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Development Finance in the Global Economy

The Road Ahead

Edited by

Tony Addison and George Mavrotas

Studies in Development Economics and Policy

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List of Abbreviations

ADB	Asian Development Bank
AfDB	African Development Bank
AfDF	African Development Fund
AIDS	acquired immune deficiency syndrome
APEC	Asia-Pacific Economic Cooperation
ARV	anti-retro viral
AsDF	Asian Development Fund
BSE	Bombay Stock Exchange
BWIs	Bretton Woods institutions
CarDB	Caribbean Development Bank
CCMs	country co-ordination mechanisms
CDI	Commitment to Development Index
CGD	Centre for Global Development
CIS	Commonwealth of Independent States
CPIA	country policy and institutional assessment
CREDIT	Centre for Research in Economic Development and International Trade, University of Nottingham
CRS	Creditor Reporting System, OECD
CTT	currency transaction tax
DFID	Department for International Development, UK
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECOSOC	Economic and Social Council, United Nations
EFA	Education for All initiative
EGDI	Expert Group for Development Initiatives
EITI	Extractive Industries Transparency Initiative
EU	European Union
FDI	foreign direct investment
FY	fiscal year
G8	Group of Eight leading industrialized nations (Canada, France, Germany, Italy, Japan, Russia, the UK and USA)
GAVI	Global Alliance for Vaccines and Immunization
GEF	Global Environment Facility
GFATM	Global Fund to Fight AIDS, Tuberculosis and Malaria
GNI	gross national income
GPGs	global public goods
HIPCs	heavily indebted poor countries
IBRD	International Bank for Reconstruction and Development

IDA	International Development Association
IDB	Inter-American Development Bank
IFAD	International Fund for Agricultural Development
IFC	International Finance Corporation
IFF	international finance facility
IFFIm	International Finance Facility for Immunization
ILO	International Labour Organization
IMF	International Monetary Fund
IPGs	international public goods
IRnet	international remittance network
ISPs	internet service providers
LAC	Latin America and Caribbean
LDC	least developed country
M&E	monitoring and evaluation
MCA	Millennium Challenge Account
MCC	Millennium Challenge Corporation
MDBs	multilateral development banks
MDGs	Millennium Development Goals
MDRI	Multilateral Debt Relief Initiative
MGFs	Multi-actor Global Funds
NEPAD	New Partnership for Africa's Development
NGOs	non-governmental organisations
NPV	net present value
NRIs	non-resident Indians
OA	official aid
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
OECD-DAC	Organisation for Economic Co-operation and Development – Development Co-operation Directorate
OOF	other official flows
PBA	performance-based allocation
PPP	purchasing power parity
PRGF	Poverty Reduction and Growth Facility
PRSPs	Poverty Reduction Strategy Papers
REER	real effective exchange rate
RPGs	regional public goods
SARs	severe acute respiratory syndrome
SDRs	special drawing rights
SSA	Sub-Saharan Africa
SWAps	sector-wide approaches
TFP	total factor productivity

TIIC	Transparency International Index of Corruption
TRIPS	Trade-Related Aspects of Intellectual Property
TWG	Transitional Working Group
UN-DESA	United Nations Department of Economic and Social Affairs
UNDP	United Nations Development Programme
UNFPA	United Nations Population Fund
UNHCR	United Nations High Commissioner for Refugees
UNICEF	United Nations Children's Fund
UNRWA	United Nations Relief and Works Agency for Palestine Refugees in the Near East
UNTA	United Nations Regular Programme of Technical Assistance
UNU-WIDER	United Nations University – World Institute for Development Economics Research
WDI	*World Development Indicators*
WFP	World Food Programme
WHO	World Health Organization
WOCCU	World Council of Credit Unions
WTO	World Trade Organization

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Development Finance in the Global Economy: The Road Ahead

Tony Addison and George Mavrotas

Introduction

Today, large volumes of global savings move through an increasingly integrated global capital market in search of investment opportunities. Capital is abundant. The developing world is receiving an increasing share of these flows, to the benefit of private investment – in production, trade and infrastructure – as well as to the balance of payments (with foreign direct investment (FDI) providing the most stable form of capital flow). Running alongside this story of private capital flow is one of increased official flows, official development assistance (ODA) having rebounded since its mid-1990s slump. And the flows of private and official capital run together at times, as with the international finance facility (IFF) which aims to leverage and front-load ODA by borrowing from international capital markets. The IFF, together with the French airline tax and proposals for global environmental taxes, the currency transaction tax (CTT) and the Global Premium Bond, constitute the new class of innovative financing mechanisms. Last, but certainly not least, the new philanthropy (increasingly in partnership with development agencies) is adding considerably to already well-established and growing flows from the charitable sector – and this source of capital has an especially close relationship with the goal of reducing poverty.

