example, are likely to be especially prone to evasion (hence hard to administer) and politically unpopular. And surcharges on existing taxes may be relatively easy to collect, but can only worsen the efficiency of the overall tax system because they simply add to the distortionary cost of existing taxes.

31. All these criteria relate, it should be stressed, to these tax instruments purely in terms of their merits in terms of tax policy and administration, and are essentially independent of the uses to which the revenue they yield is put. The question of whether it is appropriate to spend that revenue on development expenditure is logically quite distinct and is taken up in Section E below.

32. Even if the revenue is allocated to development finance, moreover, it should be emphasized that none of these criteria speak directly to the key issue of **additionality**: allocating the proceeds of a tax to development expenditure may partly or completely displace spending from traditional sources (even if separate targets are set for such spending in order to avoid displacement, the targets will presumably reflect awareness of the additional source of finance).

33. There is though one direct link between these criteria and additionality, noted in the Fall paper. This is that taxes which increase efficiency are the most likely to free additional funds, since by enabling governments to raise revenue in a less distorting way their effect is akin to an increase in the real income of the countries imposing the tax. The effect is likely to be modest, depending on the income-responsiveness of donor countries' willingness to provide aid. But the point nevertheless reinforces the preference for efficiency-enhancing taxes, and warns that taxes which cause additional efficiency losses may prove counter-productive.

## **B. Scoring Candidate Global Taxes**

34. Table 1 provides a rough rating in terms of the criteria above of the most widely discussed potential global tax instruments,<sup>12</sup> giving them ‘H’igh, ‘M’edium, or ‘L’ow marks under each. The assessments underlying these scores are those of staff, as set out in the Fall paper. They do not represent any formal consensus, and indeed there are cells on which opinions continue to differ and evidence to be scant. Some believe, for example, that a well-designed Tobin-type tax would improve efficiency by reducing exchange rate volatility. Relatively little is known about the distributional impact of financial transactions taxes: while these may bear more on the better-off to the extent that they make more use of the financial system, they may also increase the prices of goods consumed by the less well-off. And the high efficiency score for the tax on arms sales mainly reflects the undesirability that many see in the trade itself, thus implicitly assigning relatively little weight to potential problems arising from a tax, such as the intensification of illicit trade. Moreover, even within each of the broad schemes identified there are variants that differ in important respects. For all these reasons, the scorings reported are inevitably both subjective and debatable, their purpose being to advance and focus, not to resolve, consideration of these instruments.

35. Moving towards implementation of any of these candidates would require close attention to many detailed issues of policy and administration. By way of example, the next section reports some preliminary observations from work now underway on one of the candidates that scores relatively well in the table above: aviation fuel taxation.<sup>13</sup> This has recently received attention as a possible source of development finance in the EU. The purpose here, however, is not to endorse this proposal, nor to rate it over others, but rather to illustrate the kind of analysis needed to make real progress with any candidate.

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<sup>12</sup> The use of SDRs as a source of development assistance, which has some analytical similarities to a tax instrument, is considered in Appendix 2.

<sup>13</sup> Taxes on ticket prices also have some merits, though they are less well targeted to environmental damage (which arises even with empty seats). For brevity, they are not discussed here.

**Table 1: Scoring Tax Candidates /1**

	Revenue (\$Billion p.a.)	Efficiency	Equity	Collectability	Moderate Coalition Size
<i>Tax Instruments:</i>					
Global carbon tax	60-130 /2	H	M /3	H	M
'Tobin' tax	30 /4	L	M /5	M	M
General financial transactions tax	H	L	M /5	H	L
International aviation fuel	9 /6	H	M	H	M
Maritime pollution tax	1 /7	H	M	H	M
Tax on arms sales	2.5-5 /8	H	M	M	M
Taxes on global commons	L	H	H	H	H
Surtax on multinational profits	M	M	H	L	L
Surcharges on VAT or income tax	M	L	M	M	H
<i>Voluntary Contributions:</i>					
Add-ons to routine bills	L	H	H	H	H
Tax-based measures	L	H	H	M	H
Lotteries/premium bonds	M	H	H	H	H

Notes:

- /1 H = high, M = medium, L = low. Where revenue estimates are unavailable, revenue score is H (M, L) if estimated yield at a reasonable rate seems likely to exceed \$20 billion per annum (is between \$10 and \$20 billion, less than \$10 billion).
- /2 Higher figure assumes uniform application of \$21 per metric tonne; lower assumes implementation only by developed countries (Sandmo (2004)).
- /3 Assuming levied only in developing countries.
- /4 Nissanke (2003).
- /5 Relatively little is known about the distributional impact of these taxes.
- /6 Staff calculations.
- /7 Landau report (2004).
- /8 Reisen (2004).

