Sida

Development Economics Brief

CHIEF ECONOMIST TEAM (CET)

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Financing for Development – Global Trends and Sida's Partner Countries[1]

Together with the Agenda 2030, the Addis Ababa Action Agenda reminds us that in order to reach the Sustainable Development Goals - to end poverty in all its forms everywhere - it is crucial to mobilize various resources towards investments in development over and above the traditional development aid.

There are great variations in investments for development between countries, Sida's partner countries are no exception. Understanding the resource distribution and nature of incoming flows in a specific context is a prerequisite for an effective strategy to finance development goals in each country. This brief will present overall trends in financing for development, with a specific focus on Sida's partner countries.

INTRODUCTION

With Agenda 2030, adopted by 193 countries, the World stands in front of major financing needs. As the World Bank (2016) puts it, "To meet the investment needs of the Sustainable Development Goals, the global community needs to move the discussion from "Billions" in ODA to "Trillions" in investments of all kinds: public and private, national and global, in both capital and capacity". Moreover, achieving the Sustainable Development Goals (SDGs) will require the best possible use of each mobilized dollar, which includes a mindset that sustainable change is typically initiated at the country level and that each country context demand a specific solution.

The Addis Ababa Action Agenda, endorsed by the UN General Assembly in July 2015, spells out a plan on how to mobilize resources for sustainable development investments, stimulate global growth and implement Agenda 2030. There are seven action areas in the Addis Agenda; (1) Domestic public resources, (2) Domestic and international private business and finance, (3) International development cooperation, (4) International trade as an engine for development, (5) Debt and debt sustainability, (6) Addressing systemic issues, and (7) Science, technology, innovation and capacity-building, in addition to plans for Cross-cutting issues and Data, monitoring and follow-up.[2] This brief focus on some of the global trends related to action 1-5, while highlighting the financing gaps for Sida's partner countries.

TRENDS AND CURRENT FLOWS

Overall Trends of International Capital Flows

Global economic progress affects progress on all financing instruments. If available global financial resources increase, absolute levels of for example ODA and tax incomes will likely increase. Hence, increasing finance for development is partly about encouraging sustainable economic growth, but also increasing the share of global resources contributing to the 2030 agenda. Figure a provides an overview of some of the international capital flows relevant for the SDGs, highlighting (i) the relatively low levels of ODA, (ii) the importance of remittances due to its level but also stability, and (iii) the dominance of FDIs but also its volatility. This paper focuses on the main international capital inflows in Sida's partner countries where both the total level of capital flows, and the composition of those flows, differ between countries emphasizing the need for a country-specific approach to financing for development policies.

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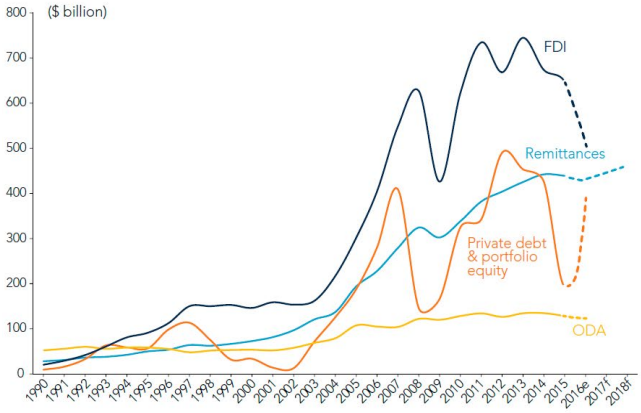
2 See https://developmentfinance.un.org/

Figure a. International capital flows

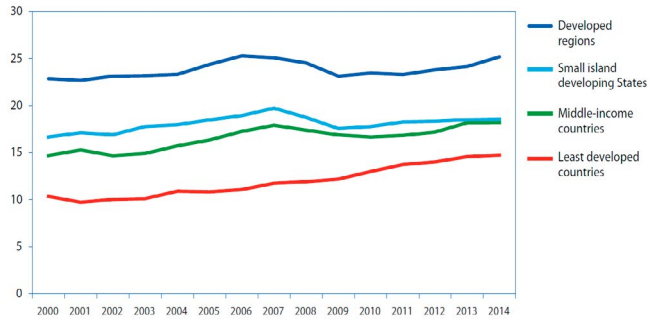


Source: World Bank staff calculations based on World Development Indicators, Migration and Development Brief 27 2017.

DOMESTIC TAXES

Domestic resources mobilization is important to build sustainability, ownership and control over the resource flows for development in a country, in addition to its redistributive effect. While tax revenues as a share of GDP has increased since 2000, the median tax revenue in LDCs is still only 15 percent of GDP compared to 25 percent in the developed regions (Figure b). The low tax collection rate is often a reflection of the structure of the economy where for example the informal sector constitutes a major part, subsistence production is not captured in the market exchange, and there are mostly micro and small enterprises that are generally not taxed. This leads to a small tax base for mobilising tax revenue through direct taxes, such as income tax and property tax. In general, developing countries mainly collect taxes through indirect taxation, such as trade and consumption taxes like value added tax (VAT). Indirect taxes are less costly to administer, but they tend to be more regressive as it taxes consumption – a large share of the spending by the poor – rather than the wealth of the higher-income earners who spend a smaller share of their income on consumption.

