

Foreign Direct Investment, Innovative Sources of Development Finance and Domestic Resource Mobilization

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1. Introduction and Background

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The Millennium Development Goals (MDGs) are now central to the work of the global development community. The MDGs represent ambitious but realizable goals, the achievement of which depends upon making rapid progress in the areas of trade, finance, and peace-building. Mobilizing additional resources is obviously crucial. Recent estimates suggest that the annual cost of meeting the MDGs lies somewhere between US\$ 50 billion (the Zedillo report estimates) and US\$ 76 billion (UNDP and World Bank estimates).³ Finding an additional US\$ 50 billion to US 76 billion is no mean feat, particularly given the stagnation in official development finance over the last decade, and the difficulties that the smaller and poorer countries face in attracting private capital flows and in mobilizing their own domestic resources.

This paper focuses on three important issues in financing development, beginning with foreign direct investment (FDI), a particularly crucial source of external development finance (section 2). The paper then summarizes the main results of a recently completed UNU-WIDER/UN-DESA project on new and innovative sources of development finance (section 3). The paper also discusses the importance of domestic resource mobilization; through the domestic financial system and by government revenue mobilization (section 4). The paper therefore offers a blend of traditional and innovative ways of finding the finance necessary to meet the MDGs, and concludes that greater international and national efforts are crucial to accelerate the financing of the MDGs. The paper has been prepared in connection with the Helsinki Process (HP) on Globalisation and Democracy on the theme “Development Finance for Millennium Development Goals” (MDGs) which is part of Track II, “Global Economic Agenda”. In preparing the paper and suggesting priorities we have tried to bear in mind the urgency of the issues, but also the political feasibility of the topics, which were discussed in the previous two meetings of Track II (October 2003 and March 2004). A companion paper discusses in more detail efforts now underway to increase the flow of official finance (Addison and Mavrotas, 2004).

2. Foreign Direct Investment

³ See Vandemoortele and Roy (2004) on costing issues in connection with the MDGs.

Given the limited availability of official financial flows, it is essential to encourage private financial flows *within a well-designed policy framework that maximizes the contribution of private flows to national development goals*. One source of private capital flow, Foreign Direct Investment (FDI), can play an important role in the overall development process, and in meeting the MDGs.⁴ First, FDI is a source of capital accumulation, both physical capital and human capital. Provided that the FDI projects are well-designed, their rate of return will raise economic growth, thereby adding to the growth of employment, an indirect effect which is additional to the jobs created by FDI projects themselves. Second, FDI can generate much-needed revenues for governments to spend on MDG-focused infrastructure and services. These revenue effects are both direct (through corporate taxes paid by the enterprises themselves as well as revenues from FDI in the natural resource sectors) and indirect (when FDI raises economic growth and therefore the economy's total tax base). Hence, FDI can contribute to the MDGs by reducing income-poverty (through its employment effect) and, via its revenue effects, as a source of finance for public spending on human development, particularly in the areas of basic health care, primary education and safety nets for the poor (on the latter see Klein *et al.*, 2001).⁵

FDI's development benefits are *potentially* strong, but whether this potential is realized or not very much depends on the host country having a clear vision of how FDI fits into its overall development strategy. Thus FDI can be used to diversify the economy thereby reducing over-dependence on a few commodity-based sectors; for example by creating new manufacturing and service-sectors, particularly in exports and in services which use the new information and communication technologies (ICTs). Both Malaysia and Mauritius have successfully used FDI in this way, including public investment in infrastructure, training, and skills to attract FDI into sectors which have high-value added. An active government policy with regard to *vertical FDI*, which entails the relocation of intermediate stages of production to take

⁴ FDI is characterized by a lasting interest in, or effective management control over, an enterprise in another country and is distinguished from portfolio flows which consist of equity flows and bond issues purchased by foreign investors.

