Concept Note: Development Finance and the Post 2015 Framework
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"Domestic resource mobilization lies at the heart of development. Illicit financial outflows drain development resources". — Task Force on the Development Impact of Illicit Financial Flows

INTRODUCTION:

Interesting and encouraging consultations are taking place in many parts of Africa with regard to Post 2015 framework. In these consultations important lessons are being drawn from the successes and shortcomings of the MDGs both in terms of process and content. The lessons learnt are contributing to improving the process and content of the Post 2015 framework. While the jury is out on a conclusive assessment of the immediate and long term impact of the MDGs on global poverty eradication, a consensus is discernible that the Post 2015 framework can't just be an extension of the MDGs with regards to its content and implementation as well as on the differentiated responsibilities of stake holders and their respective accountability.

In terms of process, a simple look at the origins of the MDGs amply shows that it was essentially donor-driven. The MDGs were largely drawn from list of International Development Goals included in the OECD DAC 1996 report entitled "*Shaping the 21st Century: The Contribution of Development Co-operation.*[1] It was this list which later mutated into the MDGs in collaboration with the UN and the World Bank. It is important to note that MDG 8 was not included in this precursor to the MDGs.

In the last couple of months African civil society organisations have been engaged in making the consultative processes as participatory and inclusive as possible. This engagement is not about

[1] Kenny, Charles, & Sumner, A. MDGs 2.0: What Goals, Targets, and Time Frame? 2011

getting “the needs of the poor considered” by donors; but about making the African voice heard to contribute to shaping the content of the Post 2015 framework.

With regard to content, the aim is to build on the positive aspects, and draw lessons from the shortcomings of the MDGs. With regard to positive lessons, there appears to be widespread agreement that, the MDGs have;

- Helped to place a broad based global poverty reduction agenda at the centre of international development policy and discourse;
- Stopped the decline of ODA and mobilised more aid to Low Income Countries in particular; and,
- Contributed to achievements of MDGs in several countries.

When looking for lessons from the shortcomings of the MDGs, the major criticisms levelled against them where:

- They were not designed to address underlying causes of poverty;
- They are weak on social justice issues such as equity and inequality, civil and socioeconomic rights, vulnerability and exclusion; and,
- They fail to address the political and economic imbalances of power in the global context that is leading to growing inequality between countries.

Content wise, the purpose of the consultations is to ensure that the Post 2015 framework overcomes the aforementioned shortcomings in order to address not only the symptoms but also the structural root causes of global poverty and inequality within and between countries.

From a financing perspective, the design of the MDGs had an almost exclusive focus and heavy reliance on ODA. In addition to renewing their pledge to raise aid to 0.7% of GNI, donor country governments reassured that “no country genuinely committed to poverty reduction, good governance and economic reform will be denied the chance to achieve the MDGs through lack of finance”.

Although Domestic Resource Mobilisation (DRM) was also mentioned in the relevant documents as an important source to finance the MDGs, it cannot be said it was given the consideration it merits. It was conceived as an easily achievable target: *“through using broad-based revenue sources, such as a value added tax, strengthening tax collection, and redirecting current spending[2]”*

Inadequate treatment of and attention to DRM (in particular its international dimension) and heavy reliance on ODA should be considered as one of the major shortcomings of MDG 8. Unfortunately, the discussion with regards to this Goal, especially its relevance to the possible financing model of the Post 2015 framework, appears to be muted in the on-going consultations. A future goal setting discussion on financing the Post 2015 framework should start with a critique of goal 8 and the financing model it incorporated.

The immediate purpose of this concept note is to provide a framework for such a discussion within the on-going CSO consultations and ultimately enable the formulation of CSO advocacy priorities on this crucial issue. Further, considering that engagement with DRM is not a one-off undertaking, it is also to propose elements which should be central to African CSO engagement with DRM in Africa, such as:

a) The causes and magnitude of illicit flows as a drainage on domestic resource mobilisation;

b) The significance of forgone and forsaken public revenue for DRM due to ill-advised tax and investment policies;

[2] “*Investing in Development: A practical Plan to Achieve the Millennium Development Goals” – page 245.* Millennium Project Report to the UN Secretary General.

c) In a broader sense, the role of taxation in DRM for Africa to self-reliantly finance its own inclusive development; and,

d) Opportunities and constraints emanating from the global financial and economic context for DRM in Africa.