### C. An Illustration: Taxing Aviation Fuel

36. Aviation fuel is currently lightly taxed, especially on international flights (to which international conventions apply). A coordinated increase in such taxes has considerable appeal on **efficiency** grounds, with two of the general considerations set out in the text being at work. First, the low level of aviation taxes may reflect tax coordination difficulties, as each country in isolation finds it difficult to impose a proper charge unilaterally given both the ease with which air operators may refuel elsewhere and the potential competitive disadvantage this would place on its own carriers and airports. Coordinated action may help overcome this failure of collective action. Second, aviation generates cross-national environmental damage calling for correction. The IPCC (1999) estimated, for example, that it accounted for about 3.5 percent of man-made global warming in 1992, and predicted this to rise to 5 percent (and perhaps 15 percent) in 2050. The exclusion of aviation emissions from the Kyoto agreement makes the failure of signatories to act on this front particularly anomalous. A tax on aviation fuel would be well-targeted to redress this inefficiency (though other instruments are also needed to deal with other external effects of aviation, such as noise pollution and airport congestion). It would also raise a worthwhile amount of **revenue**: around \$10 billion per annum, if levied globally at a rate (of say \$0.20 per gallon) which approximates the level of environmental damage.

37. Closer examination reveals other efficiency considerations needing to be assessed before making policy recommendations in this area. To the extent, for instance, that imperfections of competition in the airline industry lead to output restriction, a fuel tax could actually worsen rather than improve the allocation of resources. The implicit subsidization of some public carriers and aircraft producers, on the other hand, points in the opposite direction: towards excessive air travel. At least in some cases, moreover, consideration needs to be given to the possibility that taxing aviation fuel will shift travel to even more damaging modes. In the United States, for example, under-taxation of car fuels<sup>14</sup> may be such that shifting travel away from air may lead to a net worsening of environmental conditions.

38. The **equity** impact of such a tax deserves closer analysis. To the extent that the burden is felt by air travelers, a relatively well-off group, the tax seems likely to be reasonably progressive. The impact on less well-off travelers could be mitigated by levying the charge as a proportion of the ticket price, but at the cost of diminishing its effectiveness (since empty seats also cause damage). To the extent that there is free entry and exit into the industry, there is no effect on long-term profits, though companies will no doubt suffer transitional difficulties (eased, as it should be, by efforts to improve fuel efficiency). Potentially more problematic is the potential impact on tourist destinations.

39. The tax should be relatively **easy to collect**, given the wide experience that most countries already have in taxing fuels, the relatively small number of companies involved, and the extent to which they are already subject to regulatory oversight and flight monitoring. The key issues are likely to be the form of the agreement – a series of

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<sup>14</sup> See, for instance, Parry and Small (2004).

bilateral agreements among members has been suggested for the EU – and arrangements for mutual assurance of proper collection. In addition, domestic legal and constitutional constraints on taxation authority will have to be considered in each country that might participate.

40. Some **coalition building** is clearly needed, since otherwise countries would presumably have imposed heavier aviation fuel taxes already (proposals floated in the EU, for example, envisage cooperation from non-EU countries), but is limited to the extent that fuel capacity and time costs limit the scope for arbitrating tax differentials. These too are issues that require closer attention.

#### **D. Global Taxes: Some Issues of Implementation**

41. Detailed aspects of implementation have tended to receive relatively little attention in the debate.<sup>15</sup> As noted above, at one level there arise collection issues that are essentially the same as arise in connection with any national tax. Standard principles apply: collection will be easier, for example, the greater the concentration of potential revenue among a relatively small number of well-identified taxpayers. Clearly too a global tax will be easier to administer and comply with the closer it is to some national existing tax, and the less the cross-national differences in that tax. These considerations are reflected in the scoring above.

42. Beyond this, however, there are particular difficulties that arise if – rather than entrust all collection in a new global agency, which seems likely to be politically unpopular – collection is delegated to national tax authorities. These include:

- The incentive that each country faces to devote resources to the collection of the tax will be blunted in so far as the revenue is passed to another agency, and finances spending seen as less valuable than that from revenue retained for domestic uses. This bias in the allocation of scarce administrative resources can be mitigated (if not eliminated) relatively straightforwardly by allowing each country to retain some proportion of the revenue collected. In the European Union, for example, member states collect the revenue from the common external tariff that is passed to the central institutions of the union – but retain 10 percent as an inducement to collect.
- Rules of the game will need to be agreed, and set out in some sufficiently binding and complete form. This might take the form of multilateral or bilateral treaties (the latter being envisaged, for example, in the EU discussions on aviation fuel), or some looser compact. The range of issues to be covered will need to include the specification of the tax base – which can be far from straightforward even for relatively simple taxes, such as excises – as well as still more problematic issues

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<sup>15</sup> The discussion here concerns only the implementation of the tax itself, not the disposition of the proceeds. There are potential links between the two, in so far as transparency and effectiveness in spending may foster compliance.

such as procedures for changing any agreed rate. Some dispute resolution procedure is likely to be needed to deal with possible violations of the agreement.

