Debt and Development: How to Provide Efficient, Effective Assistance to the World's Poorest Countries?

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Sony Kapoor, Senior Advisor, Jubilee USA Network

Members of the Committee, thank you for this opportunity to appear before the committee today to discuss debt and development issues. I would like to request that my full testimony be entered as part of the record.

Debt, Development, and the Importance of US Leadership in a Critical Year

Despite advances in science and technology and growing global prosperity, billions of people live in abject poverty across Asia, Africa, and Latin America. Each year, six million children die from malnutrition before their fifth birthday. The HIV/AIDS pandemic kills more than 2 million people every year and adds to the league of millions of orphans in Africa.

The United States has made commitments to address these crises. US development policies and its efforts to address the crisis of debt, which exacerbate these crises, are the subject of today's hearing.

It is both in the interest of the United States as a compassionate nation as well as in its economic interest to have trading partners that are strong economies. Trade is an important part of the US economy and the US share of world trade is more than a third. The US is dependent on many developing countries for imports of oil, other commodities and increasingly other manufactured goods and information technology-related services. Equally, almost half our exports now go to developing countries.

In terms of financial flows, our interdependence with developing countries is on the rise. For many of these countries the US is the largest single source of investment related capital flows. In turn, developing nations hold more than one trillion dollars of US government bonds and thus are responsible for recycling capital back into the United States.

By supporting impoverished country debt cancellation and other development initiatives, the United States can help to alleviate poverty, eliminate hunger, defeat the scourge of HIV/AIDS and malaria and improve the lives of billions of people around the world. Debt cancellation and development can bring resources and hope where there is little or none.

Debt cancellation and other development initiatives help to eliminate suffering and to foster conditions for sustainable growth and economic development in developing nations. Former Secretary of State Colin Powell has argued that development is a 'core national security issue' and that "the US cannot win the war on terrorism unless we confront the social and political roots of poverty."

Development is an important tool for increasing global security and achieving global prosperity. First, if the United States increased its contributions to the development effort, it is likely that other OECD countries will follow suit and so in terms of the resources being put into development every additional dollar of contribution by the US is likely to bring in as much as two additional dollars from other OECD countries. Second, the impoverished populations that we need to help with the development effort are currently so poor that even a very small sum of money can make a vast difference in their lives. So the marginal returns to investing in development are much higher. Third, in addition to earning the goodwill of people that we help, we are also securing our long-term security and economic interests. Our actions on this front will also earn the US much goodwill in the rest of the developing and developed world.

The US 'Marshall Plan' after the world war was crucial to the rebuilding and development of post war Europe and has won the US long-term strategic and economic allies and partners.

A broad-based and effective global development policy delivers more in terms of US long-term strategic interests than almost any other policy. Debt cancellation is critical element of such a policy, as it is the most efficient form of resource delivery to developing countries.

2005 is a critical year for development and impoverished country debt cancellation. Two major new reports, one from the United Nations[1] and another from the UK's Africa Commission, have contributed to the growing global debate over what steps are needed for effective global development. The focus of the G-8 summit in July in Scotland will be development. In September, heads of state will convene at the United Nations in New York to assess international progress on development, security, and human rights. Finally in December, the next round of WTO ministerial-level trade talks will take place in Hong Kong.

Never before has the issue of development received so much attention from world leaders. There is a deeply felt need to use some of the fruits of globalization to help those who have been left out; the Millennium Development Goals are a commitment to that. Unprecedented global prosperity and knowledge of some clear steps that can be taken to alleviate poverty has created a unique opportunity for action.

The United States, as a superpower, a leading shareholder in the international financial institutions, and prominent member of the United Nations, has a particular responsibility and an interest to help move the development project forward in this critical year. This is a unique opportunity for the US to assume a natural position of leadership by advancing a bold agenda on debt cancellation, aid, trade and other development issues.

The Development Context and Issues

> *We have the opportunity in the coming decade to cut world poverty by half. Billions more people could enjoy the fruits of the global economy. Tens of*

[1] "In Larger Freedom: Towards Development, Security and Human Rights For All," Report of the UN Secretary General Kofi Annan, 2005.

> *millions of lives can be saved. The practical solutions exist. The political framework is established. And for the first time, the cost is utterly affordable. Whatever one's motivation for attacking the crisis of extreme poverty—human rights, religious values, security, fiscal prudence, ideology—the solutions are the same. All that is needed is action.*
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> – *Investing in Development*, the Millennium Project Report, January 2005

In the year 2000, the world's leaders met in the United Nations General Assembly to set out a new global vision for humanity. They agreed to goals, subsequently known as the Millennium Development Goals - to halve world poverty and hunger by the year 2015; to achieve universal primary education; to promote gender equality and empower women; to reduce child mortality; improve maternal health; to combat HIV/AIDS and other diseases; and to ensure environmental sustainability.

Since then, these goals have been adopted by most major donor agencies as guiding principles for their strategies for poverty eradication. Unfortunately, reality has not kept pace with the rhetoric. Rich countries are still far from meeting the target of 0.7 % of GDP as ODA agreed to in 1970. Trade and financial liberalization of the kind being pushed in recent years has failed to deliver the desired results. High levels of rich country subsidies and continually worsening terms of trade mean that the current imbalance between the rich and poor countries is being reinforced. Worse, even resources that rightfully belong to developing countries are flowing out of the countries in the form of 'dirty money' of hundreds of billion dollars every year. This takes the form of transfer mis-pricing, tax evasion, tax avoidance and capital flight.

Worst of all, crushing levels of debt burdens remain and developing countries collectively pay more in debt service than they receive in aid flows. Even in some of the most impoverished countries debt service exceeds spending for health care and education. Debt cancellation would mean that the money that currently flows out of the poorest countries in the form of debt servicing right now could instead be diverted to development expenditure within the country.

There are three main issues in financing development today: 1) how to enable developing countries maximize the resources they can mobilize domestically; 2) what mechanisms and source of external funds can be used to supplement these domestic resources effectively; and 3) how to ensure that these resources both domestic and external stay within the developing country and are used to finance development in an effective and efficient way.

Since the focus of the hearing is on what the United States can do to assist the world's poorest countries to develop, I will focus mostly on the latter two points as action the former falls mostly within the purview of the developing countries themselves. There is however an urgent need in the international development community to recognize that much more can and should be done on domestic resource mobilization and to help developing countries fulfill that potential to minimize dependence on external financing and to achieve sustainable development.

External Funds

In the current context of discussions on development which focus on the achievement of the Millennium Development Goals (MDGs), it is appropriate to use them as a benchmark for funding needs. It was the Monterrey Conference on Financing for Development which first drew attention to the dramatic shortfalls in resources required to achieve the internationally agreed development goals.

In the Technical section of the conference's Zedillo Report, it is suggested that "the cost of achieving the 2015 goals would probably be on the order of an extra $50 billion a year".[2] Using two different approaches the World Bank figures range between $54 and 62 billion a year, and from $35 to 76 billion per year. The recent Millennium Project report has estimated the additional ODA flows needed to meet the MDGs at between $48 and $76 billion every year from 2006-2015.

While the Monterrey Conference concluded that the first port of call for financing the MDGs should be domestic resource mobilization, it is widely agreed that large chunks of resources needed to meet the MDGs would need to be external especially for the least developed countries. So while we need to maximize the development potential of domestically available resources, external sources of finance need also to be mobilized at levels far in excess of their current levels.

The discussion on working towards the MDGs has focused mostly on three issues – Aid, Debt and Trade -- as possible mechanisms to raise enough resources to meet the MDGs. A fourth mechanism – plugging the leakage of resources from developing countries is ignored but I will address it briefly.

Because of space and time constraints, I start by focusing my analysis today on the debt crisis and the need for debt cancellation as a critical tool for development. I will then address the other broader issues.

Debt Cancellation for Global Development

The Crisis of Debt

Every day, the world's most impoverished countries pay their creditors more than $100 million in debt service. Meanwhile 30,000 children die every day because of preventable poverty[3] - that is, from hunger, lack of clean water, and diseases which could be prevented or treated if the money were available.