FINANCING AND THE POST 2015 FRAMEWORK

While financial considerations should not be the dominant factor in shaping the Post 2015 framework, their operationalization and implementation cannot be imagined without considering the financing model. ODA and DRM should thus be important component of the Post 2015 discussions.

Official Development Assistance:

The downturn trend in African economic perspective appears to have been stopped. This implies relatively less dependence on ODA. However, this should not give rise to complacency. Africa's economic growth is still characterised by inadequate job creation and low value-addition. What should be more worrying from a long term perspective is that the motor of this recent growth are sectors notoriously characterised by low and diminishing returns. According to UNDP analysis, even if high-income countries were to stop growing today Sub-Saharan Africa were to continue on its current growth patterns, it would take Sub-Saharan Africa until 2236 to catch up[3]. Therefore it is clear that we cannot afford to neglect the important role an adapted ODA can play in bringing Africa's growth on a sustainable path.

In the consensual agreement reached in Monterrey, Mexico in 2002, the gathered leaders committed to a "*substantial increase in official development assistance [to help] developing countries achieve internationally agreed development goals and objectives*"[4]. However, although ODA increased steadily since the introduction of the MDGs, rising from US$58 billion in 2000 to a projected US$125 billion in 2010, it still falls far short of the estimations of the financing gap and in comparison to what donor countries collectively pledged.

Criticising the over-reliance of the MDGs on ODA does not mean that the Post 2015 framework would not need ODA. However, for the ODA to play its due role it should be ensured that;

- Pledges and commitments are honoured to make ODA predictable and reliable;
- ODA is aligned with recipients' national development priorities and not the other way around;
- It is ensured that aid delivery of different donors is more coordinated.

In addition to the need to re-design official ODA from OECD countries along the aforementioned lines, the discussion about the role of aid in Post 2015 framework should take into consideration the fact that the relative importance of ODA in external aid and finance for development in general is no more as high as at the start of the MDGs. Sources of development finance are becoming more diverse. The importance of grants from philanthropic organisations, South-South transfers and remittances from the African Diaspora are increasing.

POLICY COHERENCE AND POLICY SOVERIGNITY WITHIN INTERNATIONAL DEVELOPMENT CONSIDERATION

When considering the role of ODA in the Post 2015 framework, the issues to be considered should not be limited to quality and quantity of financial aid.

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[3] UNDP, Human Development Report 2005: International cooperation at a crossroads – aid, trade and security in an unequal world (2005), p. 37).

[4] United Nations 2003, 14

Policy coherence

Most important in this regard is policy coherence within international development cooperation and policy sovereignty of recipient countries.

It is very crucial that the often lamented issue of policy coherence should be resolved. If OECD countries continue to tackle their own economic and financial problems without taking into consideration their impact on African countries; and try to implement solutions that could negatively impact on interests of African countries and more importantly that could jeopardize domestic resource mobilization efforts for sustained and adequate economic growth. For example, monetary and regulatory measures taken by OECD countries to address internal financial and economic crisis could result in external shocks to African countries and trigger financial and development crisis.

Policy sovereignty

Attaching policy conditionality to ODA should stop and the recognition of policy sovereignty should be at the centre of development cooperation. The issue of "policy space" is fundamental to policy sovereignty as it concerns countries' independence and flexibility in designing their economic and financial policies and institutions in light of their circumstances and devise ways and means of aligning domestic policy to international opportunities and constraints.

Policy choices are necessarily based on trade-off consideration between reasonable alternatives. They acquire their legitimacy when they are outcomes of participatory consultation processes by internal stakeholders affected by the policies and when they reflect an acceptable compromise between conflicting interests within a country's polity.

The issue of policy space/sovereignty is not only important as a matter of principle. It has also to do with the disastrous experience Africa has to endure due to the impact of policy conditionality attached to bilateral and multilateral aid.

The problem analysis underlying the policy conditionality in development cooperation in the past tends to look at crisis in African countries as mainly a result of homemade policy failures. The impact of global systemic failures is hardly given due consideration. The prescribed remedies are usually out of a one-size fits all tool kit not adapted to individual country conditions and to a crisis which is more often a confluence of external and internal factors.