⁵ FDI may also help reduce adverse shocks to the poor stemming from financial instability, when FDI flows are more stable than other private capital flows.

advantage of lower costs, is especially important. A common view is that vertical FDI is largely driven by a search for unskilled labour at the lowest cost. However, the share of low-skilled labour is only 5-10 per cent of total production costs in industrial countries, and clothing and footwear are the only sector in which low-skilled labour costs remain significant at one-third of total production costs (Kotler *et al.* 1997: 187). If low wage levels were the main attraction for foreign investors, then Africa would dominate vertical FDI, but in fact Africa receives very little FDI outside of the mineral sector (see next section). Instead, human capital and infrastructure are the main driving factors for vertical FDI. The quality of the host country's human capital stock strongly influences FDI flows as well as quality of the associated technology transfer (Keller 1996; Noorbakhsh *et al.* 2001; Saggi 2002). Large investments in education and training have enabled Malaysia, Singapore, Taiwan (and now China) to move up the value-added 'ladder' from manufacturing-intensive in unskilled labour. These countries have created highly effective partnerships with foreign investors to import, use and (soon after) develop high technology.

Good-quality ICT infrastructure and skills are now critical in integrating local producers into international 'B2B' networks, and in attracting vertical FDI in services as well as manufacturing (Addison and Heshmati, 2004). Routine tasks such as customer support and data processing in financial services, as well as higher value-added tasks such as design and product development together with software development, are examples. Multinationals providing business services and consultation are now significant investors in India where they can draw on the local ICT skills to develop business solutions for international clients. ICT capacity also influences *horizontal FDI* to produce manufactures and services for sale in the host country market, particularly in large markets such as Brazil, China and India, where ICT is increasingly used to manage supply chains (with greater efficiency and lower inventories reducing business costs).⁶ National capacities to adapt ICT to local needs (languages, preferences, and regulations) are essential. South Korean companies producing locally for the Indian consumer-goods market are heavy users of local ICT

⁶ Horizontal FDI in developing countries has traditionally been much less important than vertical FDI. For example, only 4 per cent of production by the affiliates of US multinationals in the European Union is sold back to the United States, whereas the proportion is 18 per cent for developing countries (Shatz and Venables 2000).

skills, and ICT has been central to organizing the global expansion of South Africa's companies (in the brewery sector for example).

Mineral-rich countries face particularly difficult challenges in managing FDI; they need to ensure that FDI in their mineral sectors meets national development goals, and they need to use FDI (and other sources of private capital) to diversify their non-mineral sectors. FDI in the natural-resource sectors must be subject to an open and transparent process in which contracts for lucrative mineral and energy concessions are awarded on merit (governments must also ensure that the stream of revenues produced by such investment is properly accounted for in national budgets). And governments must exercise care in any inducements they offer to attract foreign investors, particularly in the area of fiscal incentives (such as tax-holidays) and in concessions of land and other natural capital for which poor communities may have usage and ownership rights. Unfortunately, many of the oil-rich countries have performed very badly in the areas of fiscal management and in the protection of community interests; FDI in their natural resource sectors has not therefore had its expected benefits.

Hence, FDI is a useful, but not a miracle, ingredient for development. This is reflected in empirical research on the *relationship between FDI and economic growth*. For developing countries as a whole, there is a positive but weak relationship between FDI as a share of GDP and gross fixed capital formation (UNCTAD, 2003a: 77). The empirical evidence overall seems to suggest that although FDI may affect growth, growth itself is also a crucial determinant of FDI.⁷ This may be explained by the attractiveness of a growing market to foreign investors in enterprises that produce manufactures and services for domestic consumers and producers (an important motive for horizontal FDI in the larger economies of Brazil, China, and India). Thus, in so far as national development strategies achieve higher growth, they will attract more FDI, thereby creating a 'virtuous circle' of investment and growth.

2.1 FDI Trends

⁷ See Hansen and Rand (2003) and Chowdhury and Mavrotas (2003) for a recent assessment of the FDI-growth literature and new empirical evidence.

The history of the global economy shows distinct phases, some of which have been more encouraging for FDI flows than others. Globalization's first wave, one hundred years ago, featured considerable FDI to European colonies of Africa and Asia as well as in Latin America's independent states; the stock of foreign investment in developing countries was US\$ 19 billion by the eve of World War One, and up to 60 per cent of this consisted of FDI (Svedberg, 1978).