In 2003 Senegal and Malawi each spent about one third of their government revenues on debt service.[4] A quarter of the domestic resources available for development spending in poor countries such as Zambia, Mozambique, and Uganda are currently being diverted to servicing debt.[5]These are some of the many African countries which pay more debt service every year than they spend on health.[6]

Meanwhile, the continent is in the midst of a health crisis, being ravaged by HIV / AIDS, malaria and other treatable diseases. In Zambia, Mozambique and Malawi, for example, life

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[2] United Nations "Report of the High Level Panel on Financing for Development" (Zedillo Report) (2001). Technical Report, p.16. http://www.un.org/reports/financing/
[3] 80 Million Lives 2003; Bread for the World; UNICEF; World Health Organization
[4] HIPC Status of Implementation Report, August 2004, IDA / IMF
[5] Resource Rich BWIs, 100% Debt Cancellation and the MDGs, June 2004, Sony Kapoor for the Dutch Foreign Ministry
[6] In 2002 / 2003 also true of Cameroon, Ethiopia, Gambia, Guinea, Madagascar, Mauritania, Uganda and Zambia. See 'Do the Deal', ActionAid, CAFOD, Oxfam, February 2005.

expectancy is just 37 years, and in sub-Saharan Africa as a whole, nearly one in five children dies before reaching the age of five. 2.2 million Children die each year in developing countries just because they are not immunized.[7]

For every $1 developing nations receive in grant aid, they pay back more than $3 in debt service[8]. These examples highlight the contradiction of trying to deliver large amounts of overseas development aid to impoverished countries just to see it flow out in the form of debt servicing. If they did not have to repay this debt, these countries would have substantially more resources available for development related expenditure.

Sub Saharan Africa, between 1970 and 2002 received $294 billion of money in the form of debts, paid $268 in debt service yet remains with an outstanding debt stock of about $210 billion. Canceling this debt would free up significant additional resources for use in development. Clearly efforts to deliver more aid make much more sense once debt cancellation ensures that this massive outflow of scarce resources stops. That is why debt cancellation is a critical first step for the purpose of helping meet the MDGs.

This point is elegantly summarized by an excerpt from *Investing in Development* – the report of the Millennium Project which says "… dozens of heavily indebted poor and middle-income countries are forced by creditor governments to spend large proportions of their limited tax receipts on debt service, undermining their ability to finance vital investments in human capital and infrastructure. **In a pointless and debilitating churning of resources, the creditors provide development assistance with one hand and then withdraw it in debt servicing with the other**."

As a solution, the same report recommends "Deepening and extending debt relief and providing grants rather than loans". Furthermore it suggests that "Debt sustainability should be redefined as the level of debt consistent with achieving the Millennium Development Goals, arriving in 2015 without a new debt overhang. **For many heavily indebted poor countries, this will require 100 percent debt cancellation. For many heavily indebted middle-income countries, this will require more debt relief than has been on offer. For some poor countries left off the heavily indebted poor countries (HIPC) list, such as Nigeria, meeting the Goals will require significant debt cancellation.** A corollary for low-income countries is that current and future ODA should be grants rather than loans."

What is needed is an effective delivery of the financial resources needed to meet development aims and objectives. Debt cancellation and increased aid provide necessary and complementary financial flows. **In fact, both 100% debt cancellation and a doubling of aid will be needed if the Millennium Development Goals are to be met, especially in sub-Saharan Africa.**[9]

Debt Cancellation: An Effective Tool to Release Resources for Development

Debt cancellation is a highly effective means to deliver new resources for development because:

[7] State of the World's Children, UNICEF 2005
[8] All figures from Global Development Finance 2004. 'Grant aid' excludes technical assistance.
[9] "Resource Rich BWIs, 100% Debt Cancellation and the MDGs," Sony Kapoor, June 2004 for the (IOB) Dutch Foreign Ministry and "Unbreakable Link", Romilly Greenhill, 2003 for Jubilee Research UK.

- **Debt cancellation provides direct budgetary support to debtor countries.** It largely bypasses the considerable administrative overheads that attend the application for, granting and monitoring of overseas aid.

- **Debt cancellation is a durable and predictable source of income**: By contrast, aid delivery is often highly variable, being subject to the ebb and flow of political will in donor countries. In fact, debt relief can actually be counter-cyclical.

- **Debt cancellation engenders a deeper sense of country ownership**. It is widely recognized that attempts to buy reform from unwilling governments have been a failure. Debt cancellation also increases the incentives for citizens and civil society to hold their governments to account for how their tax revenues are spent.

- **High levels of debt (debt overhang) deter future private investment**. There is ample evidence to suggest that poor/indebted countries, with their low credit ratings, are actively avoided by private investors (unless there are large official inducements).

- **Debt cancellation is anti-inflationary**. Recent research by the IMF points to a correlation between higher levels of indebtedness and increased inflationary pressures.

- **Debt cancellation helps keep domestic interest rates low**. Poor countries are currently being driven to increasing levels of internal borrowing to service their external debts. This also leads to higher interest rates, making loans unaffordable for local businesses.

Some critics say that debt cancellation will create a moral hazard – an expectation of further debt cancellation. But Jubilee USA Network and the global advocates of debt cancellation call for a **one-time gesture which wipes the slate clean, allows countries to make a fresh start and remove the development-inhibiting debt overhang**. Couple with grants rather than loans for the most impoverished nations moving forward, future debt crises can be avoided.

Another argument used by opponents of debt cancellation is that the resources released will be diverted away from development expenditure. It is clear that this has not happened. The World Bank/IMF's existing debt relief program, the Heavily Indebted Poor Country (HIPC) Initiative, though a failure on many fronts, has successfully demonstrated that debt cancellation can be a very efficient way of delivering resources to priority sectors. Though the cancellation offered was very limited, even the small amounts on offer had substantial development impacts.

The UK's Africa Commission reports that for example:

- In Benin, 54% of the money saved through debt relief has been spent on health including rural primary health care and HIV programs.
- In Tanzania, debt relief enabled the government to abolish primary school fees, leading to a 66% increase in attendance.
- After Mozambique was granted debt relief, it was able to offer all children free immunization.
- In Uganda, debt relief led to 2.2 million people gaining access to clean water.

Countries that received limited debt relief under the IMF/World Bank's Heavily Indebted Poor County Initiative (HIPC) doubled poverty-reducing expenditures from 1999-2004, and saw no net increase in military spending.[10]

In fact, a recent paper by the IMF which was discussed by the institution's board on March 30, 2005 clearly states that "further debt relief holds out the promise of easing concerns about debt sustainability while attracting additional financing needed to reach the MDGs."

Full debt cancellation is a fundamental component of the package of measures needed to finance development; it can be delivered early, and should ideally be additional to agreed targets for increasing aid as a proportion of national income. Moreover where the loans have clearly been badly made, the creditor must also share the responsibility for the financial consequences.

There is hence, a very strong case for the cancellation of multilateral, bilateral and commercial debts of all poor countries that are struggling with trying to meet the MDGs. This debt cancellation, being the most efficient form of aid delivery, should be the first step in a bigger package of increased resource flows to resource constrained poor countries. But debt cancellation must be scaled up significantly from the limited relief on offer now through the HIPC Initiative.

The Shortcomings of the HIPC Initiative

The current debt relief scheme for the IMF/World Bank, the Heavily Indebted Poor Countries (HIPC) initiative, though it has delivered billions of dollars in debt relief since its inception, has, after 8 years, failed to deliver the 'sustainable exit from debt' which the G8 claimed it would provide. First, many of the poorest and most indebted countries such as Nigeria and Bangladesh are not included in the initiative. Of the 42 countries which qualified initially for the program, HIPC has so far provided actual, irrevocable debt stock cancellation for only 18 countries.[11] Even in the case of this limited group of countries, the burden of debt on remains vast and crushing.

The Initiative to date has reduced less than a third of the total debt stock owed by HIPC countries, and already signs are that new borrowing is likely to bring debt levels back to the levels before the HIPC program was introduced.

Without going into the detailed shortcomings of the HIPC Initiative, it is still possible to see why it has not delivered its promised outcome. The countries in question are amongst the poorest in the world and it is clear that in order to meet the basic needs of their citizens – even to meet the MDGs – they require huge injections of resources that have not been forthcoming. These resources dwarf the amount of debt that HIPC countries hold. Rather than the partial relief that has characterized the HIPC Initiative to date, full or 100% cancellation of debt is a critical step that needs to be taken in order to free up scare resources for development.