- Incentives to collect – and to comply – may also be weak where the effect of the tax is to place national producers at a competitive disadvantage in world markets. This might be the case, for example, for energy taxes – indeed for most of the new taxes one reason they are not already imposed is precisely the potential damage to producers from unilateral application. In such cases, audit may be less intense, for instance, or late payers pursued less aggressively. Recognizing this incentive that each country faces to favor its own producers, each country will wish to assure itself that the tax is properly applied by its partners. This may require that the instrument of agreement discussed above extend to such detail as interest and penalty rates, payment periods, and other arrangements for registration, collection, assessment and enforcement. But some aspects of collection effort – such as the frequency, nature and intensity of audit – are difficult to fully specify in a contractual agreement, and difficult for partner countries to verify directly. They may thus wish to have in place some apparatus for the monitoring of the implementation of the agreement in all participating countries, which might take the form of mutual inspection agreements or some supra-national agency intended not to collect the tax itself but to monitor its collection by national authorities.

43. Even if routine collection can be left to national tax administrations, there is thus likely to be a need for detailed formal agreements amongst participating countries, including dispute resolution procedures and, perhaps, supra-national monitoring of implementation. These tasks lie outside the remit and expertise of any extant organization, and so may require the creation of new international agencies.

#### **E. Earmarking and Additionality**

44. The discussion and scoring above concern only the merits of the candidate instruments as revenue-raising devices. Whether those proceeds should be earmarked for development expenditures – rather than simply used to enhance the overall effectiveness of wider tax systems – is conceptually a quite different question.

45. With rare exceptions, public finance specialists strongly advise against the earmarking of revenue from particular sources to particular items of expenditure. Though often apparently convenient politically, given the fungibility of funds earmarking should in principle have no real impact on the level of expenditure on the favored item if the amount of funds earmarked is less than that which would have been spent in any event: finance from other sources will simply be cut. This, in the present context, is the additionality issue. There is some evidence, from other contexts, of a ‘flypaper effect’ by which money proves “sticky” and thus less fungible than standard theory would predict, but this is a slim reed on which to hang strong expectations of additionality. It should be noted, in particular, that it is not enough simply to set targets for traditional development expenditure: these will be made in the light of earmarked funds available, and their growth may be lower than it otherwise would have been even if pre-earmarking levels were retained for the near-term.

46. More generally, experience shows that earmarking can impose significant costs in terms of lost budgetary flexibility. The issue here is not so much the loss of flexibility in respect of the new instrument itself – which is likely to be minor in revenue terms, relative to other aspects of national tax systems – as it is the risk that earmarking one tax may lead to demand for the earmarking of others, to finance, say, domestic education expenditures. There may be little such risk for taxes that are distinctively different from others in bearing on global commons (satellite positioning, for example) since in these cases the revenue naturally arises at the level of the world as a whole rather than to any country in particular, and so is also naturally spent on items of common global interest. In other cases, however, the question is whether development spending would be accepted as a national spending priority in a way that other items – such as domestic education – are not.

47. The one case in which earmarking is most accepted is in relation to taxes that serve as user fees, paid by those who benefit from some costly service provided by government though even then there is no necessary link between the amount collected (which in principle should reflect the marginal cost of the service provided) and the amount needing to be spent on its provision (which depends on average cost). Closely related to this are cases in which taxes are levied in effect to finance insurance that would otherwise be under-purchased. In the environmental context, for example, the knowledge that government will step in to deal *ex post* with catastrophic damage may create an *ex ante* incentive to under-insure. And to deal with this Samaritan's dilemma, governments may have an incentive to make insurance compulsory, with premia akin to taxes. This is the nature, for example, of the International Oil Pollution Compensation Funds (see Box). In the present context, however, it is difficult to see a user fee or insurance argument for earmarking proceeds from any particular tax to development spending.

**The International Oil Pollution Compensation Funds (IOPC Funds)** are part of an international regime of liability and compensation for oil pollution damage caused by oil spills from tankers. Under the regime, the owner of a tanker is liable to pay compensation up to a certain limit following an escape of persistent oil from his ship. If that amount does not cover all the admissible claims, further compensation is available from the IOPC Fund if the damage occurs in a State which is a member of that Fund. The IOPC Funds Secretariat is based in London. The IOPC Funds are financed by levies on certain types of oil carried by sea. The levies are paid by entities which receive oil after sea transport, and normally not by States. Anyone who has suffered pollution damage in a member State may make a claim against the IOPC Funds for compensation.