The allegation that insisting on policy sovereignty is putting African countries before the choice openness or autarchy is misplaced. This is to ensure that African countries manage negotiate the terms and conditions of their integration in to the global economy.

THE CORE ESSENCE OF MDG 8: CREATING AN ENABLING INTERNATIONAL ENVIRONMENT

Although the contribution of traditional ODA is declining both in absolute and relative terms, this does not imply that their global responsibility in the fight against poverty. As mentioned above, the MDGs have contributed to increasing aid quantity. However, this cannot be said about their role in improving development policies that underpin bilateral and multilateral development cooperation. A World Bank document on estimations of financial needs of the MDGs states this explicitly: "*These calculations assume that, with the exception of foreign aid, all other international exchanges continue as "business as usual"."* [5]

[5] World Bank: The Costs of Attaining the Millennium Development Goals , Summary of the Research Working Paper, "Development Goals: History, Prospects and Costs," by Shantayanan Devarajan, Margaret J. Miller, and Eric V. Swanson.

The parts of the Monterrey Consensus relevant to these issues are cloaked in policy neutral declarations like the following: "*We commit ourselves to sound policies, good governance at all levels and the rule of law. We also commit ourselves to mobilizing domestic resources, attracting international flows, promoting international trade as an engine for development, increasing international financial and technical cooperation for development, sustainable debt financing and external debt relief, and enhancing the coherence and consistency of the international monetary, financial and trading systems".*

MDG 8 was meant to address international issues that affect the attainment of the MDGs. However, unlike the other goals it was not given specific policy or outcome targets and indicators to gauge progress towards these targets. Further, shared commitments to address issues that involve different roles need to be specific on the differentiated responsibilities of the stakeholders. And responsibilities do not say much on issues that involve different roles and differentiated responsibilities in addressing involved issues.

Political responsibility for attainment or non-attainment of development goals of any kind ultimately lies with nation-states. The conditions for the attainment of these goals are not within the confines of a nation-state. Global structures, over which African Countries have no influence, could thwart potentials favourable conditions and amplify the impact of negative factors.

Encouraging and supporting sustainable pro-poor development progress in individual countries is important but not enough. If a commitment to *"create of an enabling international environment"* is not rhetoric, it should be understood and implemented as an essential responsibility to create the pre-condition for successful nation-state efforts to overcome poverty and attain objectives to be set out in the post-2015 framework. It must be complemented by taking concrete measures to create an enabling international environment, or at least doing no harm in pursuing egoistic national interest, for such development to take place. African countries do not have the political and economic leverage to create by themselves such an enabling international environment.

DOMESTIC RESOURCE MOBILISATION

DRM is neither a fundraising activity nor a resource extraction exercise. It can serve its purpose only if it is part of an integral part of a development strategy. It has many determinants which should be considered in their relevance to the issue

Tax policy is an important tool of domestic resource mobilisation. For it to fulfil this purpose its role should not be reduced to revenue collection and its formulation should be freed from economic dogmas. It should be conceived as the vector that creates a virtuous circle between wealth creation and revenue collection and its point of departure should be to enhance economic development to enhance government revenue. It should be considered as a vital tool to serve economic transformation by incentivising productive investment and discouraging rent-seeking. It is a tool for redistributive allocations to address vertical and horizontal inequality and equitable and inclusive development. It is further a tool to create an internal environment reasonably resilient to external shocks and contagions. All examples of successful economic development show that this is possible only when financial policy is made to serve this transformation, and not when other sectors are to serve the "requirements" of the finance sector. A fiscal policy leaves out the finance sector and fiscal policy without state intervention and prudential state control of the finance sector.

Sovereign monetary and fiscal policy

As the name implies DRM is formally part of domestic policy, however it is linked to, and affected by policies and practices in international trade, investment and finance in a multitude of ways. Forced trade liberalisation and tariff reduction has led to loss of public revenue. Making tax incentive the corner stone of investment policy amounts to subsidising foreign investment. Deregulation in the finance sector and capital account liberalisation facilitates illicit capital flight. These global issues could not thus be considered as exogenous to DRM.