There are three main types of debt owed by impoverished nations – bilateral debt, multilateral debt, and private sector debt. While bilateral and private debts have in many cases been

[10] HIPC Status of Implementation Report, August 2004, IDA / IMF
[11] As of May 2005

written off or are in arrears, the preferred creditor status of the multilateral institutions has ensured that almost all debt owed to them has been serviced regularly. Cancellation of bilateral and private sector debt may sometimes be just a paper transaction involving cancellation of debt that was not being repaid. Such a transaction while effective in reducing debt overhang may not free up any resources. In fact most HIPC debt stock reduction to date has come in the form of writing off debt in arrears – canceling debt that was not being repaid. More than 80% of the debt stock reduction to date for HIPCs has been eroded by a reduction in arrears.

HIPC debt cancellation to date has primarily been bilateral, e.g. the US has cancelled 100% of the bilateral debt owed to it by many HIPC countries. Multilateral debt remains the most significant burden for impoverished nations today.

The Growing Problem of Multilateral Debt

For all low-income countries[12] – 61 countries with a Gross National Income (GNI) less than $765 per capita – external debt outstanding has gone up 430% since 1980 and now amounts to $523 billion[13]. Debt owed to multilateral institutions has increased faster - 793% since 1980 to $154 billion, which is 30% of the total current debt stock. Multilateral creditors such as the World Bank, IMF, African Development Bank are now the largest creditors for most poor countries - especially the HIPC countries.

For the Heavily Indebted Poor Countries, external debt has gone up 320% since 1980 to $189 billion. Debt owed to multilateral institutions has increased 800% to $70 billion so it now constitutes a full 37% of the total debt up from 14% in 1980.

However, these figures understate the true share of multilateral debt as it includes countries that are not expected to reach the initiative's completion point. Multilateral debt will be by far the largest component of residual debt for most countries that will reach HIPC completion point i.e. successfully pass through the HIPC process. The International Development Association (IDA) arm of the World Bank is now by far the single largest creditor for most completion point countries.

In fact for the first 27 countries that reached decision or completion point the share of multilateral debt is expected to be all of 61% after the completion of the HIPC initiative up from 38% before the HIPC initiative.

Multilateral Debt Cancellation Frees Up Resources for Development

Multilateral creditors such as the IMF and World Bank are treated as preferred creditors, which means that their debts are serviced first. Even countries in financial trouble repay these debts as otherwise the international community might cut them off from external source of financing. Multilateral debt thus has the effect of diverting more resources away from development expenditure than other forms of debt, which may not be repaid if the country does not have resources.

[12] For a full list see http://www.worldbank.org/data/countryclass/classgroups.htm#Low_income
[13] Data from World Bank Global Development Finance 2004 CD ROM.

The cancellation of this multilateral debt would free up significant resources for development as the money that is currently going towards servicing this debt can instead be channeled into development expenditure towards meeting the MDGs.

Multilateral loans and debt come with strings attached – harmful policy conditionalities such as reducing subsidies for the poor, charging user fees for primary health care and education, privatizing public utilities and financial liberalization. These conditionalities leave limited policy space available to governments to pursue development strategies best suited to their own unique circumstances.

Multilateral debt gives the international financial institutions a large degree of leverage in driving policy in the poorest countries. A large part of the multilateral debt is rolled over – new debt is given by the multilaterals to repay the old debt owed to them – and a failure to meet conditionalities by the national governments can result in a refusal to roll over debt leading to a default that cuts the country off from external financial markets.

Canceling multilateral debt will reduce the amount of policy leverage that the international financial institutions have over the poorest countries and hence reduce the damaging conditionalities imposed on poor borrowing countries.

The doctrine of equal burden sharing for creditors – that all creditors would contribute resources for debt cancellation in the proportion of the debts owed to them - was one of the central principles of the HIPC initiative. However, this has not been borne out in implementation as bilateral creditors have contributed far more than the multilateral institutions.

In fact most multilateral debt cancellation to date has actually been financed by additional bilateral contributions. This has the effect of turning grants into loans[14] – as the money contributed by the donor countries is then recycled as additional loans by the institutions.

Multilateral debt cancellation through the use of the multilaterals' own resources is a way of redressing this imbalance. Asking the IFIs pay for multilateral debt cancellation through the use of their own resources would mean that they would be more likely to face the consequences of any bad or irresponsible lending decisions in the future and hence they would lend more carefully thus reducing the moral hazard.

Financing Multilateral Debt Cancellation

If it is increasingly clear that impoverished nations need debt cancellation to meet the Millennium Development Goals, then the question surely must be answered: How much would debt cancellation cost creditors? And how should it be financed?

The amount of resources needed to cancel 100% of the multilateral debt depends on which group of countries one looks at. For all of the 42 HIPCs about $45 billion[15] will allow the

[14] See *Results of International Debt Relief*, http://www.euforic.org/iob/detail_page.phtml?&username=guest@euforic.org&password=9999&groups=IOB&&lang=en&page=publ_nlSV

[15] In NPV or Net Present Value terms. All debt is not the same and it varies in terms of the interest rates, the period of repayment and other terms. To ensure comparability between debts owed at different terms, finance professionals use the concept of the Net Present Value which uses some assumptions to define how much the debt issued under various terms would be worth today.

cancellation of 100% of the multilateral debt. For HIPCs that have reached decision point, the amount needed is about $30 billion.

For a larger group of countries that includes all low income countries, for instance, the amount needed can be as high as $100 billion in today's money. However, low-income countries include those such as India that are expected to be on target to meet the MDGs without a need for additional debt cancellation.

Depending on which countries are included, 100% multilateral debt cancellation for the poorest countries will cost between $30 billion and $80 billion.

Some of the most contentious debates among the G-8 nations on debt cancellation center on how resources could be mobilized to finance debt cancellation. I will examine here four potential sources, including IMF gold, IBRD reserves and net income, IDA reflows, and additional creditor contributions.

IMF Gold

The IMF owns 103.4 million ounces of gold which is valued in its books at about $8.5 billion mostly because most of the gold is still held at the historical price of SDR[16] 34 or $51.5 / ounce. However the market price of the gold is much higher and as of the 28th of November 2004 it stands at $450 / ounce. If the IMF sold some of its gold, it could raise billions to finance cancellation of debts owed by impoverished nations to the IMF.

But one of the greatest concerns about the possible sale of IMF gold raised by the gold industry and others is the potential impact on gold price.

In order to completely eliminate market price impact – IMF gold could be sold under the existing Central Bank Gold Agreement under which (mostly) European Central Banks[17] plan to sell 80 million ounces of gold over the next 5 years. These banks could take a quota cut to accommodate IMF sales so that the total amount of gold sold does not exceed the 80 million ounces already announced.

Just as some central banks are selling gold others are buying it. Developing country central bank foreign exchange reserves have grown by 200% since 1997 to $1.5 trillion in 2004. However, most of this increase has been in the form of currencies – some of these banks are now seeking to have a more balanced portfolio by buying up large quantities of gold. So the IMF could sell gold directly to these central banks at a price indexed to the market price. Since the gold would not be sold outright and would not enter the open market, its impact on the market price would be minimal.

A combination of the above two mechanisms would perhaps be the most appropriate and efficient way of selling IMF gold without any significant impact on the market price. These robust arguments have helped convince previously skeptical countries and institutions that it

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[16] Special Drawing Rights; A basket of currencies comprising the US dollar, the Euro, the British Pound and the Japanese yen weighted roughly in proportion of the size of the respective economies. The IMF uses the SDR as the currency unit for accounting purposes.

[17] In most European countries, the central banks are under direct government control or under indirect control through being wholly owed by the respective finance ministries. So the decision to sell or not to sell gold can be influenced by the government. This means that if there is any political agreement on debt cancellation it can be translated into quota cuts by central banks.

is possible to sell IMF gold for debt cancellation without any adverse price impact. Based on this a growing consensus is developing on the use of IMF gold, including from a number of gold producing developing nations. HIPC Finance Ministers embraced the use of gold in a March 2005 statement.