Figure b. Median tax revenue, % of GDP



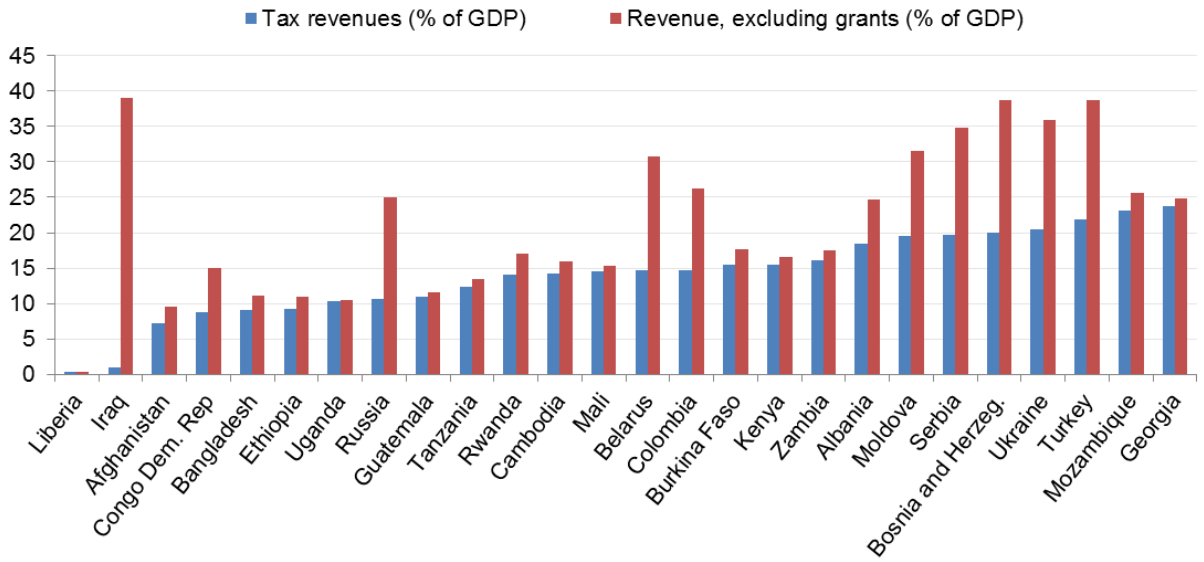
Source: IMF World Revenue Longitudinal Database, IATF 2017.

Tax revenues is the prime source of government revenues, but governments can also fund expenditure through grants, non-tax income (from for example state-owned enterprises or fees) and social contributions (mainly in developed countries). Tax revenues account for more than 80 percent of government revenues in about half of the countries in the world and more than 50 percent in almost any country.[3] However, in some countries with income from for example state-owned companies, not least in the natural resource sector, government revenues (even excluding grants) may differ significantly from tax revenues. Among Sida's partner countries, it is the European countries (and Mozambique, who has made significant tax reform progress and expect additional contributions as the resource sector continue to expand) that have the highest levels of tax revenues as a share of GDP. When adding other government income, countries such as Moldova, Serbia, Bosnia and Herzegovina, Ukraine and Turkey end up with total government revenues of as much as 30-40 percent of GDP. There are also countries where tax revenues are small but compensated by a significant share of other government revenues, not least in Iraq but also Russia, Belarus and Colombia.

The level of development impact that tax revenues are able to achieve is not only dependent on the size of the tax income, but also the development plan of the government. The benefits from increased public resources should be weighed against any negative effect on economic activity, and hence economic growth and ultimately future tax revenues. More generally, in order to increase citizens' willingness to pay taxes, and for the government to be accountable for using the tax revenues responsibly, it is important that the public sector has the capacity to plan and

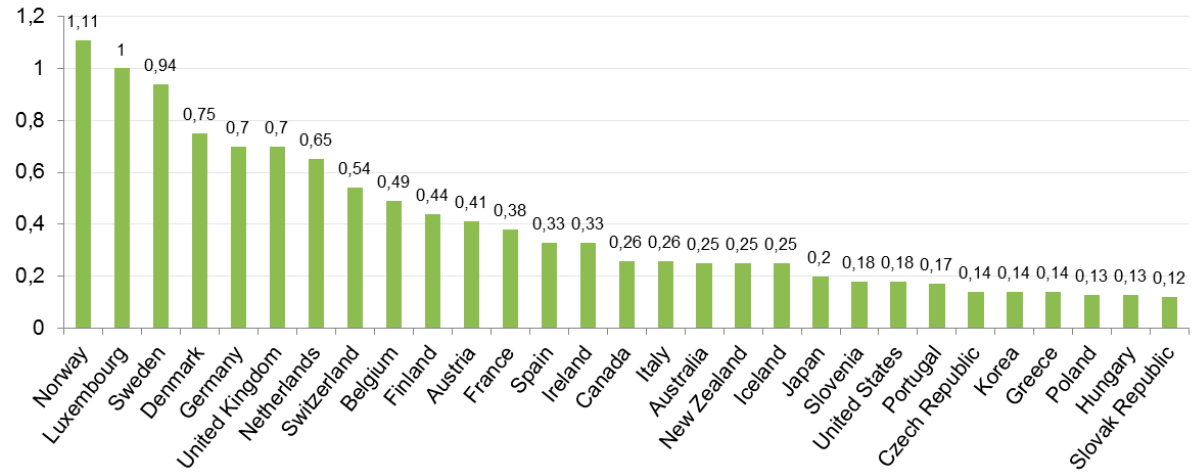
3 Esteban Ortiz-Ospina and Max Roser (2017) – 'Taxation'. Published online at OurWorldInData.org. Retrieved from: https://ourworldindata.org/taxation/ [Online Resource]

Figure c. Government and Tax revenues in Sida partner countries, most recent data 2010-2015



Note: No data for Bolivia, Cuba, Kosovo, Myanmar, Somalia, South Sudan, Sudan, Syria or Zimbabwe.
Source: World Development Indicators.

Figure d. ODA by donor 2016 as a share of GNI



Source: DAC Statistics, OECD 2017.

implement development projects. While tax revenues are currently at too low level to finance development needs of many countries, simply raising the revenues will not improve the situation if for example new distortions are added to the economy affecting overall economic growth, or the increased revenues are spent on the elites and/or captured by corruption. Thus, increasing tax revenues, strengthening government capacity, and improving the environment for economic activity go hand in hand.