Globalization's present wave encompasses a number of trends which should, in principle, be very positive for FDI in developing countries. These include: the emergence of globally integrated production and marketing networks; the associated reduction in transactions costs arising out from the spread of information and communication technologies (ICTs); and a policy environment that is now more favourable to foreign investors. The latter is evident in the proliferation of bilateral investment treaties, a greater acceptance of the merits of outward-orientated development strategy (albeit within a continuing and vigorous debate on what form this should take), the policy advice and influence of the multilateral development banks which favour FDI, and the generally positive experiences of countries that have encouraged FDI (Brooks *et al.* 2003).

The world should therefore be experiencing something of a boom in FDI to developing countries. *Yet recent years have seen a declining trend in FDI.* The picture that has recently emerged regarding FDI flows to developing countries is quite gloomy compared to the high volume of FDI inflows to the developing world in the 1980s and the 1990s. Recent data released from UNCTAD in the *World Investment Report* (UNCTAD, 2003b) and the World Bank (*Global Development Finance* 2003) clearly suggests a downturn in FDI inflows. Global FDI inflows, already down by over 40 per cent in 2001 to 823.8 US\$ billion, fell by 20 per cent to US\$ 651 billion in 2002 (Table 1).

Table 1
FDI flows to developing countries, 2001-2003^a

Host region/economy	2001	2002	2003a
World	823.8	651.2	653.1

Developed economies	589.4	460.3	467.0
Developing economies	209.4	162.1	155.7
Africa	18.8	11.0	14.4
Ghana	0.1	0.1	0.9
Morocco	2.8	0.4	1.2
Mozambique	0.3	0.4	1.0
South Africa	6.8	0.8	0.2
Latin America and the Caribbean	83.7	56.0	42.3
Argentina	3.2	1.0	-0.3
Brazil	22.5	16.6	9.1
Chile	4.5	1.6	3.1
Mexico	25.3	13.6	10.4
Venezuela	3.4	1.3	3.3
Asia and the Pacific	106.9	95.1	99.0
China	46.8	52.7	57.0
Hong Kong, China	23.8	13.7	14.3
India	3.4	3.4	3.4
Thailand	3.8	1.1	1.6
Viet Nam	1.3	1.2	1.3

Source: UNCTAD (2003b).

^a UNCTAD estimates. Note: World FDI inflows are projected on the basis of 109 economies for which data are available for part of 2003. Data for 2003 for most economies are estimated by annualising either quarterly or monthly data. The proportion of inflows to these economies in total inflows to their respective region or sub-region in 2002 is used to extrapolate the 2003 data for each region or sub-region.

In the case of the developing world in particular, the overall picture is more gloomy over the period 2001-2003, since the 23 per cent decline in 2002 (US\$162.1 billion as compared to US\$209.4 billion in the previous year) is expected to continue in 2003 to reach 155.7 billion that year as Table 1 seems to suggest. It is important to remember that FDI flows typically recover quickly after a downturn, at least on the basis of previous trends. However, what is of great concern today is not only the severity of the recent downturn but mainly its duration since only once in the past (1982-83) has a downturn lasted for two consecutive years (UNCTAD, 2003b).

It is notable that, as far as particular regions are concerned, the steepest decline was in Africa in 2002 (41 per cent) and in Latin America and the Caribbean (33 per cent) for which the 2002 was the third consecutive year of declining inflows (UNCTAD, 2003b). In the case of Asia and the Pacific, FDI flows declined for the second consecutive year, from US\$107 billion in 2001 to US\$95 billion in 2002.⁸

We need to stress that the above rather disappointing performance of FDI in recent years is a clear departure from the impressive growth rates of the 1980s and the 1990s. Indeed, the growth rate of net FDI flows to the developing world in that period reached on average 755 per cent with some regions registering even higher rates (e.g. East Asia and the Pacific and South Asia – see Table 2).