In reply to a question from the South African Parliament, Trevor Manuel, the South African Finance Minister said he favored including 5 year quotas for gold sales allocated to central banks in 2004 for the process. "The (South African) National Treasury supports the use of IMF gold sales to finance debt relief for poor countries. The sale of IMF gold when done in a managed manner that is transparent, clearly communicated to the market and ideally along the central bank gold agreement, will mean that the market can price in the IMF gold sales and thus cause no disruptions to the price of gold."

President Benjamin Mkapa of Tanzania, another major gold producing developing country agrees: "IMF Gold; I'm in favor of (using) it (for debt cancellation). I was worried it might reduce revenues for Tanzania, but I have been assured that selling gold would not drastically affect the price of gold in the world market. So I am in favor of it."[18]

In March 2005, the International Monetary Fund staff, in a paper discussed at the board level embraced the suggestions about selling IMF gold under the Central Bank Gold Agreement and directly to emerging market central banks.[19]

The IMF paper points out: "The direct sale of gold to one or several central banks would involve only a redistribution of existing official gold holdings and therefore should have little effect on the gold market." The sale of gold under the CBGA would … "offer the best prospects of limiting any potential adverse effects on the gold market, since the agreed overall sales volume is already in the public domain and has been fully discounted."[20]

Some have also raised the concern that the sale of IMF gold may impact the IMF's ability to lend. Gold, as it is currently held by the IMF, constitutes only about 2% of the resources that the IMF has available to lend. In fact, the IMF's articles forbid it from lending the gold – so the Fund can not use it for normal lending operations and this means that this gold is of no practical use to the IMF for its lending operations.

The sale of gold, would actually increase, not decrease the IMF's capacity to lend by replacing gold that cannot be used for lending with its cash equivalent (of SDR 34 per ounce), which of course can be used for lending.

The limited and responsible sale of IMF gold is a viable option to finance IMF debt cancellation for impoverished nations that need debt cancellation to meet the MDGs.

IBRD Reserves and Net Income

IBRD reserves and IBRD income allocation is another source of multilateral funds that can be used to finance multilateral debt cancellation. The IBRD could transfer up to $10 billion to the HIPC trust from its general reserve, which currently stand at $21.5 billion (total equity

[18] Remarks by President Benjamin Mkapa to the Jubilee Debt Campaign National Conference, February 26, 2005, UK.
[19] IMF, "Financing Further Debt Relief for Low-Income Countries – Preliminary Considerations," March 11, 2005, Paper for discussion by the Board.
[20] Ibid.

$37 billion). Such a transfer would merely take the IBRD's reserves to the level they were at in 1997 at which point the Bank was active and successful (and rated AAA) as it is now. Such a transfer would be worth $10 billion in NPV terms.

Additionally the IBRD could transfer up to $600 million annually from its net income to the HIPC trust over the next few years. The IBRD's net income (profit) has been more than $1 billion annually for more than 15 years in a row and has averaged $1.6 billion over the past 10 years. Such an annual transfer of $600 million up to the year 2020 can generate[21] $7.5 billion in NPV terms. It would be most prudent for the IBRD to use a combination of transfers from the reserves and income allocations.

The IBRD could mobilize up to $17.5 billion in NPV terms which should be used to part fund the cancellation of poor country debt owed to IDA. In the past, the IBRD has already transferred more than $7.5 billion to IDA from its annual earnings.

It is clear from this that an allocation of $10 billion of its reserves to IDA for debt cancellation would in no way threaten its AAA rating. In fact, according to analysis by Fitch, the IBRD would still have 465% the capital that it requires in order to hold on to a AAA rating.

IDA reflows

Another option is to draw on reflows to the International Development Association (IDA). In this scenario, debts owed to IDA are simply written off. Currently, IDA has two sources of funds for disbursing loans. One is the new donor allocations that IDA gets every three years through its replenishment cycle and the second was through the loan repayments (IDA reflows). Currently, these loan repayments constitute a small fraction of IDA's sources of finds but the share of these reflows has been growing and is set to grow more as the forty year loans that IDA disbursed in the 60s and 70s become due.

So, there is a danger, especially if no allowances are made for the drying up of these reflows that IDA disbursement volumes would be lower than they would have been otherwise. This would then tantamount to the use of debtor country own resources for the canceling of debt which though structurally still beneficial would defeat one of the key motivations of debt cancellation – the delivery of new resources to developing countries. This would happen because though a country would stop paying debt servicing, it could be accompanied by a proportionate decrease in new IDA inflows – hence no net gain in resources.

However, under a regime where donors agree to increase their future IDA allocations, to compensate for a decrease in IDA reflows, it would be the donors and not the debtors who would bear the true cost. In fact, the financing is likely to be somewhere in between with neither the donors nor the creditors bearing the full cost. This would the have the advantage of removing the debt overhang and having at least some new money for development.

Donor contributions

Donor contributions are in many ways the simplest source of money that could be used for multilateral debt cancellation. It simply involves the donors paying the debt service due on

[21] Using a discount rate of 3%

multilateral debt on behalf of the debtors. However, this is deceptively simple as though it seems that the cost if straightforward borne by the donor, it may not be the case.

This is so as money in the donor budgets is fungible and this payment for debt servicing may come at the cost of additional ODA flows. In the absence of a counterfactual, there is no real way to tell what part, if any, of the donor ODA budget has been cannibalized. Thus, though donor contributions on surface seem to be unambiguously about increased resource flows to the debtors, it may not be the case.

The Current Debate on Debt and the Urgency of Action

2005 represents a unique opportunity for progress towards the eradication of poverty. The challenge and crisis of global poverty will be addressed by world leaders in just weeks at the G-8 summit, and then again in the fall at the UN Summit in September and the World Trade Organization Ministerial meeting in December.

We must seize the opportunity to advance an agenda of development and justice. The US can begin by supporting 100% multilateral debt cancellation for all impoverished nations, without harmful economic conditions. There is a unique opportunity to advance this agenda in 2005.

Jubilee USA Network, its member organizations, and debt campaigners across the globe have been encouraged proposals from the Bush Administration, the UK government, and other G-8 nations on multilateral debt cancellation in recent months. We are encouraged that the official debate within the G-8 has moved from limited debt relief to embrace our long-time call for 100% debt cancellation.

But discussions within the G-8 have stalled and become more limited in recent months, and there is a growing danger that whatever deal is agreed to by the G-8 this summer at the July summit will be partial or inadequate. Thus there are several critical markers to be included in any deal on debt:

- **Full (100%) debt cancellation must be provided for all nations that need it to meet the Millennium Development Goals.** At least 50 nations need immediate and full multilateral debt cancellation. The Jubilee Act (HR 1130), a bi-partisan bill current under consideration by the House of Representatives, calls for full multilateral debt cancellation for 50 nations. But recent reports indicate that US and UK proposals for debt cancellation may limit countries eligible for 100% cancellation to 18 or less. The country list must be expanded.

- **Debt owed to the IMF must be cancelled as part of any G-8 agreement on debt.** There is a danger that IMF debt will not be cancelled as part of a G-8 agreement on debt cancellation. This would be intolerable, as IMF debt repayments represent 30% of debt payments by the poorest nations over the next 5 years. Moreover, other regional development banks such as the Inter-American Development Bank (IDB) have been exempt from debt cancellation proposals by the G-8 – an unacceptable oversight given the fact that the IDB is a very large source of debt for poor nations in the Americas.

- **Debt cancellation must come without harmful economic conditions.** So-called "structural adjustment" policies must not be a requirement for countries to qualify for or receive debt cancellation. Such policies have negatively impacted per capita income growth across Asia, Africa, and Latin America.

Even with the progress that has been made on debt and development, the largest source of disagreement within the G-8 over how to achieve a deal on debt remains how to pay for it. I have presented in this testimony a range of feasible options. **It is now a question of political will. At this critical moment I hope that we can work together to achieve a bold new deal on debt and a stronger, more prosperous world.**

Overseas Development Assistance (ODA)

Despite having signed up to a commitment to give 0.7% of their GDP as Overseas Development Aid (ODA) in 1970 under a UN General Assembly Resolution rich countries have been allocating progressively smaller proportions of their GDP as ODA. Through the actual amounts have fluctuated, the trend towards lower levels has been clear with ODA having decreased from 0.51% of GDP in 1960 to 0.25% in 2005. There have been increasing calls for the rich countries to meet their commitments – in the past couple of years this has resulted in six countries Belgium, Finland, France, Ireland, Spain and the UK specifying timetables to meet the 0.7% target before 2015. Five countries – Denmark, Luxembourg, Netherlands, Norway and Sweden already give more than 0.7% of GDP as ODA.