The IOPC Funds were established through international agreements now agreed by 86 nations (93 by 2006). The United States, faced with legal limitations from separate laws in effect in most of the 50 states, did not join. It set up its own parallel system with the Oil Pollution Act of 1990, but the IOPC Funds have operated effectively even without the participation of the United States.

48. At its most fundamental, earmarking indicates a lack of faith in government, and in budgetary processes. It does not assure additionality as surely as would a simple

increase in explicit development assistance. While there might perhaps be some demonstration effect in building political support for development assistance by making it more visible to taxpayers, it is not clear that the same could not be achieved by improving information on and appreciation of traditional development spending.

### **Moving Forward**

49. This paper provides a framework for the assessment of global tax proposals based on the criteria of revenue adequacy and stability, efficiency, equity, ease of collection, and minimum required coalition size. The rough rankings presented do not represent any formal consensus – the intention is not to select or rule out any alternatives, but to focus international attention on how to move forward on the more promising proposals. Forward movement will require political decisions, agreement on specific instruments, and detailed work on implementation.

### **III. Voluntary Contributions**

50. Private contributions to fund development – while not a substitute for ODA – are increasing in importance. Grants from NGOs play an increasingly prominent role as a stable source of international flows. According to DAC data, voluntary contributions by individuals channeled internationally through NGOs have doubled in nominal terms since 1990, increasing from \$5 billion to over \$10 billion.<sup>16</sup> In addition, financing from private foundations has grown substantially, especially for initiatives on developing country diseases.

51. As with global tax mechanisms, it is important, but far from easy, to ensure that the establishment or encouragement of voluntary contributions results in truly additional flows that are used effectively and do not distort development flows by overemphasizing some needs at the expense of others. Another important issue, as voluntary contributions increase, is to find ways to reduce fragmentation, and – as with other donor support – to align the aid flows such contributions finance with recipient country priorities and programs.

52. The extraordinary level of private (as well as public) outflows in response to the tsunami disaster demonstrated both the potential for voluntary contributions and the relative lack of supporting architecture. In a number of donor countries, private flows exceeded public ODA. This response was clearly positive in terms of funding, and may point to the value of increasing public awareness about development issues. At the same time, however, it also gives rise to a number of significant risks. Even leaving aside bilateral and multilateral flows, immediately available aid flows from voluntary

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<sup>16</sup> Consistent global data that differentiate between contributions from individuals and corporation and non-profit foundations are not available. A “back-of-the-envelope” estimate by Micklewright and Wright is that voluntary contributions given for development purposes were about \$17 billion from the OECD countries in 2001. Atkinson (2005), ch. 7. Aggregate data are not available with respect to the also significant flows from non-OECD countries.

contributions through NGOs will likely exceed absorptive capacity. This could result in waste and corruption – and public disillusionment in both recipient and donor countries. Other negative reactions may be caused by donor groups that view the delivery of aid as achieving purposes beyond immediate humanitarian or development needs. Many tsunami-response aid programs remain highly fragmented and outside government-driven recovery frameworks, potentially undermining sector strategies aimed at long-term sustainable recovery. And it remains to be seen whether these flows can be used effectively not just for humanitarian purposes but also for reconstruction and development.

53. Enhancing voluntary giving: New modalities have also been created to support and encourage voluntary contributions for development. Examples include sponsorship contributions, which tackle the lack of proximity between donors and development projects by connecting individual donors with specific children, and steady-state giving arrangements between individuals and NGOs. The internet can also provide a platform for more direct connection between donors and final development results.<sup>17</sup> In addition, there is potential for increased voluntary contribution elements in the increasing number of public-private partnerships for development, such as in work to foster vaccine pull mechanisms.

54. Voluntary contributions by private individuals and businesses are made in a range of ways that could be expanded, encouraged and made more effective without impinging on their private and voluntary nature. Some mechanisms, such as the use of opt-in charges on routine payments – for example for utilities or via the establishment of “affinity” credit cards that provide funding for development through voluntary surcharges – could be undertaken by interested banks or companies. Others, such as income-tax based measures providing for additional opt-in (or opt-out) payments or deductibility of gifts, or the creation of a special purpose global lottery or premium bond, would require regulatory action by participating countries, either unilaterally or acting in concert.