After many years of stagnation in the availability of finance for the developing world, the *aggregate* picture is brighter. But caution is also necessary. FDI is concentrated on a narrow range of countries (with China dominating), and while FDI into the smaller economies of Sub-Saharan Africa (SSA) is rising, it remains confined mainly to its traditional destination – the mining sector (which benefits growth but leaves economies undiversified). Private portfolio flows into equities and bonds are still concentrated on a narrow range of emerging markets, and while such flows into the so-called 'frontier markets' have risen in recent years – as investors' appetite for risk has increased – this is from a small base, especially in SSA. The good news on ODA is tempered by the fact that a significant part of the recent growth consists of debt relief.

Reducing the debt overhang of the heavily indebted poor countries (HIPCs) has been important to restoring their attractiveness to investors (Nigeria's international credit rating is now the same as Ukraine's) but many observers (including many poor countries) question whether debt relief represents a true net addition to their resources (and part of the jump in aid consists of cancelling the bad loans given to Saddam Hussein's Iraq). OECD-DAC warns that ODA could dip over the next few years, and this will imperil achievement of the Millennium Development Goals (MDGs) by 2015. And the effectiveness of aid is continually contested, most forcibly and recently by Bill Easterly (2006). Even among those favourably disposed to aid there are widely different views over the ability of poor countries to absorb and make good use of substantially larger flows (Mavrotas 2002; Killick 2005; Riddell 2007).

In summary, there is much to be positive about (especially when compared to the dismal decades of the 1980s and 1990s) but we are far from claiming victory in the battle to obtain more and better finance for the developing world, especially for the smaller and more vulnerable economies. There are ideas aplenty, and intellectual creativity in this area is certainly not confined to economists. The new international financial architecture raises many political and foreign-policy issues: finding the finance to tackle global environmental and health problems is recognized increasingly as being in everyone's interest; foreign aid is now viewed as an important part of the post-9/11 international security framework; and the balance of power in setting the international finance agenda is shifting, not only within the group of rich countries (as between the United States, Europe and Japan) but also between rich and poor countries, as China and India become increasingly important global actors. Political scientists and international relations specialists are now busy debating the implications of these trends both for the international financial architecture and for the global economy more widely.

This book aims to provide an overview and assessment of where we stand in the debate, and where we need to go from here in constructing a system of international finance that serves the needs of poor countries and especially of poor people. It contains contributions by specialists in economics, international relations, and political science; and a number of the authors have been at the centre of the international policy debate. The book is part of a stream of UNU-WIDER work in this area since 2000, including the study by Griffith-Jones *et al.* (2001) on short-term capital flows; the 2001 conference on debt relief (Addison *et al.* 2004); the 2003 conference 'Sharing Global Prosperity'; the study led by Sir Anthony Atkinson on new sources of development finance undertaken for the UN General Assembly (Atkinson 2004); and the 2006 conference on aid policy. This stream of research activity was stimulated by the lead-up to the 2002 UN Financing for Development summit held in Monterrey (Mexico) and its aftermath, the associated (and intense) activity around the MDGs, and the desire to continue UNU-WIDER's long-standing work on the global economy and the developing world that has, since the 1980s, sought to understand the implications of rapid economic change (Calvo *et al*. 1989; Wyplosz 2001; Nayyar 2002).

This chapter provides an introduction to the main issues raised by the volume. The next two sections provide a short overview of development financing in order to place the individual chapters in an overall context, first discussing the changing picture for private financial flows and then official development finance as well as the new class of (innovative) sources of development finance. The penultimate section introduces the chapters in this collection, summarizing the main points of each, linking them together and to the earlier contextual discussion. In the concluding section we note that, while the development finance picture is now brighter than it was just a few years ago, much more action is necessary if this is not to be yet another false dawn.