Now the United States needs to increase its ODA contribution to 0.7% GDP from the current level of 0.15% of GDP which puts it last amongst the major donor countries. This could easily be easily done. Surveys of Americans show that most think the federal government devotes 15% - 20% of its budget to ODA whereas the real figure is smaller than 1%. The same surveys also show that Americans would like to decrease this contribution to about 10%. This gives ample scope for increasing ODA to 0.7% of GDP – this figure will lie well within the 10% of expenditure cap that the public wants[22].

While the administration deserves credit for the innovative Millennium Challenge Accounts (MCAs) and increased spending on HIV/AIDS but this is nowhere near enough of what is needed. The MCA focus on a few well performing countries is not enough and **the US needs to find practical ways to engage with the other countries that do not qualify for the MCA.**

Equally important as the amount of aid is the quality of aid and aid effectiveness. The largest chunk of US development assistance goes to its strategic allies – such as Israel, Egypt and Russia and now Iraq and Pakistan. Less than half of US aid flows to the world's poorest countries such as those in Sub Saharan Africa which need most assistance. **A much greater share of US aid needs to flow to the poorest nations.**

As much as 70% of US aid is 'tied' to the use of US goods and services. This severely inhibits competition and is inimical to the development of local private sector suppliers and contractor skills in recipient countries. This 'tying' of aid forces recipient countries to buy more expensive US goods and services rather than competitively tender for the most cost effective providers. This diminishes the value of US aid by as much as 25% but more

[22] www.cgdev.org

important goes against the principles of local private sector and entrepreneurial development that are so critical to our professed philosophy of a market economy. It encourages aid dependency and reduces sustainability and self sufficiency. **This tying of aid is inconsistent with our professed belief in poverty reduction, free markets, competitive bidding and should be abolished. Other countries have already taken the lead and the US should follow suit.**

US aid needs to be more flexible – too many laws and directives currently specify exactly where and how ODA should be used. This in conjunction with the severe administrative burden that the management of multiple donors with different priorities and dozens of projects imposes on limited local bureaucracy further erodes the effectiveness of aid. **There is a worldwide trend towards donor co-ordination and multilateral giving which the US should increasingly subscribe to and it should let recipient countries choose their own development priorities for using aid money.**

Migrant Remittances

One of the most significant developments in the field of external resource delivery to developing countries has been a large growth in migrant remittances. Remittances can help supplement savings in recipient countries, finance consumption, education and investment and act as seed capital for small scale entrepreneurial ventures. Perhaps the biggest attraction of remittances is that they are very stable over time and can in fact be countercyclical and provide social security for the recipient community.

However, remittances are not aid; nor can they substitute for aid. While, it is true that they can play a role in poverty alleviation this role should not be overestimated as remittances are very unevenly distributed both within and across countries. Low income countries account for less than a third of total remittances to developing counties and here too just four countries – India, Bangladesh, Pakistan and Vietnam account for over two thirds of the total remittance flows to the group of sixty one low income countries. **Sub Saharan Africa receives a tiny fraction of remittance flows even though its needs are perhaps the greatest.**

Even for countries that are large recipients of remittances, certain areas within a country account for the largest proportion of emigrants and hence receive a disproportionate share of inward remittances. **So remittances can complement aid to the poorest countries but cannot substitute it.**

It is well known that remittances especially from low income workers in developed countries to poor rural communities in their countries of origin carry the highest transaction costs which can sometimes reach as much as 30% of the face value of the transactions. It is these transfers not the transfers from the professional emigrants to their urban households, which have the most development potential.

There is thus an urgent need for both developing and developed countries to act to reduce some of the punitive costs associated with remittances. **The US needs to take urgent policy action to help facilitate a lower transaction costs for remittances especially to the poorest countries. Perhaps it would be a worthwhile idea to explore making remittances fully or partially tax deductible to help stimulate higher levels of remittance flows.**

Foreign Direct Investment

Foreign direct investment is widely regarded as an important source of financing for developing countries. It can help facilitate the transfer of technology, build up local skills and help stimulate local private sector development.

However, in reality the development impact of FDI is questionable. Empirical work on this has been inconclusive. Also, the magnitude of FDI that flows into the poorest countries is not very significant. In fact, only about 13 billion of net FDI went to the whole group of low income countries and of this about two thirds was concentrated in just five countries – India, Nigeria, Vietnam, Angola and Azerbaijan and the total FDI flowing to Sub Saharan Africa (besides Nigeria) was negligible.

Also, over the past five years for which data is available, for about $100 billion dollars of total FDI that flowed into low income countries more than $45 billion flowed out in the form of profit remittances. This highlights one of the biggest problems with FDI. Since it is for profit investment, it means that as profits are taken out, countries need to attract higher and higher flows of FDI to keep net inflows.

FDI is also concentrated in the extractive sector and it has been shown that while such FDI can help poor countries exploit natural resources, it contribute little to the development of a vibrant domestic private sector. It can also lead to environmental damage and has been known to play a part in conflict.

Increasingly, FDI is taking the shape of acquisitions of local firms by MNCs which has less overall development impact than green-field investments.

Most of all, developing countries are falling over themselves to try and attract the limited amount of FDI that is available and in order to do this are offering incentives such as lower or zero income tax rates, or tax holidays or offering to help construct the infrastructure that the MNC needs or help relax labor laws. As a study by McKinsey, the consulting firm has found out, such incentives serve no purpose except to pitch one country against another and to encourage a race to the bottom. In aggregate, such incentives had little influence on the decision of investors. However, as a result of such incentives, the effective rates of taxation in some of the poorest countries in the world have turned negative thus further eroding the already limited development impact of FDI.

Portfolio flows

Portfolio flows to developing countries are even more concentrated in the middle income countries and apart from a few countries such as India play a negligible role in low income country resource flows.

Their development impact is even more questionable than that of FDI as they are usually invested for a very short term with a pure profit motive and involve no form of technology or skill transfer whatsoever. Instead, they have been known to play and important role in the boom bust cycle often observed in immature poor country financial markets such as stocks or real estates. Sometimes, as in SE Asia, these flows can also help trigger a financial crisis which can have a very damaging effect on the economy.

Plugging the leaks

Taxation is at the heart of the ‘social contract’ between a modern sovereign state and its citizens. In return for fulfilling duties such as ‘paying a fair share of taxes’ citizens are provided with security, infrastructure and essential services such as education and basic health services.

Taxation is the primary source of revenue for governments and provides them with the funds that they need to provide infrastructure, security and other amenities to their citizens. The role of governments is especially important in the most impoverished countries where the income level of average citizens is so low that they cannot afford to purchase even the most basic services through private means even in the few cases where such a choice exists.

It is widely acknowledged that without active state intervention and participation in basic health, education and infrastructure services the development of the least developed countries could not be envisaged. It is a very serious matter then that the resources available to them to fund development expenditure are diminishing.

There are three relevant themes here with implications that go far beyond just the effect on government revenues. The three are ‘Tax Avoidance’, ‘Tax Evasion’ and ‘Tax Competition’. Related themes include ‘Tax Havens’, ‘Transfer Mis-pricing’ and ‘Capital Flight’.

One major route by which Foreign Direct Investment (FDI) is expected to contribute to development in a country is through the Tax Revenue that is generated on the profits on the FDI which then can be used by the government to finance development expenditure. However, faced with an ever increasing negotiating power wielded by MNCs, desperation for scarce foreign exchange which is needed to pay off huge outstanding debt burdens and severe competition amongst themselves – developing countries are offering increasing sops to MNCs to invest in their country.