55. These mechanisms too can be evaluated by the criteria set out in Section A, and so are included in Table 1 above. Significant **revenue** could be raised by lottery schemes if these were able to capture a significant part of the profits of those that currently exist. The evidence (for the United States) does suggest that tax deductibility enhances giving (though whether the additional giving exceeds the revenue cost of the deduction is by no means clear). It is in terms of **equity** and **efficiency**, however, that voluntariness is especially appealing. It is hard to argue that the impact of payments that are optional can be regressive, and by the same token such payments cannot increase the distortionary impact of the tax system. In the case of lotteries, however, some, from a paternalistic perspective, are concerned by the disproportionate take-up of actuarially unfair bets by the less well-off. Efficiency is arguably highest for tax-based schemes that provide some matching of private gifts, as is the case implicitly with deductibility of contributions (since \$1 of gift costs the giver less than \$1 in foregone after-tax income) and could be made more explicit by schemes that provide direct matching, perhaps at rate that did not vary with the taxpayer’s marginal tax rate. Against this, however, experience suggests

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<sup>17</sup> See, for example, [globalgiving.com](http://globalgiving.com).

that tax schemes can create opportunities for tax avoidance, to prevent which tight monitoring of the uses to which the gifts are put may be needed. Since voluntary schemes typically rest on well-trying financial arrangements, **collectability** is typically high. Voluntariness does not mean, however, that all will be in support of such schemes. For instance, there is a clear risk that a lottery whose proceeds are devoted to development finance may crowd out lottery-financed support of other charitable and cultural causes, incurring resistance from other interest groups.

56. But there are two still more important points. First, as noted above, voluntariness itself does not assure **additionality**: direct giving may erode political support for giving by government, for example, and tax deductibility may reduce government revenues (and hence capacity to support these and other causes) by more than it increases private giving. Second, voluntary giving by the residents of one country does not place it at any competitive disadvantage in world markets, so there is no obvious reason why countries should not adopt such schemes unilaterally; they thus score highly in terms of the criterion of **coalition** size. But that in itself means that the case for international coordination is weak. And indeed, many countries already and unilaterally give tax deductions for charitable contributions, and allow this for development-focused gifts as much as any other. Many also provide for optional add-ons to tax bills, such as to support religious activities (the Church tax in several northern European countries) or fund electoral expenses: there is no reason why they should not add similar provision for development spending. Apart perhaps from some effect in demonstrating solidarity, collective action is not needed to further encourage voluntary giving.

### **Moving Forward**

57. The scale of voluntary contributions is on the increase. The tsunami response and other developments point to possible shifts – and associated risks – in the way funds can flow. At the same time, a steady proliferation of new funds and facilities for specific purposes compounds harmonization and simplification problems, potentially distorting country-based approaches. In addition, good governance and effective delivery channels need to be assured for voluntary contributions to be seen as successful by donors. With these shifts in mind, against the backdrop of a relative lack of clear and consistent worldwide data about these flows, the international community could benefit from a more systematic work program to explore what can be done, specifically by governments, to encourage private and voluntary flows for development, and to foster their effective channeling and use in support of developing countries' own priorities.

### **IV. Blending Arrangements**

58. As discussed in the Fall paper, the leverage of current aid flows could potentially be enhanced through appropriately designed blending (and guarantee) arrangements between bilateral and multilateral lenders. In principle, blending mechanisms could serve to achieve any target level of concessionality, from market to grant terms, by combining grants and financing with different terms and characteristics. Applied globally, such mechanisms could increase both the volume and the impact of development finance by

matching the concessionality of funds to recipient needs, and provide impetus to investments in areas of particular importance to achieving the MDGs. In addition to the financial gains, blending mechanisms could generate substantial non-financial gains by bringing about greater harmonization of donor priorities and enhancing collaboration among donors and between donors and recipients.

59. Development funding sources include bilateral ODA, multilateral organization financing, private sector flows, and voluntary contributions whether from individuals, foundations or NGOs. These funding sources are typically associated with different funding instruments, notably grants, loans and guarantees. Bilateral ODA is now largely in the form of grants. MDB financing is largely extended as loans: the development banks offer relatively low-interest, non-concessional loans the relative cost of which are based on the capital backing of members, while the concessional windows such as IDA extend highly concessional loans and more recently some grants. Private sector financing takes the form of market interest loans, while voluntary contributions are generally grants. And in specific circumstances, different providers – including bilaterals, MDBs and foundations – may provide guarantees.

60. The international community is already using blending between different sources and types of financing to gain leverage and provide financing tailored to meet different needs between and within countries. For instance, the French aid agency, Agence Française de Développement, uses grant financing and guarantees extensively to leverage non-concessional loans and private financing based on country and project circumstances. In the multilateral system, there is a well articulated framework for tailoring development financing to country circumstances that includes blending. “IDA-only” countries with per capita incomes below the IDA cut-off receive highly concessional financing and grants. Creditworthy blend countries have access to both non-concessional MDB and concessional loans, and creditworthy middle-income countries are eligible for non-concessional MDB lending. Nevertheless, the present system is one with gaps rather than a smooth spectrum of eligibility and matching funding.