Private development financing

Demographics shape global capital flows through the global savings rate and, since the population shares of the working young and the retired old vary across countries, the pattern of cross-border capital flows. Financing the pension and health costs of ageing societies, notably Europe and Japan but also increasingly China, is having powerful effects on international capital markets. For Northern-based pension funds this has led to a somewhat desperate search for yield as returns on the North's sovereign debt (which has the least risk of default) have fallen since the early 1990s, and particularly since the start of the 2000s, because of a strong growth in demand (amplified by a shift from equities to bonds by investors following the 1999–2001 sell-off in equity markets). A scenario is emerging in which ageing societies increasingly invest in the equity and bond markets of youthful developing countries, a potentially 'win–win' outcome for both; Northern investors get higher returns and the South gets more (and cheaper) capital. If this works well, it will create bigger and more liquid Southern markets for sovereign debt, equities, corporate debt and, eventually, municipal debt and property as asset classes for Northern (and Southern) investors. India's capital markets are already benefiting from this effect, although it is not without its costs (the speculation in these markets will no doubt lead to some booms and busts along the way). Optimists speak of a new era in which the need for concessional loans and grants from development agencies will decline rapidly, with ODA possibly becoming extinct (much to the satisfaction of those who question aid's effectiveness).

This mutually beneficial scenario is not, however, a done deal, and some very fundamental problems remain that are more difficult to overcome than the optimists allow. Perhaps the most important of all is that the recipients of increased private capital flows need effectively to turn these into investments that generate higher economic growth, and therefore deliver the higher returns global investors expect. Otherwise, they will go elsewhere in their search for yield. Global investors must also be sufficiently risk-taking to allocate a large enough share of their portfolio to the relevant asset categories to benefit significantly from any superior returns; for the moment they are willing to take on such increased risk, for reasons we discuss shortly (but this is far from being a given and the decision is much affected by the easing of global monetary policy since the start of the 2000s). Southern recipients must also improve corporate governance substantially to protect shareholder rights (otherwise equity investment will not be sustained), build better sovereign-debt management (a tough challenge for the poorer countries), and improve their macroeconomic management to cope with the real-economy effects of the capital inflows (thereby ensuring that they facilitate rather than undermine economic development). We can expect more use of derivative instruments by global investors to hedge currency and political risks; and innovation to reduce the costs of such hedging could do much to stimulate flows to the lesser-known and riskier countries.

But not all risks can be hedged (or are indeed observable, since many are asymmetric – as between lender and borrower). The political risks of investing in poor countries remain high (giving rise to insecure property rights) and to a degree unpredictable – including those associated with adverse global climate changes. So the world's capital markets are unlikely ever to achieve textbook perfection in which every investment need of poor countries is matched by willing global investors. Consequently there will remain considerable space for official flows. And the need for ODA could actually rise much further (even beyond that projected to meet MDG requirements) as the effects of global warming take their toll on the South (in particular, a greater variance of rainfall in Africa's agricultural margins, and increased flooding in the many densely populated and low-lying lands of Asia).

Alongside financial globalization, and interacting with it, are geopolitical changes of immense importance to everyone. China is in an especially interesting position. China is both a recipient of portfolio flows (its sovereign bond issues are regularly over-subscribed by Northern pension funds) as well as an increasing source, since it must cope with its own rapidly ageing population, including the effect on the ratio of workers-to-pensioners of the 'one-child' policy adopted in Maoist times (which in part explains China's very high personal savings rate). China is now attempting to invest its massive reserves through a specially created investment authority (initiated in 2007), and the country will no doubt become a big investor in the equity markets of the rest of the developing world. This will accentuate the decline in yields now occurring on emerging market investments, requiring all investors (including those in the North) to devote more of their portfolio to these markets (that is, to take on more risk) if they are to meet their overall targets for asset growth to match their liabilities. The growth in the latter greatly exceeds the projections made just a decade ago in the mid-1990s because the rate of improvement in life expectancy is rising every year (not just in the North but also in China), imposing on pension funds a 'longevity risk' (pension payments will go on much longer); a typical large or medium-sized company in the UK has a pension scheme with liabilities that are a quarter of its market capitalization.[1]

Not far behind China is India (a country that one of the chapters in this volume assesses in detail; see further discussion below). Both China and India now borrow very little (as a share of their total financing) from the World Bank, and nothing at all from the IMF (making India a net creditor of the Fund). Brazil has also stepped back from borrowing from the Bretton Woods institutions (BWIs). The fact that the world's three largest emerging economies have moved in this direction has further reduced the IMF's role (one borrower, Turkey, now accounts for much of the IMF's outstanding lending). This is not to say that the BWIs are unnecessary: the World Bank's financing of health and social protection in India provides much-needed sector support, for example. But it is to say that we have shifted rapidly from the world of just twenty years ago (or indeed ten, if we recall the Asian financial crisis) when the BWIs called the shots.