A typical example could look like – MNC XYZ wants to put a $100 million bottling plant in East Africa to cater to regional demand. It goes to country A and negotiates a 20% concessional tax rate instead of the standard 30%. It then goes to country B and gets them to offer a 10% tax rate using country A’s offer as a bargaining chip. With these deals in hand it finally convinces country C to charge only a 5% tax rate and offer the company free land and infrastructure facilities where the costs of these is greater than any tax revenue that would be generated on company XYZ’s profits. Thus country C ends up with a negative effective rate of taxation and countries A and B having lost the investment would offer even steeper tax discounts next time there is an expression of interest from a foreign firm. This example is not academic but reflects the reality on the ground in several impoverished countries where effective tax rates are now turning negative.

Trade is supposed to contribute in a major way to development primarily through revenues generated for the governments as well as through private profit that accrues to the country. More than 60% of international trade is actually intra – company trade – transactions between subsidiaries of the same firm. More than 55% of international trade (in fact most of the intra – company trade) passes through offshore tax havens providing perfect opportunities for transfer mis-pricing and profits laundering. Ball point pens (not made from gold) priced at $800 per piece, a liter of apple juice priced at $1,012, a plastic bucket priced at $725 – these are some extreme but real examples of transactions that are used to transfer profits out of countries (both developing and developed) to zero tax fiscal paradises (tax havens). The effect on developing countries is more severe as their tax authorities lack the resources or the sophistication that tax authorities in developed countries have and hence MNCs find it easier to get away with mis-priced transactions.

Tax Evasion, Avoidance for both companies and rich individuals in developing countries is also widespread with Tax Havens playing a very major role in facilitating capital flight and money laundering which depletes the governments and countries of scarce resources needed for development. It has been estimated that developing countries collectively lose as much as $500 billion of money every year to dirty money flows.

This is an order of magnitude higher than current ODA levels and if even a fraction of these resources can be tapped for development, the level of funding for the MDGs would receive a big boost. These monies are also ideally suited for development as a large fraction of this is money owed to governments in developing countries – i.e. money that can then be directly used to fund development expenditure. It is also better quality money because unlike ODA – which carries with it the weight associated with a donor-recipient unequal relationship – capturing dirty money flows for development empowers developing countries as they get a larger share of what is rightfully theirs – so it is a form a domestic resources – which the Monterrey Consensus highlighted were ideally suited for development.

The actions needed to tackle these issues would benefit both developing and developed economies tremendously. The only real losers might be the small island tax havens which would then need to explore other avenues for raising resources. It is extremely important to note that the gain that tax havens derive from haven related activities are a very small fraction (much less than 1%) of the losses that these actions inflict on other non haven nation states. That is why a strong case can be made for the creation of a fund that will help facilitate the transition from a haven economy to a more sustainable and diversified one. This fund could easily be financed out of the proceeds of the gains accruing to developed economies from the abolition of tax haven related activity. This suggestion for a generous fund for tax havens that renounce haven activity would go a long way in reducing the opposition from these countries to moves to crack down on tax haven activity.

Amongst the steps that need to be taken are:

- Establishing a forum for international tax co-operation (not just between the OECD) countries that would facilitate an automatic exchange of information between tax authorities so that tax evasion cannot happen through the exploitation of the gaps between various tax jurisdictions. It would lower the incentives and opportunities for tax evasion, tax avoidance and transfer mispricing.

- Having an agreement on a minimum rate of corporation taxation would be very helpful to put limits to tax competition. The rate does not need to be very high as even a low rate could prevent tax rates from becoming negative.

- Legislation of a general anti avoidance principle would help clamp down on tax avoidance activity by making it illegal to indulge in activities aimed primarily at reducing tax liabilities.

- Eliminating bank secrecy would go a long way in catching perpetrators that are currently able to hide behind this secrecy and be safe from being prosecuted for laws they have broken. This would also be a very significant step in tackling the problems associated with terrorist financing, money laundering, smuggling and capital flight.

- Having an international agreement on company accounts that give a detailed breakdown of economic activity, profits and tax paid in each jurisdiction would make it much harder to avoid and evade taxes and engage in transfer mis-pricing at a large scale.

Some of these measures such as the legislation of a general anti avoidance principal can be unilateral but most others need to have at least a degree of international co-operation. This is where the USA and OECD countries can take a lead and support these issues not just from a development perspective but also as issues that would simultaneously have significant advantages for their own citizens.

Also, politically it is much more realistic to expect an agreement or consensus on the need and mechanisms for 'international tax co-operation' than for 'international taxation'. The magnitude of monetary flows that can be mobilized for example by concerted and co-coordinated action against tax havens, are also an order of magnitude higher than the revenue estimates from many of the proposed international taxes such as the 'Tobin Tax'. For example, a combination of measures suggested in the above section could easily result in as much as $100 - $200 billion of resources becoming available to developing countries in the medium run.

Unlike most other sources of development funding which imply a zero sum game – both ODA and Debt Cancellation for example imply a transfer of resources from citizens in the OECD countries to citizens in the developing world – money accruing from international tax co-operation is a win-win game. The same issues which are inhibiting development in countries as diverse as Brazil and Kenya are the factors which are leading to an erosion of the welfare sate in OECD countries. The interests of a majority of citizens in both the developing and developed world are then aligned pitting them against the interests of the super rich elite who number a few million at most.

It is also easy to get diverse constituencies such as labour unions and religious groups mobilized on the issue and parties from both the right and left end of the spectrum have much to gain. The left can use the additional monetary flows to increase welfare and infrastructure spending without unpopular tax rate hikes and the right can cut tax rates without unpopular cuts in the welfare state. Additionally security issues such as closing down channels which can be used for terrorist financing and money laundering would play well with the right of the electorate.

In fact, tax avoidance and tax evasion cost OECD governments hundreds of billions dollars every year. Co-coordinated action on international co-operation on tax matters could easily net these governments at least half of this money in new income every year. For example, the unpaid income tax on income of the more than $11.5 trillion dollars of assets held offshore alone is estimated to be about $255 billion every year. Using even $50 billion or 10% of these new tax revenues for increasing ODA flows can easily help finance the MDGs. Of course, this action will also help release tens of billions of dollars of developing countries' own money too.

The issue of tackling tax avoidance and tax evasion is thus something that has a lot of latent public support as well as support from both developing and developed country governments. **The sheer size of the problem and the positive impacts on both developing and developed countries mean that this is an issue that is likely to be politically feasible in the medium run. Policy makers and campaigners should push for the tax justice to be included as a financing for development theme because it is so central to the development debate and because the issue has not yet got the kind of attention that it deserves. So short term action can lead to some easy wins (such as the enactment of legislation enshrining the general anti avoidance principle in law by developing countries) and create the momentum and profile needed to co-coordinated action on the medium term with the potential to generate hundreds of billions of dollars for both developing and developed nations.**

Trade Liberalization

Trade liberalization and private sector involvement can play a significant role in fostering growth and development. They can help through capacity building, increasing income levels, a diversification of the economy, infrastructure development and faster growth levels. However, there is a need for caution.

The great benefits being promised by the theoretical models are, to begin with, based on questionable assumptions. Even worse, the real life implementation of trade liberalization as has been observed over the past few decades is very different from what we see on paper. Worst of all, this liberalization in its current form has not brought about most of the benefits promised though the costs imposed have been real.

Trade liberalization should be used as one amongst many policy instruments in the context of a national strategy for achieving growth and development. Trade liberalization without the external and internal supporting set of conditions has led countries to slow and erratic growth, rising poverty and unemployment, de-industrialization, a very dangerous erosion of fiscal revenues and environmental degradation

Empirical evidence from countries that have been able to use trade liberalization as an instrument for increasing growth and development (ranging from China and India, less recently the East Asian tigers, and, during this century and the last one, today developed countries such as United States and Netherlands) shows that they:

1) implemented it on a selective basis, giving priority to sectors that had achieved a certain level of economies of scale and were ready for international competition,
2) had secured a certain market and access conditions that would allow them to further develop sectors
3) had the flexibility to pace and sequence the trade liberalization process, as well as roll-it back when reforms did not work or outlived their usefulness
4) had been able to previously use trade protections as an instrument to build strong and competitive national industries
5) The state facilitated –through different policy instruments-- the provision of access to credit on affordable terms for the national industry.