Table 2
Annual averages of net FDI inflows to developing countries and selected regions, 1970-99 (US\$ million)

Region	FDI net inflows			Growth rate (%)	
	1970s	1980s	1990s	1970s-80s	1980s-90s
East Asia and Pacific	749	3,967	43,347	430	993
Latin America and Caribbean	2,498	5,714	3,748	129	556
Middle East and North Africa	-129	806	3,836	-725	376
South Asia	61	256	2,278	323	789
Sub-Saharan Africa (SSA)	773	1,102	3,509	43	218
All developing countries	4,013	12,059	10,308	201	755
SSA's share (%)	19	9	3		

Source: World Bank (2003) & Asiedu (2004).

The geographical concentration of FDI in a small group of countries (and sectors) is an important issue: FDI is concentrated in a small group of countries most of them in East Asia and Latin America receiving more than 70% of the total FDI directed to developing countries, with China alone receiving almost 25% of the total (GDF, 2002 & 2003). Note that China was the top recipient of FDI inflows in the world after Luxembourg with US\$53 billion in 2002 (UNCTAD 2003b).

2.2 FDI to Africa: The Different Story

⁸ It is notable, however, that the downturn was unevenly distributed by sub-region, country and industry.

Table 2 clearly suggests that FDI to the region has increased over time thus indicating an absolute progress. However, it is also clear from the Table that the growth rate is substantially lower than that for developing countries as a whole, thus causing the region's share to decline over time i.e. relative decline (Asiedu, 2004). The above declining trend in FDI flows is very worrying in view of the crucial importance of FDI flows (as well as other sources of finance) for achieving the MDGs in the region as well as the overall disappointing progress in the region concerning the MDGs recently.⁹

A relevant issue is the role of infrastructure for attracting FDI inflows. A recent UNCTAD survey of the executives of multinational corporations (UNCTAD, 2000) suggests that the state of (physical) infrastructure is one of the key inhibiting factors for undertaking FDI projects in Africa, along with limited access to finance, high administrative costs, the tax regime, poor access to global markets, low level of skills and the regulatory and legal framework governing FDI among others. These disadvantages to foreign investment more than offset the low price of labour in Africa.

A related issue is the contribution of foreign capital (including FDI) to infrastructure. It is notable that in the 1990s infrastructure for the developing world as a whole attracted substantial private capital flows reaching a peak of over US\$120 billion in 1997 thus exceeding ODA flows to infrastructure that year. The Asian financial crisis of 1997, however, had a dramatic effect on private capital flows to infrastructure during the period 1997-99 reducing them by almost 50 per cent during the above period. For the whole decade, however, total private investment in infrastructure (US\$550 billion) was more than three times as much as total ODA flows (UNCTAD 2001 and PPI Database, 2000). Africa was not however the main recipient of the above spectacular increase in private sector financing of infrastructure since 80 per cent of private capital flows (in the form of FDI and portfolio flows) channeling to infrastructure sectors went to just six upper middle income countries – Brazil (receiving almost one third of the total), Argentina, Mexico, South Korea, Malaysia

⁹ On this front, it is important to note that NEPAD recently estimated that the region needs to fill a gap of US\$64 billion (equivalent to 12 per cent of GDP) in order to achieve its millennium goal of reducing poverty rate by half by 2015 (see Asiedu 2004 for further details).

and Hungary. This means that ODA flows remain the principal source of financing infrastructure in developing countries and in particular in the Africa region (UNCTAD 2001). On the other hand, FDI in Africa is concentrated mostly in the mineral sector. It is notable that ICT or other soft infrastructure can diversify FDI to other non-mineral sectors in the region.¹⁰

The vast literature on the determinants of FDI clearly concludes that *inter alia* the level of skills and the quality of the human capital base in host countries is of paramount importance for attracting foreign investors and large amounts of private capital in the form of FDI and portfolio flows.¹¹ *Africa's investment in skills through education and training programmes is very low*, however, with education/GDP spending ratios not exceeding 3 to 4 per cent on average in many African countries. This calls for massive investment in education and training to improve the human capital base of the region with important implications for private capital flows and capital flight reversal (Addison and Mavrotas, 2003).