61. While there is considerable potential to improve the coherence of development finance and to exploit synergies and leverage from the different pools and types of finance, there are three areas where blending can play a particularly important role in giving impetus to scaling up efforts to meet the MDGs.

62. *First, a blend of concessional loans and grants can help the poorest (IDA-only) countries to scale up investment and spending to meet the MDGs without undermining debt sustainability.* As highlighted in the Global Monitoring Report 2005, the poorest countries face the largest gaps in financing needs to meet the MDGs and must rely on external official financing to a substantial extent in covering these needs. There is broad agreement that the poorest countries should receive highly concessional resources, with amounts adjusted to take performance and absorptive capacity into account. IDA-only countries with per capita incomes below the IDA cut-off have traditionally received grants from bilateral donors and highly concessional loans from multilateral agencies.

Recent discussions on financing for these countries have focused on the need for grant funding for global or regional public goods projects, and to ensure long-term debt sustainability. Accordingly, the recently agreed replenishments for IDA and the African Development Fund provide for financing terms – combining grants and concessional loans – based on country debt sustainability assessments. The volume of country allocations will continue to be based on performance, but the terms of financing will reflect each country’s level of debt distress and capacity to manage debt. Under the IDA14 framework, nearly 40 IDA recipients will receive 100 percent grant funding. In addition, IDA has a blending arrangements pilot in place, in the form of a “buy-down” program to support financing for global or regional public goods in health.

63. *Second, blending can be used to give impetus to the MDG agenda in middle-income countries and to finance global and regional public goods.* While middle-income countries, as a group, have performed well in recent years (as measured by growth and steadily improving scores in the Bank’s Country Policy and Institutional Assessment (CPIA) process), these averages conceal a very diverse picture and a large unfinished MDG agenda. Domestic resources and private external finance will provide the bulk of financing needed in some middle-income countries. However, official development finance continues to have an important role in supporting development, to catalyze private finance and help accelerate progress towards meeting the MDGs. In many cases, therefore, non-concessional MDB lending is either the only or the best available form of finance to help countries achieve the MDGs, to cover long-term infrastructure needs, and to support institutional and second-generation reforms. Concessional forms of finance could also play a role in providing external finance for advice and capacity building, in helping to scale up programs and investments to meet the MDGs where countries face fiscal and debt constraints, and to finance global public goods such as efforts to combat HIV/AIDs or preserve the global environment. In particular, many middle income and blend countries have large pockets of poor people and have large social and social infrastructure financing requirements. While the bulk of such financing will come from domestic resources, blending of bilateral grant financing with MDB lending can augment the amount of resources and ensure the most effective use of the available pool of financing to push the MDG agenda. This is especially so where bilateral programs are either small or not well targeted to meeting development goals.

64. *Third, blending can help address the needs of the so-called “gap countries” whose development financing needs are inadequately met in the current system.* Gap countries are ineligible for IDA financing other than on an exceptional basis, since per capita GNI is above the IDA cutoff of \$895.<sup>18</sup> They are not creditworthy for IBRD or other non-concessional borrowing, and have limited capacity to carry MDB debt.<sup>19</sup> For

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<sup>18</sup> By broad consensus among shareholders, some gap countries continue to receive exceptional funding from IDA, in some cases on hardened terms, which in a world of limited funding raises equity issues. Agreement by donors on these exceptions has to be renewed periodically, and the countries receive reduced IDA allocations and no grants.

<sup>19</sup> In principle, no developing country should be left without access to either IBRD or IDA, provided its performance is adequate. “Issues related to IBRD Lending in Blend Countries”, SecM2001-0581/1, September 28, 2001.

these gap countries, specialized blending arrangements such as a combined buy-down and guarantee, described below, might offer a way to use IBRD financing while protecting IBRD's financial integrity as well as the countries' need to select debt instruments that are consistent with their debt servicing ability.

### **Blending Mechanisms**

65. Different blending mechanisms could be structured in a variety of ways to provide different types of funding appropriate to country and program circumstances. As this work moves forward in support of specific programs, it would be useful to develop standard approaches to minimize transaction costs of blending arrangements.

66. Project-specific arrangements could use grants to finance or subsidize specific elements of a project otherwise financed by loans, typically elements that normally would be financially unviable such as power supply to remote rural areas. An example would be the Pamir Private Power Project in Tajikistan to generate and supply electricity, financed by multilateral, bilateral and private entities. The project incorporates tariff subsidy mechanisms, supported by IDA and a grant from Switzerland, to ensure basic provision of electricity to the poorest.