It is important to mention several features and trends of current trade agreements that might hinder the ability of countries to implement a pro-development trade policy

Trade in services: current FTAs tend to incorporate trade in services, especially requiring countries to eliminate regulations that might act as barriers to foreign service providers. In many trade agreements the trend is towards “negative list” approach and require countries to slash regulations that are not the “least trade-restrictive.” Countries signing onto these agreements are deprived from instruments to ensure that services needed to support the development of the productive economy are provided on affordable terms (such as financial services, transport, tele-communications)

Intellectual property rights: current FTAs tend to incorporate strong patent protection, in some cases (TRIPs-Plus mode pursued by United States) stronger than the conditions existing under the WTO Agreement. Since these protections enforce a monopoly by the owners of the patents, TRIPs-type protections had been criticized as not being really about competition, leading to even strong supporters of trade liberalization to call for taking intellectual property rights out of trade agreements. Access to technology in affordable terms is another condition required for the productive sector to be able to compete successfully.

Foreign investment: current FTAs also incorporate rules that protect rights of foreign investors, grant them National Treatment, Most Favored Nation, ban performance requirements by the host state. FDI comprises capital, know-how, technology, managerial skills and access to markets, all assets that can enhance the competitiveness of a country in international markets. However, FDI can only make this contribution when its different factors are incorporated into the local productive economy, which requires unpacking them. Investment agreements prevent countries from using policy instruments suitable to this purpose, especially performance requirements.

Cross-border capital flows: current FTAs tend to also incorporate (either under investment or financial services) rules that strip the state away from its power to establish capital controls or otherwise manage foreign capital inflows and outflows. These capital flows have been successfully used by states to ensure a stable exchange rate policy suitable to enhance export performance. Also to prevent the build up of unsustainable public and private sector debt profiles that trigger damaging financial crises.

Trade liberalization can be used to help development but must be pursued in a controlled manner. Poor countries can benefit from a reduction in import tariffs but this benefit is maximized when the abolition of tariffs is selective – on goods and services that facilitate development such as capital goods. An across the board slashing of tariffs has been shown to increase import penetration to excessive levels, discourage the development of local industries, worsen both the current account and the fiscal balance and result in a massive increase in import of luxury goods for the elite classes.

Technology transfer is a very important source of long term development under the trade regime but is not being seen in actual implementation. The liberalization of financial services too, instead of removing credit constraints has been seen to decrease access to credit for the poorest and serve as a channel for the flight of capital.

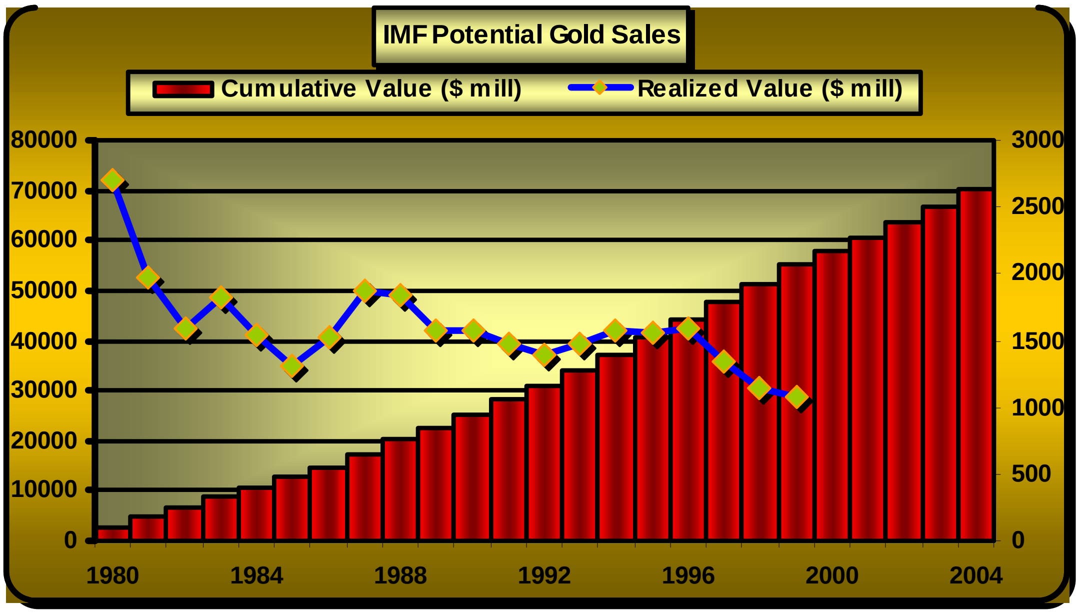
Other major issues and positive steps that can be taken

Some of the other major steps that the US can take to help maximize development for the poorest countries involve the role of the International Financial Institutions.

Maximizing the efficiency of resources available to the IFI's

The opportunity cost of holding gold

The IMF claims that the benefits of gold holdings are being passed on to members. However, this is misleading as these stated benefits are intangible and insignificant compared to the significant opportunity cost of holding undervalued gold reserves. According to our calculations[23], if the IMF had sold its gold holdings into the market gradually over a period of say twenty years from 1980 and invested the proceeds, it would have had current reserves of more than $78 billion[24]; almost twice the current market value of its gold holdings of $42 billion.



It is important to recollect, that Fund staff in 1979-1980 wanted to sell the gold and invest proceeds in income generating assets but were thwarted by lack of political will. **Had the fund sold gold gradually and invested in income generating assets, it would have had current reserves worth as much as twice the current market value of gold. So the IMF should sell some of its gold and thus use resources available more efficiently.**

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[23] We assume that the IMF sold 5 million ounces of gold in the market every year from 1980-1999 at the market price and the proceeds from such sales in excess of SDR 35 per ounce were invested in securities yielding 5% per annum. A simple calculation shows that the IMF would now have more than $70 billion. If we add the current book value of IMF gold of about $8 billion this gives a potential current market value of $78 billion. This compares with the actual current market value of $42 billion..

[24] In Can the IMF and the World Bank cancel 100% of HIPC debt – by Sony Kapoor September 2003 at Jubilee Research for Debt and Development Coalition Ireland, we have used slightly different assumptions. In that paper, we performed conservative calculations that used a 10% discount to the market price of gold. Also, instead of using the actual value of SDR 35 we used $43 throughout as an approximation. This gave a current potential market value of $71 billion as compared to the present calculation that gives a value of $78 billion.

The IMF should transfer PRGF resources to IDA

The PRGF has been attacked by many development professionals as not being conducive to development, as severely limiting policy space, as not being concessional enough and for general ineffectiveness.

In the PRGF, the Fund has overstepped its mandate and it should immediately transfer the money available in the PRGF to IDA where it may be used to create a compensatory financing facility for commodity price shocks or just go into the general IDA pool. It is likely that this money would be more efficiently used then.

The IBRD needs to use its resources more effectively

In recent times IBRD's capacity utilization for its lending has been hovering around 50-55%. This not only means that IBRD resources may not be being used effectively but also imposes a higher interest cost on the limited borrowers currently borrowing from the IBRD.

Moreover there is clear evidence that the IBRD has excessive reserves which can be used better either through an allocation to IDA or through other means.

Modernizing the delivery of development assistance

The institutions need to go back to the spirit of their original mandate. The IMF needs to go back to being the guardian of financial stability in the international economy, lender of last resort, macroeconomic data and surveillance and institutional capacity building around systems of account, data collection and reporting and perhaps being a platform for discussion around the role that the BIS currently plays. It needs to play a merely advisory role not a hands-on policeman role in designing macro policy.

The IBRD needs to go back to being a bank and not a policy making institution. While it is important to have development oriented research and advice this should be consultative and advisory rather than binding. It needs to behave more like a private sector bank in terms of lending for projects with a more hands off approach.

IDA needs to become primarily a grant making facility. Poor countries have had problems repaying even the deeply discounted loans they have taken on. This is partly because of the exchange rate risk. Once the fall in the exchange rates of the local currencies is accounted for IDA loans are no longer very concessional. Since we have not addressed the problem of exchange rate risk yet, it is best to perhaps mostly disburse grants.

MIGA does not belong to the World Bank group. It should be either spun off or shut down altogether. Most countries have EXIM banks that serve the same function.

IFC can be much better if it is seen more as a standard setter for banks and private sector.

IBRD and IDA should be split separated.