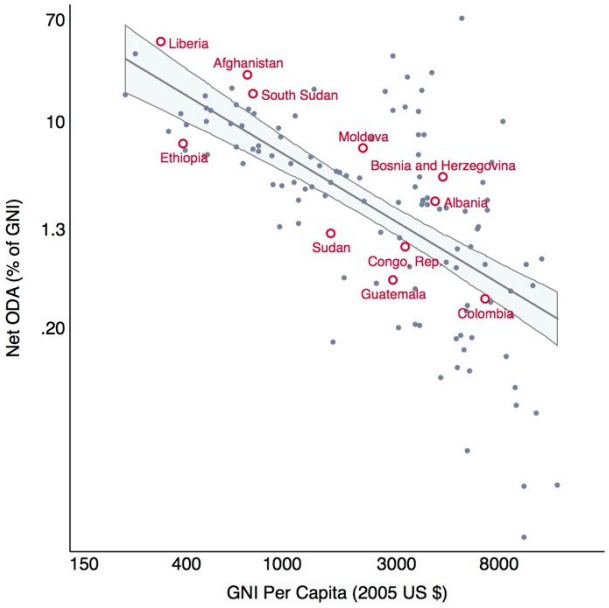
International Aid

While total ODA in absolute terms has increased over the years (see Figure a), average net ODA as a share of GNI only rose to 0.32 percent in 2016, and that partly due to higher costs for refugees in the donor countries. The levels of ODA from most donor countries are still well below the internationally agreed 0.7 of GNI level (see Figure d).

There is a negative relationship between aid as a share of GNI and income per capita in the receiving

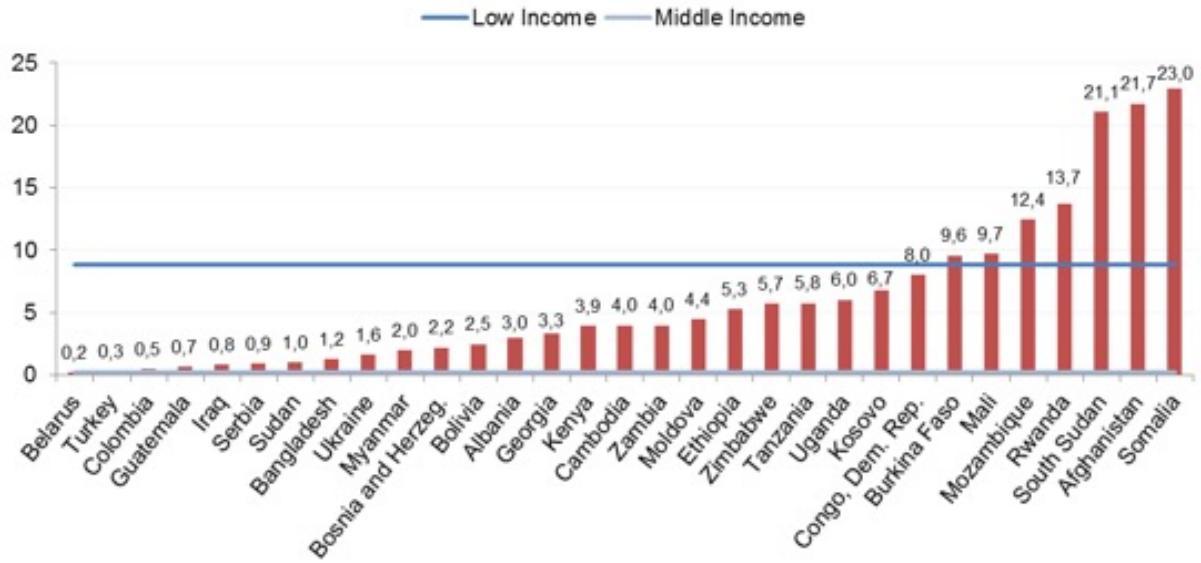
country. However, there is still a wide spread between aid levels for countries at similar income per capita levels. Figure e shows the cross-country relationship between ODA as a share of GNI and income per capita, where the fitted line represents the typical level of ODA for a given income per capita level. Outliers among Sida's partner countries are highlighted and those that are above the line have ODA levels that are higher than expected for their income level and those that are below have lower than expected. Sida's partner countries with a typical ODA per capita level for their income per capita level are not highlighted. Among those Sida partner countries that have significantly higher aid levels than expected for their income level are Liberia, Moldova, Georgia, Afghanistan, South Sudan, Bosnia and Hercegovina, and Albania, while those lower than expected are Sudan, Ethiopia, Republic of Congo, Guatemala and Colombia. For many of these there is a country-specific, more or less explicit, explanation for why this is the case. In Figure f ODA as a share of the receiving country's GNI is spelled out for all Sida partner countries where data is available.

Figure e. Cross-country relationship between ODA as a share of GNI and income per capita



Source: Own calculations based on World Development Indicators.

Figure f. Net ODA received as a share of GNI 2015 in Sida partner countries

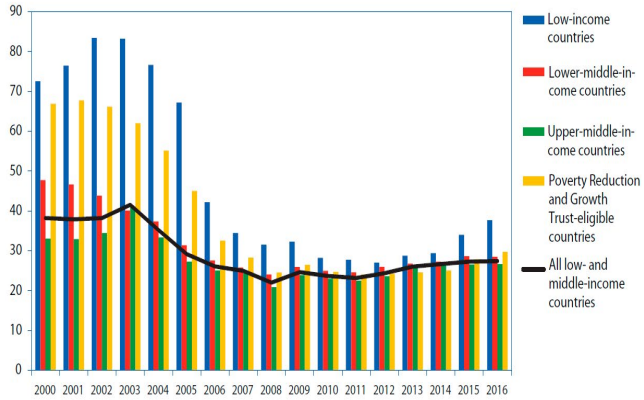


Note: Cuba, Liberia, Russia and Syria are not included.
Source: Own calculations based on World Development Indicators.

External Debt

Low-income countries have often struggled with large external debts although, thanks in large part to international debt relief initiatives, debt burdens have been reduced (see Figure g). An average low-income country would have external debt levels around 40 percent of GDP, while an average middle-income country would have around 30 percent of debt.