2.4 FDI: Possible Policy Directions

Recent years have witnessed a *proliferation of international investment agreements* affecting FDI. These agreements affect crucially the parameters for national policy-making in the area of FDI. However, as the recent World Investment Report (2003) correctly argues, *a new approach is urgently required* so that the benefits from entering into international investment agreements and the *need to secure sufficient policy space* are properly balanced. This is an important area in which the Helsinki Process may have an impact and needs to be prioritized. A relevant issue is whether the Trade-Related Investment Measures (TRIMs) and other international investment agreements actually alter the allocation of resources in production and trade or simply affect the distribution between firms and host countries – see Brooks *et al.* (2003) for a detailed discussion.

An issue of crucial importance concerns the negotiation of the International Investment Agreements (IIAs), i.e. the *need to find a development-oriented balance*

¹⁰ See Addison and Mavrotas (2003) for a detailed discussion of the issue of infrastructure in Africa.

¹¹ It is clearly beyond the scope of the present paper to review the vast literature on the determinants of FDI. The reader should refer to Schneider and Frey (1985), Lizondo (1990), Pearce, Islam and Sauvart (1992), and de Melo (1997), *inter alia*.

when negotiating the objectives, content, structure and implementation of future investment agreements. It is becoming increasingly clear that the development dimension (which seems to be absent from many investment agreements in the past) needs to be an integral part of the new IIAs. This can support national policies in host countries to attract more FDI and to benefit more from it, of crucial relevance to the achievement of MDGs (UNCTAD 2003b).

The particular features of the FDI flows to the Africa region call for an integrated approach to attract more FDI to the region. UNCTAD has recently proposed an *African Investment Initiative* so that interested intergovernmental and civil society organizations in the region to coordinate with NEPAD (UNCTAD 2003b). The above Initiative could improve the national/international investment framework, support national investment promotion efforts, promote information dissemination and public-private sector dialogue in the area of FDI and facilitate business linkages.

In the past a number of FDI performance criteria have been used such as local content, export and technology transfer requirements. However, past experience seems to suggest that the above have not always been effective. A more efficient route to take might be possibly to concentrate on getting the fundamentals right with respect to the policy environment and the development of the local skill and technology development system. Ensuring coherence between trade and investment policies is equally important since the liberalization of FDI policies without trade liberalization may reduce the gains from FDI especially with respect to export growth (ILO, 2002).

Finally, the employment implications of FDI and the IIAs need to be re-examined in view of their importance for social welfare and poverty reduction.

3. Innovative Sources of Development Finance

The MDGs can be achieved by either doubling the existing amount of ODA and other private capital flows and/or mobilizing domestic development finance. In case it is not entirely feasible (or substantial time is required) to raise the funds which are necessary to meet the MDGs from existing sources alternative ways of financing need

to be explored. Recent years (and months) have witnessed an ongoing discussion of a number of innovative proposals on this front many of them under discussion at the moment in the international development community. Against this background, in what follows we briefly summarize the key findings of a recent UNU-WIDER project conducted in collaboration with UN-DESA on “Innovative Sources for Development Finance”, and directed by Anthony Atkinson (Atkinson, forthcoming 2004).¹² The following are innovative sources for development finance which have been considered in detail in the above project:

Global Environmental Taxation: Tax on goods generating environmental externalities, with specific reference to a tax on use of hydrocarbon fuels according to their carbon content. It has a substantial revenue raising potential since tax on high-income countries alone could raise revenue of \$50bn (see Sandmo, 2003 for a detailed discussion).

Currency Transactions Tax (better known as “Tobin’s tax”): Tax on foreign currency transactions, covering a range of transactions (spot, forward, future, swaps & other derivatives). The tax could generate at a minimum \$15-28bn for global public use (Nissanke 2003).

Development-focused Special Drawing Rights (SDRs): creation of SDRs for development purposes with donor countries making their SDR allocation available to fund development. Regarding revenue raising potential, allocation of \$25-\$30bn could make significant contribution but depends on frequency (see Aryeetey 2004).