The present strength of the sovereign debt market is the result of abundant global liquidity (with real interest rates at historically very low levels in recent years). Consequently there is a danger that as the interest-rate cycle turns, and liquidity contracts, emerging markets will turn down as they did in the past (Addison 2007). The US Federal Reserve, the Bank of England, and the European Central Bank have all begun to tighten over 2006–7. Yet, despite some strains (a wobble in Ecuador's sovereign debt market and a sharp sell-off in Chinese equities in 2007) there is not as yet any sign of major trouble, and the compression in spreads of emerging market over developed country debt that has marked recent years is continuing. In some cases the fundamentals in emerging markets have improved sufficiently to attract further inflows even as US monetary policy tightens with, perhaps, the search for yield by investors from ageing societies putting some kind of floor under the market. Still, we should not be too sanguine: financial crises are twice as prevalent today as they were in that other era (pre-1914) of financial globalization (Eichengreen and Bordo 2001).

The financial services industry is, not surprisingly, in a golden era; it will constitute 10 per cent of global GDP by 2020 and the emerging economies are its fastest-growing markets (Goldman Sachs 2003). Financial services are also showing modest but respectable growth in the poorer countries, with more direct investment by foreign banks in joint ventures with local partners (thereby helping to recapitalize banking systems) propelled in part by an expanding middle-class demanding more insurance, banking and housing finance (with, in some countries, increased efforts to provide formal financial products to poor people as well; Mexico has several interesting initiatives). This offers more scope for connecting domestic and international capital markets to the benefit of poorer countries in securing a larger share of global portfolio flows (and perhaps to poor people, but this will not be accomplished without much institutional innovation and a large measure of private or public subsidy, at least initially). It also requires heavy investment in financial regulation to ensure that the increasing sophistication of financial sectors in poor countries does not undermine their macroeconomic stability when new financial institutions engage in imprudent borrowing and lending (see Brownbridge and Kirkpatrick 1999; Stiglitz 1999; Guha-Khasnobis and Mavrotas 2008; Mavrotas 2008).

The poorer and smaller countries are becoming better known to international investors since declining yields on emerging market debt – the consequence of large inflows in recent years and a reduction in the supply of such debt – have encouraged investors into 'frontier markets' (Addison 2007). This is paralleled by increased investment in equities in these countries as well. Traditionally, these markets were bypassed in favour of the bigger, better-known and deeper financial markets of countries such as Brazil, China, India and South Africa. Information asymmetries and high transactions costs have made it difficult for small, poor countries to tap into global capital markets, but this is starting to change. The large write-offs of HIPC debt have helped Ghana and Nigeria to raise their sovereign credit ratings (an effect we discuss further below). At the time of writing, twenty SSA countries have a sovereign credit rating (compared to only one in 1997), and many can now borrow commercially at interest rates less than half those of the past. And they have access to the international capital market on a scale unimaginable only a few years ago.

Their underdeveloped capital markets do, however, lack liquidity, and large flows can potentially destabilize poor economies (causing large changes in exchange rates that could undermine growth, for example); so, again, careful macroeconomic management – including, at times, the judicious use of capital controls – is necessary (Stiglitz *et al.* 2006). This must temper recent optimism, and there are dangers ahead that require careful navigation, not least re-running 'that '70s show' in which countries borrowed recklessly on the back of the 1970s commodity boom – only to see themselves saddled subsequently with enormous foreign debts (Collier and Gunning 1999). These had to be serviced on the back of meagre export earnings when commodity prices collapsed again in the recession of the 1980s.

So it is imperative that, this time round, the borrowed funds are used to fund infrastructure to diversify economies away from their traditional dependence on commodity exports. Getting the right infrastructure in place is no easy task, and one priority must be transport and communications infrastructure that facilitates more intra-Africa trade; the transport costs that countries face in trading with each other remain absurdly high, a problem that has been emphasized repeatedly for decades, but one for which there has been too little finance available.