Figure g. External debt, % of GDP

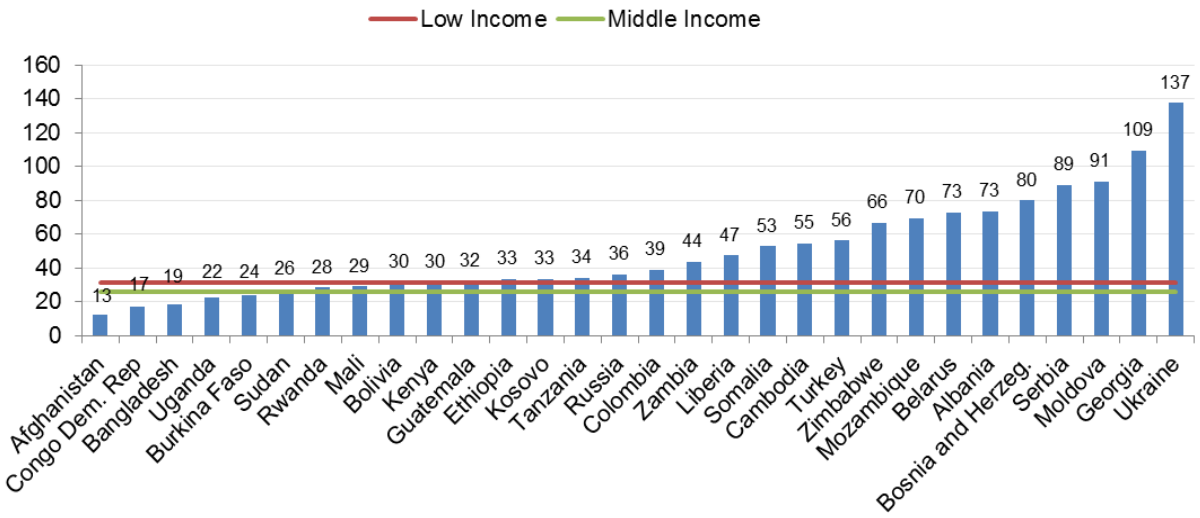


Source: IMF World Revenue Longitudinal Database, IATF 2017.

To avoid excessive build-up of new debt but at the same time mobilizing financing for development needs, it is important to assess both the level and sustainability of debt. Increased debt can bring about crucial investments for increased productivity and accelerated development, but it can also put pressure on available government resources due to increased interest payments. Hence, the potential for future returns needs to be assessed and set against current costs, which may differ depending on the specific debt financing agreement.

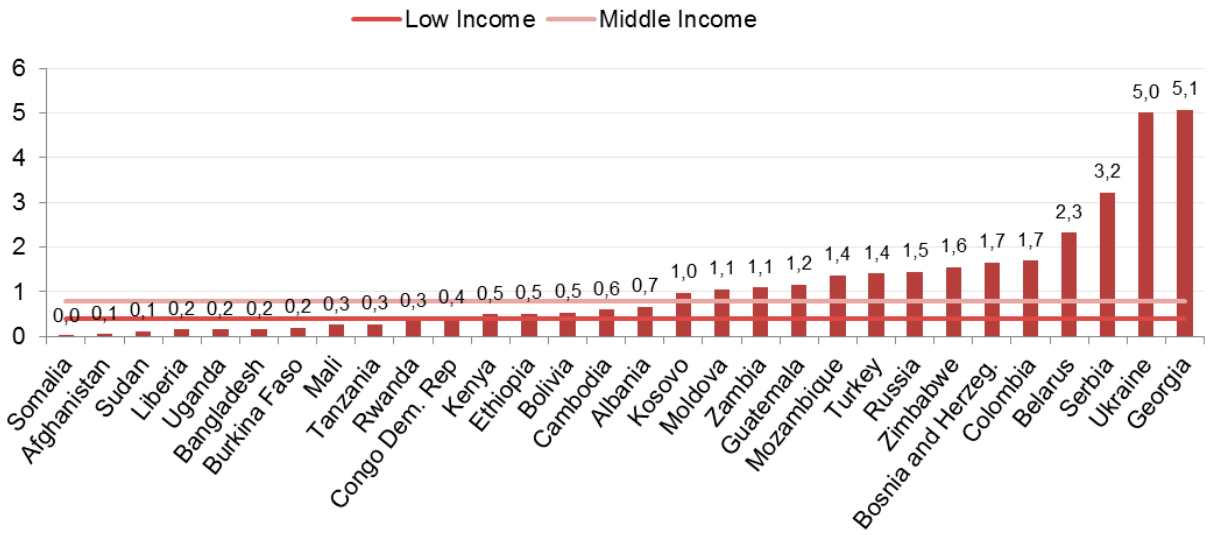
Figure h shows the level of external debt in Sida's partner countries. Partner countries with debt levels above 70 percent of GNI are all in Europe. The resulting interest payments are below 2 percent of GNI in all countries except Belarus, Serbia, Ukraine, and Georgia that record higher levels debt as a percentage of GNI (see Figure i). However, most of Sida's partner countries are above their respective income groups (LICs or MICs) averages when it comes to interest payments. If the level of loans and its fiscal impact are considered a risk or not depends on the debt sustainability assessment, i.e. the ability of the country to repay the loan.

Figure h. External debt stocks as a share of GNI 2015 in Sida partner countries



Note: No data for Cuba, Iraq, Myanmar, South Sudan or Syria.
Source: Own calculations based on World Development Indicators.

Figure i. Interest payments on external debt as a share of GNI 2015 in Sida partner countries



Note: No data for Cuba, Iraq, Myanmar, South Sudan or Syria.
Source: Own calculations based on World Development Indicators.

Table a presents the risk conclusions from the latest Debt Sustainability Assessments in each partner country.[4] Three of Sida's partner countries are in debt distress, South Sudan, Sudan and Zimbabwe. Afghanistan and Somalia are at high risk.

Table a. Debt sustainability Assessment

Country	Level
South Sudan	In debt distress
Sudan	In debt distress
Zimbabwe	In debt distress
Afghanistan	High
Somalia	High
Burkina Faso	Moderate
Congo Dem. Rep	Moderate
Ethiopia	Moderate
Liberia	Moderate
Mali	Moderate
Mozambique	Moderate
Zambia	Moderate
Bangladesh	Low
Bolivia	Low
Kenya	Low
Moldova	Low
Myanmar	Low
Rwanda	Low
Tanzania	Low
Uganda	Low

Source: IMF 2017.

4 https://www.imf.org/external/pubs/ft/dsa/. DSA reports are available for each country.