Global Lottery & Global Premium Bond: the proposal, which has its origins in a Crisis Management Initiative (a Finnish NGO led by the former Finnish President Martti Ahtisaari) proposal, is about a global lottery operated through national state-operated and state-licensed lotteries with proceeds shared between national participants and an independent foundation established in conjunction with UN. Its revenue potential is hard to estimate but could reach \$6bn a year. A Global Premium

¹² See summary Table 3 for further discussion (Atkinson, 2004).

Bond, parallel to national bonds with lottery prizes in place of interest; it provides loan finance but volume is hard to estimate (see Addison and Chowdhury 2003).

The International Finance Facility (IFF): a proposal published recently by the HM Treasury and DFID in the U.K. aiming to accelerate progress with the MDGs by frontloading aid so that the MDGs can be achieved (January 2003). Long-term, but conditional, funding guaranteed to the poorest countries by the donor countries; long-term pledges of a flow of annual payments to the IFF would leverage additional money from the international capital markets. It could achieve flow of \$50bn for 2010-2015 building up from 2006 & falling to zero by 2020 (see Mavrotas 2003).

Remittances from migrants: reducing the cost of remittances (logistics), encouraging repatriation (financial institutions) and regularizing the status of migrants (legal) may increase substantially the remittances for development funding. Remittances are a large, growing and relatively stable flow of funds and they can contribute to micro-household projects. A reduction in transfer costs could significantly increase remittances (see Solimano 2003 for a detailed discussion).

The Case of Private Donations for International Development: Charitable donations by private individuals & firms may be increased by tax incentives, global funds, corporate giving and the Internet; total charitable giving is sizeable and there is potential for development to attract larger shares (see Micklewright and Wright 2003).

Needless to say, some of the above proposals have been extensively discussed in the literature recently (a good example is the Tobin tax) while others are entirely or relatively new (e.g. Global Premium Bond, IFF). It is also important to stress that there is a distinct risk of crowding out in some of the proposals i.e. new and innovative sources of development financing may crowd-out existing sources in certain cases (the additionality issue); furthermore, political economy issues are of relevance to the above sources of development financing (see Atkinson 2003 & 2004 for a detailed discussion).

4. Domestic Resource Mobilization

Domestic resource mobilization has two dimensions, both important to achieving the MDGs. The first is building the *domestic financial system* (the banking and insurance sector as well as the market for equities and public and private debt). The second is increasing government *revenue mobilization*.

4.1 Building the Domestic Financial System

Building the domestic financial system has been neglected as a potential source of development financing in connection with the MDGs in recent work. However, there is substantial potential there which if realized can help significantly towards the achievement of the MDGs. *The HP needs to emphasize the above important route which has the additional advantage of engaging directly local communities in the overall development financing process.* Furthermore, financial sector development can enhance savings mobilization and domestic investment for pro-poor growth, an important channel that needs to be clearly addressed in the Process.¹³ The issue is becoming of crucial importance in view of the overall low savings rates of many low-income economies in recent years (most of them in Africa) and the fact that a substantial number of developing countries have undertaken a series of financial reforms recently to improve economic performance.¹⁴

Indeed, many developing countries often lack an appropriate financial sector, which provides incentives for individuals to save and acts as an efficient intermediary to convert these savings into credit for borrowers. The financial liberalization experience of many low-income countries in recent years, although towards the right direction in certain cases, seems to suggest that transforming the financial structure of an economy is a complicated process which assumes a deep understanding of the entire set of interactions between financial sector reforms and the economy (Mavrotas,

¹³ Cambodia provides an example of how potential in this area has not been realized: although deposits exceed lending by about 3% of GDP the government is not allowed to use domestic resources for development financing due to policy conditionalities; the problem is further aggravated by the lack of appropriate financial markets.

¹⁴ A recent study on Zambia has shown that financial sector reforms were unable to boost savings due, *inter alia*, to poor design and inappropriate regulation (Maimbo and Mavrotas, 2004).