67. Buy-downs can be used to tailor financing terms to a target level of concessionality. An oft-cited example is the blending of DFID grants with IBRD loans in the health and education sectors in China, which effectively reduced the loan interest rate. Another results-oriented example is the polio eradication projects in Nigeria and Pakistan, where IDA credits (on regular concessional terms) were combined with grant support from foundations. Successful completion of the projects triggers the buy-downs, releasing foundation resources from a trust fund to purchase and cancel the credits, effectively turning them into grants.

68. With traditional parallel or joint co-financing, the borrower deals with multiple financing streams and with the administrative burden of diverse procurement, supervision and audit requirements of different lenders and donors. In the buy-down examples above, a prepayment mechanism (a trust fund) was established, lowering the administrative costs as well as the overall cost of funds to the ultimate borrowers.

69. Buy-downs to lower the debt service cost could be a way forward for middle-income countries that are willing to borrow for MDG programs only at more concessional rates. Debt service buy-downs alone would not provide a solution for non-creditworthy gap countries, as they would not resolve the underlying creditworthiness limitation arising from their lack of capacity to carry non-concessional debt.

70. Blending guarantee support with multilateral lending could be attractive in different circumstances. MDB lending to some countries is limited by single country exposure limits or other lending limits based on portfolio risk considerations. In these cases, a third party guarantee from a bilateral donor could support additional lending.

The likelihood of the guarantee being triggered would be low for creditworthy borrowers. For borrowers where limited creditworthiness constrains MDB lending, a guarantee could be used to transfer the credit risk of the borrower to a highly creditworthy donor. Use of guarantees to non-creditworthy borrowers is not recommended, as they are unable to take on debt service obligations for MDB lending, giving rise to a higher risk of default that could trigger the bilateral guarantee.

71. It may be useful to combine buy-downs and guarantees in particular circumstances, including for example in gap countries. Buy-downs reduce credit risk, but unless full debt service is paid for through blended grant funding, remaining credit risks will need to be addressed with guarantee support. A combination of buy-downs and guarantees could enable an MDB to increase lending directed at meeting the MDGs and, at the same time, lower the probability that the guarantees would be triggered. Such arrangements would further allow the benefiting countries to avoid an additional build-up of MDB debt, which may prove difficult to service.

### **Moving Forward**

72. The Bank is exploring the use of blending arrangements in gap and middle-income countries as part of a larger work program aimed at strengthening cooperation between development partners in supporting development in these countries. In this context, the Bank has begun the process of systematically sounding out the appetite of ODA providers and interest of potential recipients in participating in a variety of blending and other cooperative arrangements, designed to enhance the overall effectiveness of support for these countries. In parallel, further examination is needed of how the use of concessional flows in middle-income countries could be supported and rationalized, at the same time assuring additionality. Further work and consultations are planned to develop more specific proposals.

## Appendix 1: Remittances

1. International migrant remittances are not development assistance, but private flows. However, they represent a large and stable source of external finance for developing countries. Recorded flows of remittances to developing countries, not counting flows through informal channels, reached an estimated \$126 billion in 2004, from \$116 billion in 2003. The surge in recorded remittance flows since 2001 has made them the second largest source of external financing in developing countries, after foreign direct investment. Remittances tend to be more evenly distributed than private capital flows – remittances as a share of GDP are larger in poor countries than in middle-income countries.

2. The global policy agenda on remittances can be grouped under four areas: (i) improving data; (ii) reducing costs and strengthening financial infrastructure; (iii) understanding the development impact of remittances; and (iv) enhancing the integrity and efficiency of money transfer systems. The Bank has developed a comprehensive work program on remittances covering these four areas. Early findings from this work and policy recommendations will be published in the *Global Economic Prospects 2006: International Remittances and Migration*, to be published in November this year.

3. Reducing remittance costs has emerged as the most promising area of policy intervention. Strengthening the financial infrastructure supporting remittances would involve generating competition among remittance agents; improving migrants' access to banks in the source countries; and improving financial access in the recipient countries. It would also involve strengthening the financial integrity of remittance transactions while taking care that such policies may run counter to the efforts to reduce remittance costs. The Bank, together with the Bank for International Settlements Committee for Payment and Settlement Systems, is leading a task force to improve efficiency of retail payment systems and develop a set of voluntary standards for remittance agencies.