Public, private and foreign investments

Government revenues are often limited and domestic savings low in developing countries. Hence, tapping into foreign savings and attracting foreign capital becomes an interesting option for funding domestic investment needs. However, private investments tend to be highly volatile and unequally distributed across regions, where the countries with largest development needs are usually receiving the lowest levels of private investment.

The global foreign direct investment (FDI) flows are the largest external source of capital flows followed by remittances and private debt and equity investments. While the long-term trend in FDI is increasing, the global FDI flows fell 13 percent in 2016, reaching an estimated USD 1.52 trillion[5]. The rapid decline was due to weak economic growth and sluggish world trade volumes.

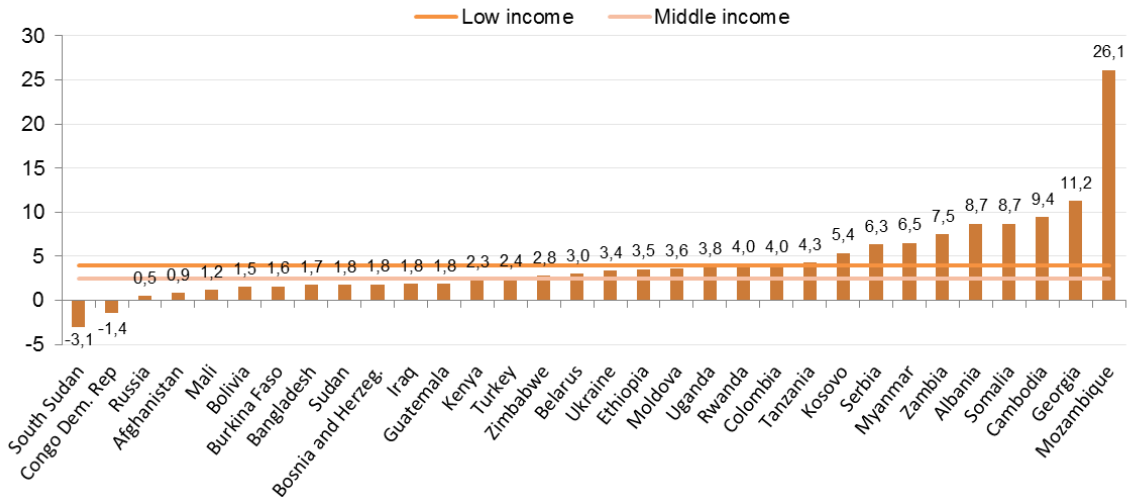
The developed economies remain as main destinations for FDI, led by USA and the UK. However, so-called developing Asia has been successful in attracting FDI mainly to China, Hong Kong (China), and Singapore. Also, developing economies in Latin America, most notably Brazil, have been able to maintain sizable investment flows from abroad. Africa has a mere 3 percent of the global FDI flows and their share is declining. The vast majority of the African FDI is flowing to Egypt, Nigeria, and South Africa that are not Sida's partner countries.

5 UNCTAD: Global Investment Trends Monitor 25, Feb 2017.

Mozambique is by far the largest recipient of FDI inflows among Sida's partner countries due to so-called megaprojects in natural resources extraction rather than broader development projects. Even though the absolute capital flows of foreign capital may not be large, the incoming FDI as a share of GDP is still significant in many of Sida's partner countries (Figure j). In addition to Mozambique, also Georgia, Cambodia, Somalia, Albania and Zambia are receiving above-average levels of FDI. Partner countries in conflict and fragile situations do not generally receive any inflows at all, or experience outflows of private capital and divestment as is the case in South Sudan and DRC.

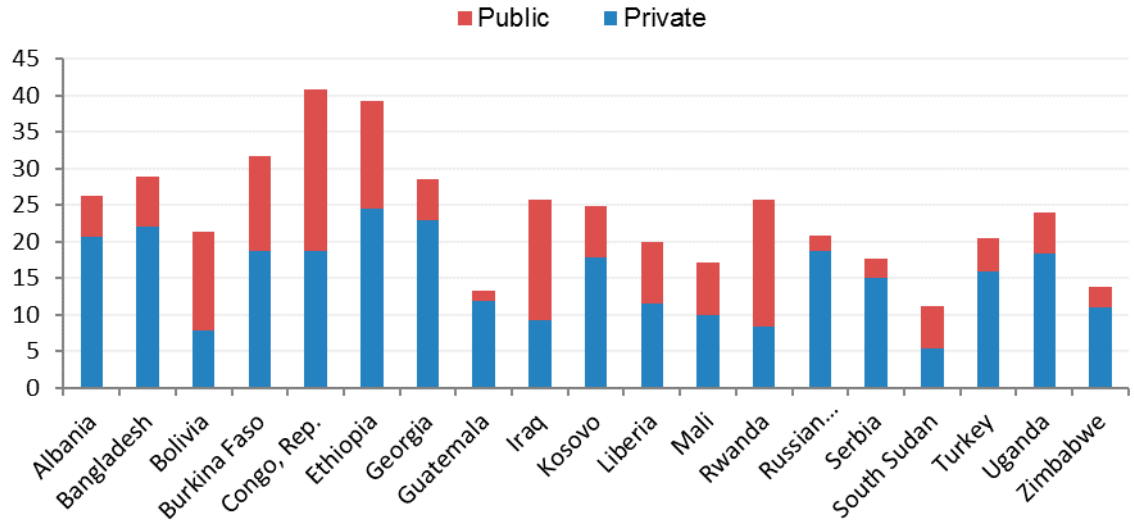
As foreign investments to Sida's partner countries are still limited, most countries rely on mobilisation of domestic, public and private, capital. The mix of investment that drive economic development present interesting variation in pattern (Figure k): First, while the investments in countries like Guatemala are almost entirely privately funded, economic development in countries like Rwanda is largely government led. Secondly, the drivers that have been proven to attract foreign investment are largely the same that promote domestic, private investment and economic development. Hence for a development led by public investment, it is important that they aim to crowd in, rather than crowd out, private investments from domestic and foreign sources.

Figure j. Foreign direct investment, net inflows as a share of GDP 2015 in Sida partner countries



Note: Cuba, Liberia, Syria are not included. Source: Own calculations based on World Development Indicators.