At least today's financial markets offer more tools for hedging commodity price and exchange rate risks, and governments would be well-advised to use these, as the bonanza of cheap world capital cannot last for ever. At some point before 2012 global inflation will rise (perhaps as a result of China's seemingly insatiable demand for steel, copper and oil), requiring the major central banks to tighten interest rates: easy credit will then come to an end, risk premiums will jump (including those on emerging market debt), and countries that have not used their borrowing productively will be exposed to the chill winds of expensive credit again.

It is therefore worrying that, despite all the chatter about a 'new international financial architecture' over the last few years, we are no closer to its realization. There is still no institutional mechanism to manage private debt default, since the IMF's proposal for a sovereign debt restructuring mechanism fell by the wayside in 2003. And there are some very good ideas – such as GDP-indexed bonds and linking debt-service to commodity prices – that remain on the drawing board (Griffith-Jones and Sharma 2006). It is in the good times, when credit is easy and commodity prices are high, that we should be building a financial architecture that is robust for the bad times that inevitably arise.

Official development assistance

At the 2005 G8 summit in Gleneagles (Scotland) the UK extracted pledges from heads of state to add US$50 billion to annual aid flows up to 2010, with at least half the increase going to SSA. Moreover, the traditional mechanisms of ODA are now starting to connect to the debate around 'new' or 'innovative' sources of finance (discussed in the next section) specifically through the UK's IFF proposal promoted by HM Treasury (with the heavyweight political backing of Gordon Brown, UK Chancellor of the Exchequer at the time). The IFF will leverage additional money from the international capital markets (through a securitization process) to achieve a flow of US$50 billion from 2010 to the MDG target date of 2015 (Mavrotas 2004; Moore and Hulme 2004). Given the novel nature of its borrowing, one major issue has been how well the IFF fits into the fiscal frameworks of donor countries themselves; Eurostat has ruled that IFF borrowing need not be included in the government borrowing of EU member states (an important decision, since the latter is limited by the EU's stability and growth pact) but the IFF does not appear to be compatible with the budgetary procedures of Canada and the United States. An International Finance Facility for Immunization (IFFIm) is now in place and, aside from its inherent desirability, it also constitutes a pilot for an eventual IFF.

Two years on from Gleneagles, however, the promises were only half-delivered. ODA in fact fell by 1.8 per cent in real terms in 2005–6 (excluding debt relief to Iraq and Nigeria, which boosted the 2006 total: including this debt relief yields a fall of 5.1 per cent in real terms over 2005–6). Far from rising to meet the MDG goals, aid to SSA from OECD-DAC donors was constant in 2006, once debt relief to Nigeria is excluded out (OECD-DAC 2007). The UK, Spain and Sweden have increased their aid sharply, with the UK moving up to become the world's second-largest bilateral donor. But aid from many European countries is stagnant or has fallen (notably from Finland and Italy), while US and Japanese aid has also fallen. It seems that the predictions made during Gleneagles that donors were fudging their commitments have proved all too true, and the donor community has come in for some sharp criticism. Richard Manning, chair of OECD-DAC, made it clear that the problem is one of supply rather than demand: 'the promises will not be credible unless we begin to see substantial rises in 2007 and 2008. The shortfall reflected a lack of will in the rich nations, rather than Africa's inability to absorb more aid'.[2] Aid absorption itself remains a thorny issue, with wide differences of view (Killick 2005; Gupta *et al*. 2005; Easterly 2006; Guillaumont and Guillaumont-Jeanneney 2006; Heller *et al*. 2006; Bourguignon and Sundberg 2007; Riddell 2007). But one key dimension is the quality of fiscal management and the ability of countries to translate additional resources into effective pro-development (and pro-poor) infrastructure and services; this is at the core of questions over whether aid can be scaled up by shifting from traditional project aid to budgetary support (McGillivray and Morrissey 2004; Mavrotas 2005; Koeberk *et al*. 2007).