2004). At the same time, the recent experience of the Asian financial crisis clearly suggests that whilst financial liberalization may be desirable, the process must be correctly regulated, which requires building institutional capacity – a costly process (Stiglitz 1999, Brownbridge and Kirkpatrick 1999).¹⁵

As in the case of FDI, portfolio flows are characterized by a *high degree of geographical concentration* with a large share channeled to a small group of countries leaving regions such as sub-Saharan Africa with a rather negligible share. A relevant issue in this case is the *volatility* of the flows which makes countries entirely dependent on them particularly vulnerable during macroeconomic and financial crises. In the aftermath of the recent financial crisis in Asia there has been a revived interest in this form of capital flows and on how appropriate international action could be adopted (via regulatory mechanisms) to protect developing countries from financial crises.

4.2 Government Revenue Mobilization

Official development assistance funds a large proportion of public spending in many low-income developing countries, particularly in countries recovering from conflict. In many SSA countries, the public investment budget is almost entirely funded by donors. To effectively meet the MDG targets, governments need to mobilize more domestic revenues, and there are opportunities in even the poorest countries to do this. However, governments need to undertake considerable institutional investment to improve often archaic tax administrations (Addison and Levin, 2004).

The introduction of VAT in a number of developing countries has been successful in raising more revenue. But it is important to complement the VAT with either exemptions and/or excise duties to make it less regressive, thereby reducing the burden on poorer households. Excise duties have received less attention in the reform agenda compared to other instruments, but they can raise substantial revenue and at the same time be distributional friendly. However, one needs to have realistic rates to

¹⁵ It is notable that the UN Secretary General has recently announced 2005 as the *International Year of Microcredit* (29 December 2003).

avoid avoidance and corruption and they should be seen as long-term opportunity for raising revenue as the economy develops and the consumption of luxury commodities rises.

One important issue is broadening the tax base. According to the empirical evidence broadening the VAT base cannot be achieved without increasing the tax burden of the poor. Accordingly, broadening the VAT base should be a low priority and should be implemented only in those countries where the net fiscal incidence (ie the net impact of taxation and public spending taken together) is favourable to the poor. Priority should instead be given to the wide divergence between the effective and statutory tax rates. There is considerable scope for raising tax revenue without increasing tax rates by reinforcing tax and customs administration, reducing tax exemptions and fighting fraud and corruption (including within the tax authorities themselves). Improving the collection of direct taxes is also important, and the emphasis should be on reducing tax evasion. In order to protect poorer households it is important to set the income tax threshold at a suitably high level (as has been done in Kenya for example).

Building institutional capacity has been a crucial component in the reform agenda. First, governments should provide a governance framework within which revenue authorities can perform effectively without continual compromise. Second, governments need to respect the independence of the revenue authority and address the need to maintain incentives for staff within such service. Third, governments also have to recognise that weaknesses in budgetary and expenditure management systems will undermine the potential economic and political returns on investment in the revenue services. Fourth, institutional components have been biased towards organisation, IT-related procedures and manpower upgrading, with insufficient attention to accountability and anti-corruption institution building and cost-effectiveness of administration.

5. Conclusions

In conclusion, our view is that the HP, and in particular, Track II, should focus (as far as this topic is concerned) on a few issues which have been rather overlooked by

previous work (see in particular the international investment agreements in the case of FDI) but, at the same time, are of crucial importance to the developing world.

Policies enhancing domestic resource mobilization (by expanding the tax base in developing countries, particularly in sub-Saharan Africa, mobilizing domestic savings, increasing access to financial services and deepening financial sector development) have a prominent role to play in the challenging effort to use all available sources, both domestic and external so that the MDGs can be met.

In the case of new sources for development finance, Track II and the overall HP can add substantial weight to existing findings and proposals such as those related to the recent WIDER-DESA UN project on *Innovative Sources for Development Finance*. Finally, the Process, by focusing on these issues, could send a significant signal to the international community calling for further attention as well as urgent action on this front. By doing so, the HP can have a crucial impact on the current agendas and thinking on these issues.

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