Figure k. Investment as a share of GDP (2015)



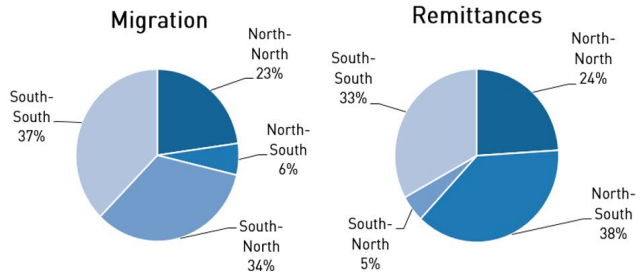
Note: Only partner countries with available data are displayed. For Albania and Rwanda the data are from 2014 (most recently available). Source: World Development Indicators.

Remittances

Formal global remittances are estimated to USD 429 billion a year, but informal remittances are estimated to double that number. As Figure l shows, remittances are three times larger than ODA flows, and considerably more stable than private investment and other more speculative financial flows. While remittances have been stable or even counter-cyclical throughout the economic slow-downs, remittances flows have now been estimated - for the second year in a row - to have decreased due to slower growth in sending countries and weakening of euro and other currencies in sending countries against the US dollar (as remittances are often measured in dollar terms). This down-turn is still estimated to be temporary, and already 2017 the remittance flows are projected to grow by 3.3 percent.[6]

There are currently around 200 million international migrants in the world, and for the first time women account to half of the migrant labour force. The majority of the international migrants move within their own region, and although South-North migration is subject to a vivid policy debate, it only accounts for one third of the total stock of migrants (Figure l). The largest group of migrants move within the global South, and South-South remittances are also a major contributor to the global remittance flows as well as incomes in the developing countries.

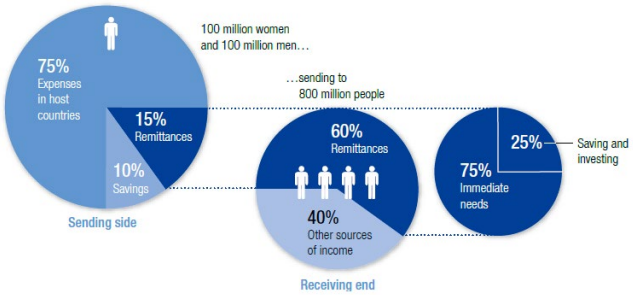
Figure l. South-South migration is larger than South-North Migration



Source: World Bank "Migration and Remittances Factbook 2016".

Although the largest share of the incomes of the migrants stay in their host countries and contribute to economic development in countries where they work, approximately 15 percent of their earnings are sent back home to the family members who stayed behind (Figure m). There are 800 million people receiving remittances and for them remittances make up 60 percent of the household budget. 75 percent goes to immediate needs while 25 percent is used for savings. Remittances has been shown to have a significant effect on poverty reduction and an important source of financing for the SDGs[7].

Figure m. Distribution of migrant's incomes and receiving family's spending



Source: IFAD 2017, Sending Money Home: Contributing to the SDGs, one family at a time.

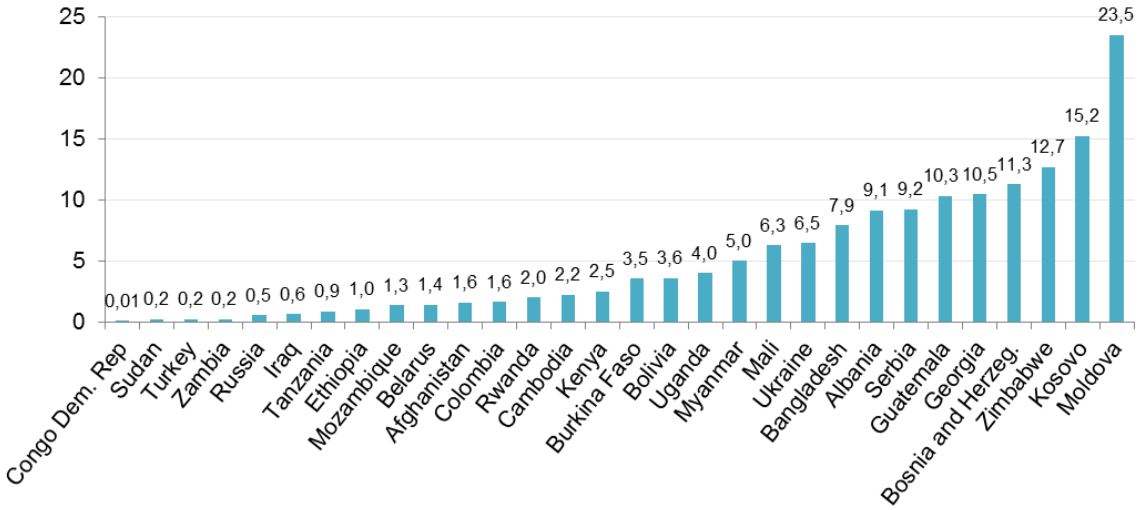
Half of Sida's partner countries are highly dependent[8] on remittances. The most remittance-dependent partner countries are found in Eastern-Europe with high circular migration flows mainly to Russia, but also to Italy and Germany, not seldom as unregistered workers. Also in Latin America migration to USA is a significant and increasing source of household income.

6 World Bank Group & KNOMAD: Migration and Development Brief 27, April 2017.

7 IFAD: "Sending Money Home: Contributing to the SDGs, one family at a time", June 2017.

8 Remittances higher than 3 percent of GDP.

Figure n. Remittances as a share of GDP 2015 in Sida partner countries



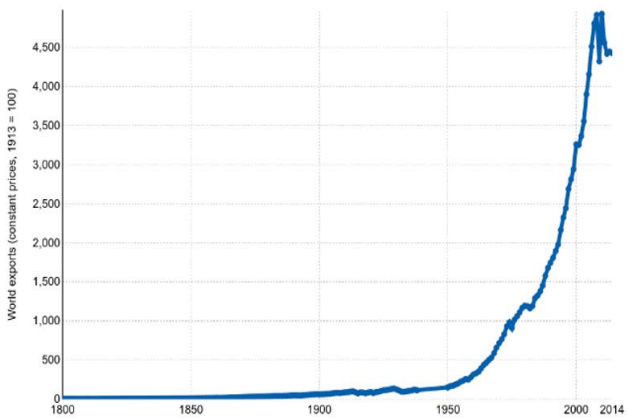
Note: Cuba, Liberia, Somalia, South Sudan, and Syria are not included. No data for LIC and MIC remittances as a share of GDP.
Source: World Development Indicators.