Meanwhile, as many of Africa's traditional Western donors stall, new players have come into the arena, buoyed up by their large-scale accumulation of foreign-exchange reserves. Once itself a large net recipient of aid, China is becoming a major aid donor in Central Asia, the poorer countries of South-East Asia and especially in Africa; at its 2006 Africa summit (attended by forty-eight African leaders) China pledged US$5.5 billion in aid to the region, and could be Africa's largest bilateral donor by 2010. Not surprisingly, China's new prominence as a donor is receiving mixed reviews. Optimists look to the large-scale infrastructure projects that China's aid is capable of funding, especially in easing the transportation of Africa's commodity exports which are now in high demand (a return to China's donor role in the 1970s when, in a very different political context, it funded the Tanzam railway linking Zambia to Dar es Salaam's port). China's funding of African infrastructure rose from US$700 million in 2003 to US$2–3 billion per year over 2005–6 (Naím 2007: 96). Pessimists go so far as to claim that China's aid represents a threat to Africa's healthy sustainable development. China could use its enormous reserves to contribute to the next replenishment of the International Development Association (it gave nothing to the last IDA replenishment in 2005) thereby dispelling some of the accusations that it is following the well-trodden path of Western donors in using its aid largely for commercial and diplomatic gain. As Richard Manning emphasizes, what is needed is a constructive dialogue between DAC and China, and other 'emerging' donors, to encourage their take-up of DAC procedures and norms (Manning 2006). As a permanent member of the UN Security Council, China has a duty to set an example in ensuring that *all* aid is used for development purposes.

Debt relief constitutes a significant part of the recent ODA increase following the HIPC Initiative (later 'Enhanced') and then the Multilateral Debt Relief Initiative (MDRI) arising out of the Gleneagles decision to cut debt further. Whether much of this debt would ever have been repaid, and therefore whether it actually represents a true addition to ODA, remains a contested point (for a critique, see Eurodad 2006). Nigeria has also cut its commercial debt. In March 2007, Nigeria redeemed most of the debt owed to its commercial creditors (the London Club) in a deal that Nenadi Usman, the finance minister, said would 'free Nigeria from its historic debt overhang' (which in the late 1990s amounted to US$35 billion, equivalent to 60 per cent of GDP).[3] The last US$500 million has been bought back, and there are high hopes that Nigeria's sovereign bonds can now achieve an investment-grade rating. Although a politically unpopular decision at home (much of the debt was incurred by Nigeria's feckless military rulers with little thought to the future), recent debt buy-backs will lower the country's risk premium and make it easier to finance the budget – including much needed spending on basic health services, primary education, and pro-poor infrastructure (all of which are needed to haul Nigeria out of deep poverty).

Similarly, at the time of writing, Ghana is expected to raise up to US$750 million in 2007 from the international capital market, and overall the prospects for the region's poorer borrowers have improved significantly after completion of relief under the Enhanced HIPC Initiative and the MDRI. While eight African countries continue to languish at pre-decision point status under the HIPC Initiative (Central African Republic and Sudan, for example) debt relief is unlikely to do much to resolve their urgent political problems (the genocide in Sudan's Darfur region, in particular).

Having only just eliminated their HIPC debt (largely the legacy of past concessional aid loans to fund structural adjustment), why are countries in a hurry to borrow commercially? One reason is that aid is an uncertain way of funding the public budget, and the time since Gleneagles has not inspired confidence that aid is anything but a fickle friend.[4] And so African countries are turning to commercial borrowing, taking advantage of a world that is, at least for the moment, abundant in capital looking for a return. This provides an excellent opportunity to finance Africa's enormous investment backlog not only in 'hard' infrastructure but also in human capital. With the midpoint of the MDGs now upon us (as at June 2007) Africa is far behind on the education and health-care investments it needs to get close to the 2015 targets, and borrowing to achieve these targets is all too necessary, given the many broken promises of the aid 'community'.