A key component of domestic resource mobilisation is a sovereign fiscal policy. Financial sector regulation and capital account control are key tools of domestic fiscal policy. Capital account control through inflow and outflow regulation enables a country to deploy counter-cyclical stability policy, to shelter its currency from speculative attacks, and more broadly to elaborate and implement a monetary and financial policy that propels economic development. Finance sector regulation is also a key tool for enhancing development of the national financial sector.

Although research by IMF staff amply show that those countries that insisted on financial sector regulation and capital account controls were least hard hit by the global financial crisis, capital account regulation is still stigmatised in donor aid conditionality. Of late the IMF has moved a bit on this issue, but not far enough. In a recent paper, it "allows" CAC as a measure of last resort after other measures such as foreign currency accumulation, letting national currency appreciation cutting budget deficits have proven failed. This not only defies the principle that prevention is better than cure, but also it is like consciously keeping the most effective medicine until the condition of the patient worsens.

The discussion around onerous debt appears to have receded from policy debate in Africa. However, servicing and repayment of debt (including odious debt) should not be neglected. These still constitute a huge drain on DRM. As the South Centre reminds us "*there remains the need for an internationally accepted debt exit mechanism that embraces all donors and provides a "fresh start" to indebted countries and includes provisions for cancelling odious debt, eliminating policy-based debt conditionalities, and opening a route to exiting from debt*"[6].

CURBING ILLICIT FINANCIAL FLOWS

> "The costs of this financial haemorrhage have been significant for African countries. In the short run, massive capital outflows and drainage of national savings have undermined growth by stifling private capital formation. In the medium to long term, delayed investments in support of capital formation and expansion have caused the tax base to remain narrow. Naturally and to the extent that capital flight may encourage external borrowing, debt service payments also increased and further compromised public investment prospects. Furthermore, capital flight has had adverse welfare and distributional consequences on the overwhelming majority of poor in numerous countries in that it heightened income inequality and jeopardized employment prospects. In the majority of countries in the sub-region, unemployment rates have remained exceedingly high in the absence of investment and industrial expansion". (Ndung'u, Governor of the Central Bank of Kenya in his keynote address at a policy seminar of Governors of African central banks in 2007)

[6] South Centre: Finance for development: From Monterrey to Doha. *A South Centre input into the preparatory Process leading to Doha Meeting, July 2008.*

Based on estimations regarding financing needs to achieve the MDGs, it can be stated that even 100% fulfilment of donor ODA pledges will not be sufficient to finance the Post 2015 framework. In addition to mobilising other external resources outside the ODA, tackling illicit flows from Africa should be at the centre of resource mobilisation to finance the Post 2015 framework.

Estimates on the magnitude of illicit financial flows from developing countries vary enormously, but even the most conservative suggest that the total outflow exceeds significantly the amount of official development assistance from the OECD countries. Countries must attack the illicit outflow of monies and recover what is now illegally held abroad.

The latest Global Financial Integrity report estimates that such flows have totalled $854 billion between 1970 and 2008. This estimate is regarded as conservative, since it addresses only one form of trade mispricing, does not include the mispricing of services, and does not encompass the proceeds of smuggling. Adjusting the $854 billion estimate to take into account some of the components of illicit flows not covered, it is not unreasonable to estimate total illicit outflows from the continent across the 38 years at some $1.8 trillion[7].

If this staggering loss of capital would have been retained in the continent most African countries could have paid off their outstanding external debt and could have still retained surplus for economic development and service provision.

Although there is no agreement on the exact figures involved in illicit financial flows, there is a widespread consensus now that illicit flows from Africa are larger relative to both ODA and FDI and curbing these flows would be an enormous gain to African countries. What is lacking is an agreement on measures and the required urgent actions to curb them.

However, staggering as these figures are, and encouraging as the widespread agreement on their impact on African countries might be, they don't tell the whole story. In fact it will be quite restrictive and misleading if the resource flow discourse and advocacy in Africa were to be limited to "marketing" these figures and exposing the mechanisms deployed to generate them captured in official statistics. GFI researchers themselves admit that these figures are conservative estimates and that they leave out activities and mechanisms that propel possibly more illicit flows than those captured in these estimates. A look at the caveats in GFI documents about the methodology used to estimate shows not only such us trade in services.