While there are many costs to migration it has also many benefits, such as income through remittances when domestic employment opportunities fail, as well as less tangible benefits such as increased know-how, innovation diffusion and cross-cultural exchange. In addition, as 25 percent of the income remittances are saved and invested, large inflows of remittances generate substantial inflows of long-term resources for development.

Trade

In the last decades trade expansion has been faster than ever before, although there are just recently signs of a more volatile development (see Figure o).[9] Today, the sum of exports and imports across nations is higher than 50% of global production. Available empirical evidence shows that trade lead to economic growth on the aggregate, through a number of channels such as specialization and knowledge transfer. However, through liberalization and economic integration, the relative prices of some goods go up, while others will go down. Hence, trade may create winners and losers, depending on what different people produce and consume, and what factors of production they can contribute with to the economy. It is important to consider the distributional consequences of trade liberalization and policies to ensure everyone is better off in the end.

Figure o. The value of global exports

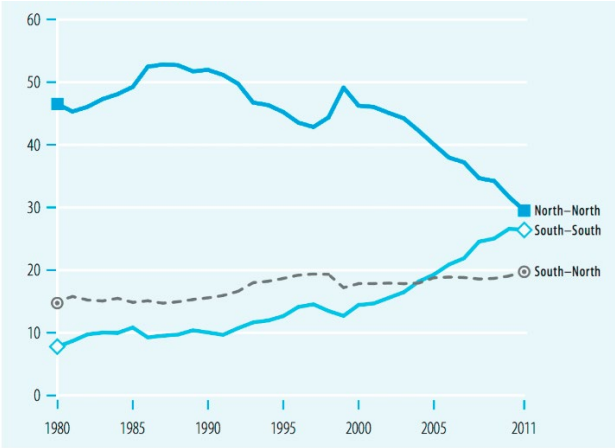


Source: Our world in data.

Trade among developing nations (often referred to as South–South trade), more than tripled in the period 1980–2011 and is now as important as North-North trade (see Figure p). China has been a key driver of this dynamic. The UN Human Development Report (2013) estimates that between 1992 and 2011, China's trade with Sub-Saharan Africa rose from $1 billion to more than $140 billion.

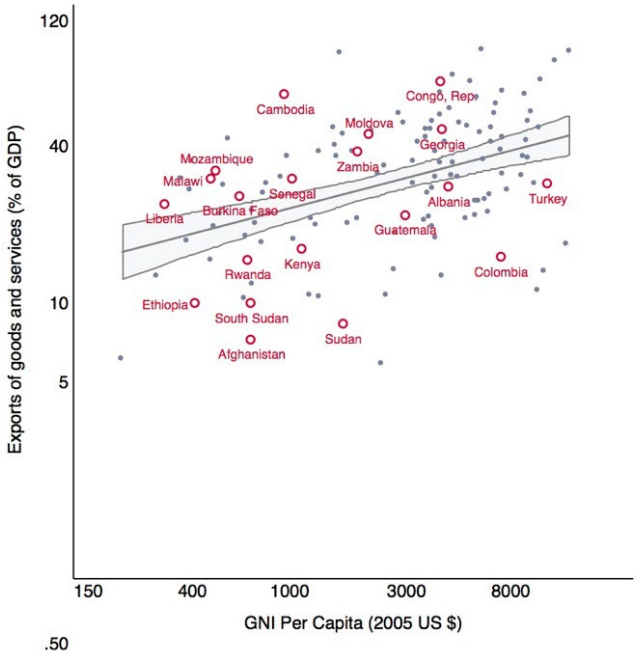
9 The 'first wave of globalization' was characterized by inter-industry trade. This means that countries exported goods that were very different to what they imported – England exchanged machines for Australian wool and Indian tea. This changed in the 'second wave of globalization'. Intra-industry trade (i.e. the exchange of broadly similar goods and services) has increased substantially since the Second World War – France now both imports and exports cars to and from Germany.

Figure p. Share of world merchandise trade (%)



Note: North in 1980 refers to Australia, Canada, Japan, New Zealand, the United States and Western Europe.
Source: HDRO calculations based on UNSD (2012).

Figure q. Cross-country relationship between exports as a share of GDP and income per capita

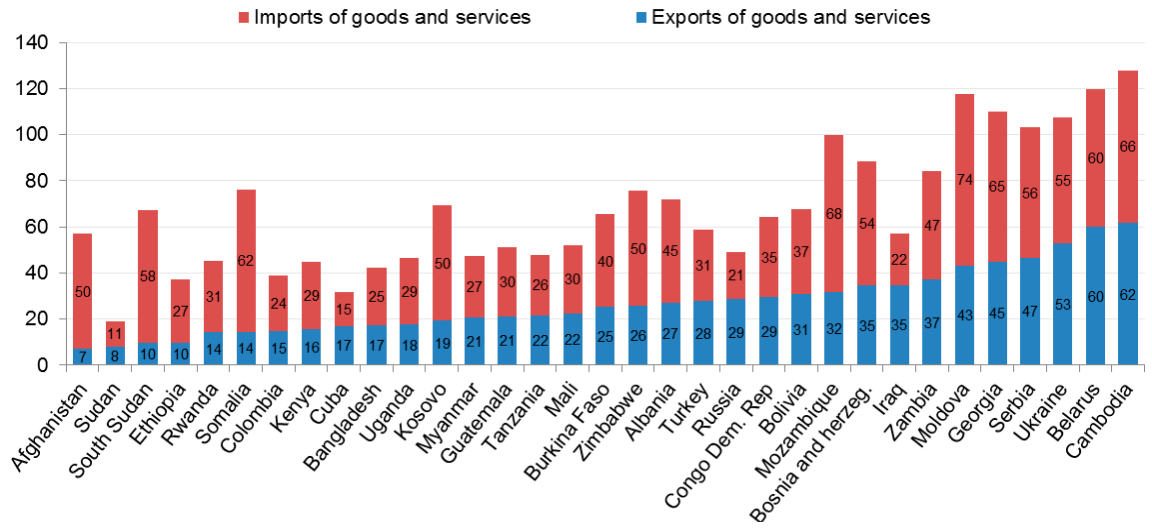


Source: Own calculations based on World Development Indicators.