The macro-governance structure of these institutions needs to be changed – we need to hold ourselves to the same levels of democratic decision making that we expect of other institutions and bodies. Developing countries need more representation and the overall structure needs to be democracy based. The US uses a one person one vote system not one where the biggest taxpayers get more of a voice. We need to do the same for these institutions. Perhaps a combination of population and economy based voting is feasible in the medium term.

At the same time, the incentive structure within these institutions needs to be changed. Lessons can be learned here from the private sector and incentives for staff should be aligned with the stated macro goal of the institution. So staff performance should be measured not on how much loans they disbursed but on how much their action have facilitated development – this system would work better if feedback from developing countries is incorporated into staff evaluation.

On managing budgets basic common sense should apply. The IMF needs to help develop technical and educational capacity on managing budgets – develop robust systems. CSO can help replicate this at a local level.

The IFIs need to stress on full transparency both with the public and with the parliament. That is why budget based support is good for the development of **accountability** as each dollar is allocated and spend with parliamentary oversight. **The IFIs should discourage off budget financing which seems to be a growing trend.** It stretches the limited resources of the domestic authorities and at the same time can reduce accountability and transparency.

The IFIs need to help developing countries mobilize and retain their own resources – this can be done with the help of debt relief which immediately frees up domestic resources for domestic use. Even if debt relief comes at the cost of some aid – i.e. debt relief is financed by decreased aid flows it is very positive for institutional building and for better budgetary practices.

Citizens have more of a sense of ownership of money released from debt relief and this creates the incentives for increased democratic scrutiny and accountability – critical for long term institutional building. Citizens will participate more actively in governance and this will also help weed out corruption in the long run. The United States' own experience with regards to democratic accountability of the Federal government to the congress and citizens who scrutinize how their taxes are spent is very encouraging.

Countries need more income, therefore, they should be encouraged to tax corporations--domestic and international and avoid harmful tax competition. International co-operation on tax policies of taxing where wealth is created and helping countries cark down on intra-firm transfer mis-pricing and tracking and reversing capital flight will all help develop more domestic revenue practices, better budgetary policy and encourage democratic participation and local institutional building. If governments can tax their own and earn local revenue, they will need less ODA/WB loans and there will be a greater sense of ownership and this in fact is the only route to sustainable development and decreasing aid dependence.

Aid and external assistance are volatile. Moreover they are more often than not accountable to external donor based structures and do not encourage the development of domestic systems.

The IFIs need to encourage country ownership, institutional development and sustainability, participation, transparency and accountability and confirm with international standards on the environment, indigenous people and governance etc.

The IFIs need to give countries policy space by moving away from Economic Policy Conditionality – DfiD has set a good precedent which should be followed.

Managing commodity price shocks

For managing commodity price shocks – there are four broad options available.

Building developing country reserves – This can be done when the commodity prices are high. The Norwegian oil fund and the Nigerian oil pool are good examples. However, this can prove tricky when commodity prices instead of just fluctuating are in a long term decline. This can also be done thorough fiscal austerity which is extremely difficult for countries with populations decimated by hunger, poverty and disease.

Compensatory Financing Facility – The development of such a facility should be encouraged and this needs to be able to disburse substantial sums of grant funds in the medium term as commodity prices are in secular decline. Such a facility can be established under the auspices of IDA with contributions coming in from both bilateral and multilateral donors. Seed capital for this could be provided by the PRGF and/or the sale of IMF gold. Some income can be generated by using income proceeds from the sale of IMF gold.

Diversification – We see ourselves in some form of a neo-colonial paradigm where poor countries are stuck in an international system as provides of primary commodities. Moreover, in the past they have been tacitly encouraged by the IFIs as well as donors to move towards cash crops and other primary commodity generation so as to maximize foreign exchange earnings. While, for a small group of countries this may have been a good idea we have now ended up in a situation where there is a systemic oversupply of most primary commodities and hence prices have been in long term secular decline.

The only way out of this is to, with an immediate emphasis, encourage and finance the diversification of developing countries productive sector – both within the primary commodity sector and away from it. Standardized – one size fits all models – need to stop being peddled.

Systemic reform - Countries need to be able to resume practice of commodity boards to buy from small farmers at guaranteed price and sell on market when prices are higher. There is a need to explore the use of derivatives to assist with short-term price volatility.

Developed countries need to a) open their markets, and b) cut out the subsidies that create surplus on international market at below production costs; allow countries to have import barriers--also source of revenue; need to support research on how to tame commodity shocks. Perhaps we need to revisit the original idea of international commodity agreements which failed in its original incarnation.

Increasing absorptive capacity

Much recent research has focused on absorptive capacity and capacity building in poor countries. It is clear from this that capacity issues are closely linked with poor infrastructure and poor institutions. Many measures can help increase absorptive capacity for the poorest countries. Some of these are

Improving transparency, improving procurement systems, reducing leakage, reducing time between allocation of external funds and disbursement and the democratization of institutions all help towards increasing capacity building for the poorest countries.

There is a string case for the development of infrastructure development to remove infrastructural bottlenecks. But it is important to be sure about who such development is targeted at. If it caters to the elite few in a country rather than the general populace, it is likely that it will fail in the long term. It is also important to ensure that there are no white elephant projects which erode credibility in the donor institutions and waste precious resources.

It is important to ensure that financing is adequate and that growth and revenue projections realistic. Else, the project may run into trouble mid-life or there may not be enough revenue generation for the purpose of the maintenance of the infrastructure.

The choices made need to be participatory and aligned with the priorities of the local government and population.

Capacity building should not automatically translate into huge flows of technical assistance. Excessive dependence on external contractors and consultant and equipment reduces trust in local talent. Instead, capacity building needs to be synergistic – feed on itself to generate even more capacity. This is entirely feasible – a big infrastructure development project for example, **offers great opportunities for maximizing the involvement of local firms, contractors, consultants and individuals and leaves them more experienced, confident and dependable**. So it generates even more long term capacity while building infrastructure.

This is the only route to sustainable capacity building. However, current practice falls far short of this ideal **with a very strong emphasis on 'tied aid' external contractors and the general use of expatriate talent and resources. This practice severely constraints local capacity building and needs to be stopped instantly.**

Development needs to emphasize longer term needs such as educational infrastructure. The collapse of higher education in Africa is very alarming.

The US green card system is a good place to start the discussion on the movement of natural persons. There needs to be an expansion on the temporary movement to of natural persons and a check on the alarming loss of professionals especially from the poorest countries in Africa. Sensible steps need to be taken to help the development of an experienced

In summary

Broadly the main issues involved in tackling the problem of development are

1) **Freeing up more policy space for poor countries. This would help them have domestically owned development strategies, give flexibility to adapt to local**

conditions and allow them to foster a better and more accountable democratic regime.

2) **Being wary of pushing standardized one size fits all policy approaches including indiscriminate trade liberalization. Such standardized policies have partly been responsible for the race to the bottom that has been observed in taxation issues as well as in commodity prices.**
3) **Increasing the quality and quantity of resources available to developing countries. There needs to be an increase in the quantity of ODA in the short to medium term. Moreover, in order to increase the effectiveness of aid, there needs to be higher donor co-ordination, reduced economic policy conditionality and an immediate 'untying' of aid.**
4) **Stopping the leakage of resources from developing countries. Billions of dollars flow out of the poor countries in the world in the form of debt servicing as well as dirty capital flows. Debt should be immediately cancelled and action should be taken to minimize the outflow of money through tax avoidance, tax evasion, transfer mis-pricing and illegal capital flight.**

I would like to sincerely thank members of the congress for this opportunity. I will be available for follow up questions at any time and am happy to make supporting documentation available.

Sony Kapoor - Biography

Sony Kapoor works on issues relating to international finance, development and governance both with Non Governmental Organisations and various Governments. He is the senior policy advisor to Jubilee USA Network, Christian Aid UK and the International Tax Justice Network, which advocates regulation of tax havens. Sony is also a member of the New Rules for Global Finance Coalition.

For the past two years, Sony has played a leading role in the international policy and advocacy effort around multilateral debt cancellation and other development issues. Sony has written extensively on debt, financial stability, taxation, and development financing.

Mr. Kapoor has a background in the financial services industry having worked both as a banker and a derivatives trader. He has a Masters degree in international finance from the London School of Economics and an MBA in Finance. Sony also holds an engineering degree from the prestigious Indian Institute of Technology.