The estimations are based comparison of bilateral trade data held at IMF Direction of Trade Statistics. But this database cannot pick up illicit flows resulting from *same-invoice faking*; and yet "several studies have plausibly indicated that illicit flows through same-invoice faking are at least as large if not larger (and almost impossible to detect) than those involving mispricing between invoices".

GFI and other studies admits that mis-invoicing in trade in services offer much larger opportunities for profit shifting due mainly to the difficulty of pricing services across different countries on a comparable basis. However, the figures on illicit flows in these studies do not include trade in services. Given the fact that intra-subsidiary trade makes up 60% of international trade and, secondly and more importantly, the preferred mechanism of the global tax avoidance industry is works based on the principle of avoidance by works on the principle of "shifting costs as far as possible from tangibles to intangibles", it is not difficult to imagine the financial and policy implications of this omission.

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[7] Global Financial Integrity: Illicit Financial Flows from Africa: Hidden Resource for Development, 2010

Equally important for domestic resource mobilisation is that these estimates do not take into consideration very important forgone public revenue because of ill-advised tax policies such as tax incentives which cost African countries millions of dollars annually. The issue of tax intensive is crucial not only because of the huge tax expenditure it entails. In practice it signifies subsidising FDI to the detriment of local business. It leads to race to the bottom tax competition between African countries to the detriment of cooperation within and between regions.

Despite the agreement on the consequences of illicit flows, the analysis of the drivers of illicit flows is inadequate and even misleading in terms of the relative significance given to some of the various drivers. The issue of correct assessment of drivers is vital because it will not be possible to formulate adequate and preventive policy that can minimise the practice without deep analysis of, and agreement on the key drivers of illicit flows.

For example, some try to explain "portfolio choice" as a major driver of capital flight from Africa. Others would emphasise governance issues such as corruption and or macroeconomic issues such as inflation or stability as major drivers of illicit flows. While capital flight as a result of portfolio choice and outflows due to dissatisfaction with governance issues and macroeconomic climate are not only plausible but also legitimate. They are also adequate reasons to explain reasons for legal capital flight. However, these cannot equally explain and be drivers of illicit flows drivers of illicit flows which are largely comprised of funds that are unrecorded in the countries of origin because they are illegally earned or transferred.

An in-depth analysis of drivers of illicit flows with the view of curbing these flows and enhancing DRM should look at the following factors:

- Structural factors such as the existence of tax havens and secrecy jurisdictions which "lease sovereignty" to offer sanctuary to hide ill-gotten assets from legitimate governments;
- Business policies and practices to evade and avoid taxes as well as to escape regulation;
- Extremely unequal economic growth which incentivises stashing away undeserved wealth;
- Corruption and kick-backs in investment and procurement agreements; and,
- Outright criminal activities.

Finally, the magnitude of illicit flows should not be taken as the only and main challenge in DRM discourse. Illicit flows not only minimise the revenues needed for improving governance institutions, the provision of public services and for growth-enhancing investment such as infrastructure development. They create leakages and damage linkages in the overall economy. They erode legitimacy of economic activities and thus thwart vital economic development in general. They undermine the development and strengthening of relevant institutions for economic development. As Mike Moore puts it, "the apparently internal issues of weak institutions in poor countries both contribute to the prevalence and adverse effects of illicit flows and are partly caused by these flows".

Promoting Multilateralism and Strengthening the UN system

Illicit financial flows cannot be curtailed without the collaborative effort of OECD and Africa countries. Needless to say, African countries need to improve economic governance, adopt a range of macroeconomic policy measures which mitigate capital flight to curb illicit flows. However, these domestic measures will not succeed unless complemented by measures by OECD countries. Such measures would include ending the ease with which illicit capital flows are absorbed by tax havens in their jurisdiction by enforcing automatic exchange of relevant tax information between jurisdictions and disclosure of beneficial ownership. OECD countries need to enforce more transparency and accountability of the their MNCs for their activities in African countries

It is in Africa's interest that global economic, financial and resource flow issues are dealt within the framework of multilateralism. The growing erosion the UN as the only instance with legitimacy to deal with such issues will weaken Africa's potential to pursue its legitimate interest at the global level. Only multilateralism and enhanced role of the UN as a legitimate multilateral institution could redress economic and power imbalances and give voice to African countries.

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