4. Improving remittance data is a key step in developing the remittance policy agenda. In addition to estimating the size of informal flows and estimating flows in some countries that currently do not publish remittance data, bilateral flow data (and if possible, corridor-specific data) need to be generated for informing policy design and implementation. The Bank was asked by the G8 to lead a working group to improve remittance statistics. The Bank organized a first meeting of this inter-governmental working group in January 2005 in collaboration with the IMF and the UN. A draft report of this working group is due to be circulated for consultations in September 2005, to be finally published in early 2006. The Bank is planning to undertake several household surveys to empirically assess the impact of remittances on poverty and inequality, and entrepreneurship in migrant-sending countries.

5. Preliminary findings suggest that remittances can have a sizable impact on income poverty, and they are more likely to reduce inequality when poor households can afford to migrate. In addition, the Bank is studying the impact of remittances on growth, country risk, and financial development of remittance receiving countries. It is also studying how developing countries may be able to securitize future remittance flows and raise external financing.

6. While remittances provide foreign currency, they (like FDI or exports) are not equivalent to or a substitute for official development assistance. They reflect the reward for individual employment and represent intra-household reallocation in the same way as occurs within non-immigrant families. By bypassing governments they target some needs better than ODA – but some worse. There is a strong case for encouraging remittances by reducing their cost, but little value in targeting them to specific uses (e.g., "productive investment") through direct policy intervention.

## Appendix 2: SDRs as a Source of Additional Development Finance

1. Proposals to use SDRs to provide additional financing for development have a long history, and were reinvigorated prior to Monterrey by George Soros. The Soros proposal has been further considered in the context of recent work on innovative financing modalities, including in the Report of the Technical Group and the Landau Report.
2. Allocations of SDRs for developmental purposes are not possible under the existing IMF Articles of Agreement, which recognize only the criterion of long-term global need for liquidity, on which there is currently insufficient international agreement. Allocations in the absence of a long-term global need would require an amendment of the Articles. Further, under the existing Articles, SDRs would be allocated on the basis of quotas, so that advanced countries would receive the bulk of the additional SDR allocations.
3. However, under the existing Articles nothing would prevent a redistribution of SDRs from advanced to developing countries, either for general development finance or for specific purposes. Under the Soros proposal, rich countries would donate some of their SDR holdings to a trust fund aimed at financing global public goods (such as HIV-AIDS) and other development programs.<sup>20</sup> Such a scheme would be relatively simple, and it appears equitable in terms of sharing the financial burden of development among countries.
4. The proposal also has some disadvantages. It implies a cost to donor countries, as central banks in developed countries would continue to pay interest on their entire cumulative SDR allocation. This cost would ultimately be borne by the treasuries of these countries. Initial funds could in theory be drawn from the SDR 21.4 billion Special Allocation of SDRs adopted by the IMF Board of Governors in 1997 (the proposed Fourth Amendment). However, the Amendment is still not in force, as it has not yet been accepted by a qualified majority of the IMF membership.
5. Finally, the SDR was conceived as an instrument to provide additional liquidity to the world economy. A redistribution of SDRs as mentioned above would be equivalent to a transfer of resources from donors to developing countries which could be more simply accomplished through other instruments. An allocation of additional SDRs purely for development financing could also set global liquidity at levels inconsistent with the needs of the global economy.

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<sup>20</sup> Taking into account the provision in Article XVII, Section 3(i) of the IMF's Articles of Agreement, it is also questionable whether such a "trust" could be designated as a "holder of SDRs".

### **Appendix 3: The Millennium Challenge Account**

1. The United States established its Millennium Challenge Account (MCA) based on Monterrey principles. The MCA directs new U.S. aid flows to poor countries selected based on their relative strong performance measured by independent indicators on three categories of policies: ruling justly; investing in people; and economic freedom. To date, 17 countries have been determined to be eligible to apply for MCA assistance. A “Threshold” program provides additional incentive for policy reform by offering assistance to 13 countries to improve in areas where they fell short of qualifying for the MCA.

2. MCA eligible countries identify priorities and develop their MCA proposals, in consultation with civil society and the private sector, based on their assessment of the greatest barriers to development. MCA proposals are evaluated based on their contribution to reducing poverty through sustainable economic growth and are not restricted to any particular sector or area. MCA countries will join with the Millennium Challenge Corporation in a multi-year public Compact, funded up front, for achieving shared development objectives. The Compact identifies the responsibilities of each partner and contains clear objectives, benchmarks to measure progress, procedures to ensure fiscal accountability for the use of MCA assistance, and a plan for monitoring and evaluation of results. Programs are designed to enable progress to be sustained after the funding under the MCA Compact has ended.

3. The U.S. Administration’s FY2006 budget request of \$3 billion would double the 2005 appropriated level. It is expected that MCA disbursements to partner countries will begin in Spring 2005.

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