Figure q shows the cross-country relationship between exports as a share of GDP and income per capita, where the fitted line represents the typical level of export for a given income per capita level. Sida countries are highlighted and those that are above the line have export levels that are higher than expected for their income level and those that are below have lower than expected. Among those Sida partner countries that have significantly higher export levels than expected for their income level are Liberia, Mozambique, Malawi, Senegal, Zambia, Moldova, Georgia, Burkina Faso and not least Cambodia and Republic of Congo. Those with lower than expected export levels are Rwanda, Sudan, Turkey, Ethiopia, Afghanistan, South Sudan, Kenya, Guatemala, Albania and Colombia. The remaining partner countries have export levels that are typical for their respective income per capita level. Each partner country has its own explanation to why this is the case and what could possibly be done about it.

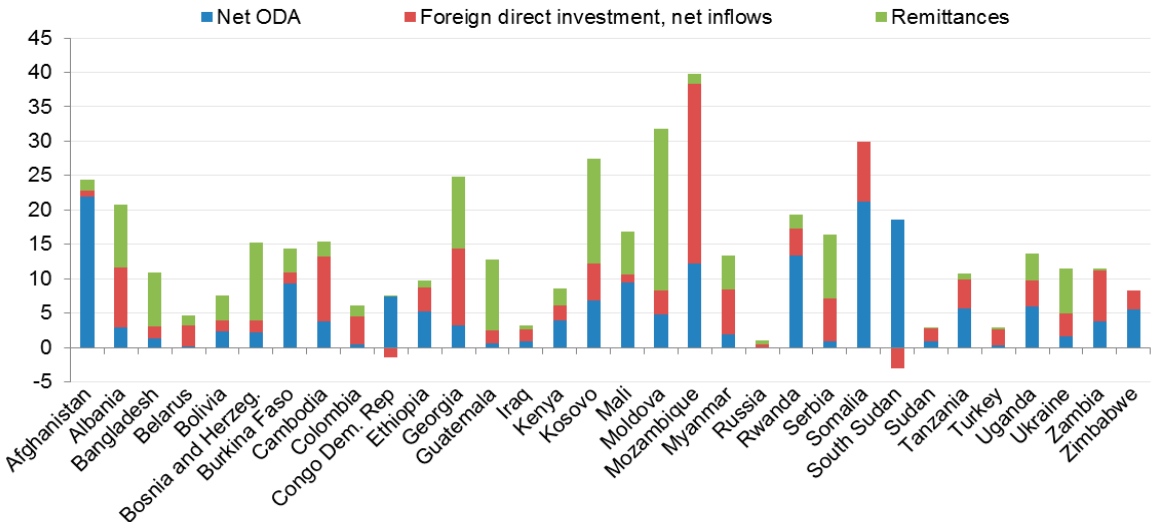
Figure r presents trade, exports and imports, in Sida's partner countries with available data. Cambodia, Belarus, Ukraine, Serbia, Georgia and Moldova, all had exports representing more than 40 percent of their GDP. Most countries have a negative trade balance, i.e. they import more than they export, with the exception of Cuba, Iraq and Belarus. Negative trade balance as such is not problematic as imports are welfare increasing as cheaper imported goods increase opportunity and choice for consumers. However, higher imports imply that a country consumes more than it produces and as imports will need to be financed in foreign currency a high negative trade balance may put a strain on foreign exchange reserves and/or exchange rate, and may even increase the pressure on external debt and related interest payments. Of Sida's partner countries, Afghanistan, South Sudan, Ethiopia, Rwanda, Somalia, Kosovo, and Mozambique, have imports that are more than double that of their exports. For more information about exports and imports (products and trading partners) in a specific country we refer to the excellent visualizations of the Observatory of Economic Complexity.

Figure r. Trade balance 2015 in Sida partner countries, % of GDP



Note: Syria and Liberia are not included. Source: World Development Indicators.

Figure s. Capital inflows as a share of GDP 2015 in Sida partner countries



Note: Cuba, Liberia and Syria are not included. Source: Own calculations based on World Development Indicators.

CONCLUSIONS: UNLOCKING FINANCING FOR DEVELOPMENT

One conclusion from this analysis is that different countries have not only different levels but also very different composition of development finance (figure s). It is important to find the right mix for a given context at a given point in time. This assessment can help in benchmarking the levels for a specific country in relation to others and indicate where there are potential opportunities. However, in the search for more development finance it is crucial to respect the underlying raison d'étre of each flow and choose an appropriate instrument to stimulate each flow. If financial flows of a certain kind to a certain country are limited, there is a reason for it and depending on what that reason is, the strategy may range from doing nothing to full aid financing (or any public, private or blended finance that fits in-between), ideally complemented with a strategy to address the original constraint.

Each financing instrument is different in several dimensions; what type of investment it would normally finance, but also in terms of how it can be encouraged overall and managed. While ODA (i.e. tax revenues from the sending country) and domestic tax revenues are similar in nature both when it comes to collection and appropriate use as a source of funding for government's development priorities, remittances should rather be compared to domestic wages. They are private income earned in another country aimed to fund consumption and private savings for household members left behind. While remittances often end up contributing to poverty reduction and community development and complement government funded social security programs in the most vulnerable areas, the two sources of funding should not be thought of as substitutes but rather as complements. Furthermore, foreign direct investment and local investors are both investing in economically profitable projects in developing countries, and while these projects oftentimes have great development potential, investment flows will not replace government funding in public goods. Focus should instead be put on how public investments can crowd in private investments, and how public and private funding can work together to realize investments. Recognition of the driving forces and intended use of each flow is the starting point for a solid strategy for mobilising an optimal mix of funding for each development area.

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