New sources of development finance

What are now called 'new' or 'innovative' sources of development finance have attracted increasing attention since the start of the 2000s, following initial work done around the time of the 2002 UN Financing for Development Summit in Monterrey (Clunies-Ross 2004) and in part stimulated by frustration at the fall in ODA in the 1990s and the need to finance the MDGs as set out at the 2000 UN Millennium Summit. At the start of the decade, a panel chaired by President Ernesto Zedillo of Mexico calculated that roughly US$50 billion was necessary in addition to existing annual ODA flows to achieve the international development goals (subsequently the MDGs) (UN 2001). Interest in these new sources of development finance has also grown in response to the pressing need for more global public goods, especially in peacekeeping (reflecting the intense pressure on the peacekeeping resources of the UN and regional bodies such as the African Union), health (in the light of new pandemics such as SARS and avian influenza as well as the continuing HIV/AIDS crisis) and global climate change – concern for the latter accelerating in 2005–6 especially (on global public goods, see Kaul *et al*. 2003). In 2000, the UN General Assembly called for a rigorous follow-up study to the Zedillo report, and this was undertaken by UNU-WIDER in association with the UN Department of Economic and Social Affairs, and led by Sir Anthony Atkinson of Oxford University (Atkinson 2004). A study by the French government (Landau 2004) considered additional proposals, including a tax on airline fuel that has become a cornerstone of French action in innovative finance. Innovative finance has also become an issue for political co-operation between Europe and the larger emerging economies; thus in September 2004, the Governments of Brazil, Chile, France and Spain convened a heads of state meeting at the UN on an 'Action Against Hunger and Poverty Initiative'.

One 'old-new' source – and still in many ways the best known – is the currency transactions tax (CTT), originally known as the 'Tobin tax' after the economist James Tobin (who argued for the tax as a way to stabilize the extreme fluctuations in exchange rates that followed the breakdown of the Bretton Woods system in the 1970s). Tobin himself rejected the use of the tax in its modern financing-for-development guise, but it has proved to be a remarkably resilient idea within global civil society (see, for example, Pätomaki and Sehm-Pätomaki 1999) despite intense criticism from many economists. The CTT would be applied to foreign exchange transactions including the spot, forward and future markets as well as swaps and other derivatives. Countries that host major centres of international finance (notably New York, London and Frankfurt) do not favour the CTT, and even France has been lukewarm.

How much the CTT and other such sources of finance could raise remains an open question, depending as it does on the tax rates used, compliance, and the willingness (or otherwise) of national authorities to sign on. The

UNU-WIDER study assessed the relative merits of global environmental taxes (specifically, a carbon-use tax) and the CTT, as well as frameworks for international taxation more generally, and found that comparatively low tax rates could mobilize large revenues (Atkinson 2004). The CTT could generate US$15–28 billion per year (Nissanke 2004), and taxing hydrocarbon fuels could generate another US$50 billion (Sandmo 2004). Note that, to make an effective dent in global carbon emissions, the tax rates would have to be significantly higher than those used in the UNU-WIDER calculations, and while such taxes do have 'double dividends' – reducing adverse global climate change in the case of carbon taxes as well as raising revenue – they remain controversial, as the recent 'Stern Report' points out (Stern 2006).

The UNU-WIDER assessment informed the report of the French government (Landau 2004) as well as the 2004 'Action Against Hunger and Poverty Initiative' of the governments of Brazil, Chile, France and Spain. UNU-WIDER's findings were well received by the developing-country and European members of the UN General Assembly (although the developing countries did affirm that innovative sources of finance need to be *additional* to ODA) but the United States remains opposed to global taxes, arguing that they infringe national sovereignty (Addison *et al*. 2005a, 2005b). The present US administration's position is in part bound up with its reluctance to be swayed by scientific evidence on global warming, and therefore its extreme reluctance to sign up to any comprehensive action, be it the Kyoto protocol or global environmental taxes. But this reluctance is steadily being chipped away, not least by the state government of California, which is now taking global climate change very seriously. More fundamentally, global taxes raise issues of who will run the necessary tax authority; the UN would seem to offer the best home, but if the UN took on this role it would represent a large shift of power from its constituent (nation-state) members. Innovative finance in synergy with action on global climate change could become an avenue for recasting the UN's global role, although the practical and political issues that must be overcome remain formidable, but it is hoped not insurmountable.

Aside from global taxes, the remaining ideas in the innovative finance area are a mixed bag. The UK's IFF (a blend of ODA leveraged by private capital markets), which we have already discussed; the creation of Special Drawing Rights (SDRs) for development purposes (donor countries making their SDR allocation available for poorer countries) a long-standing idea but one that has been given a recent boost; innovations using IT to scale up charitable donations for development, especially for micro-enterprises; the Finnish proposal for a global lottery; and a global premium (prize) bond for poverty reduction. Others have looked to remittances, which now amount to US$80 billion per annum (matching annual aid flows), and while this is a very old flow there are new proposals to reduce transaction costs for poorer households and communities by creating new financial services for