financial IMPOSSIBLE ARCHITECTURE

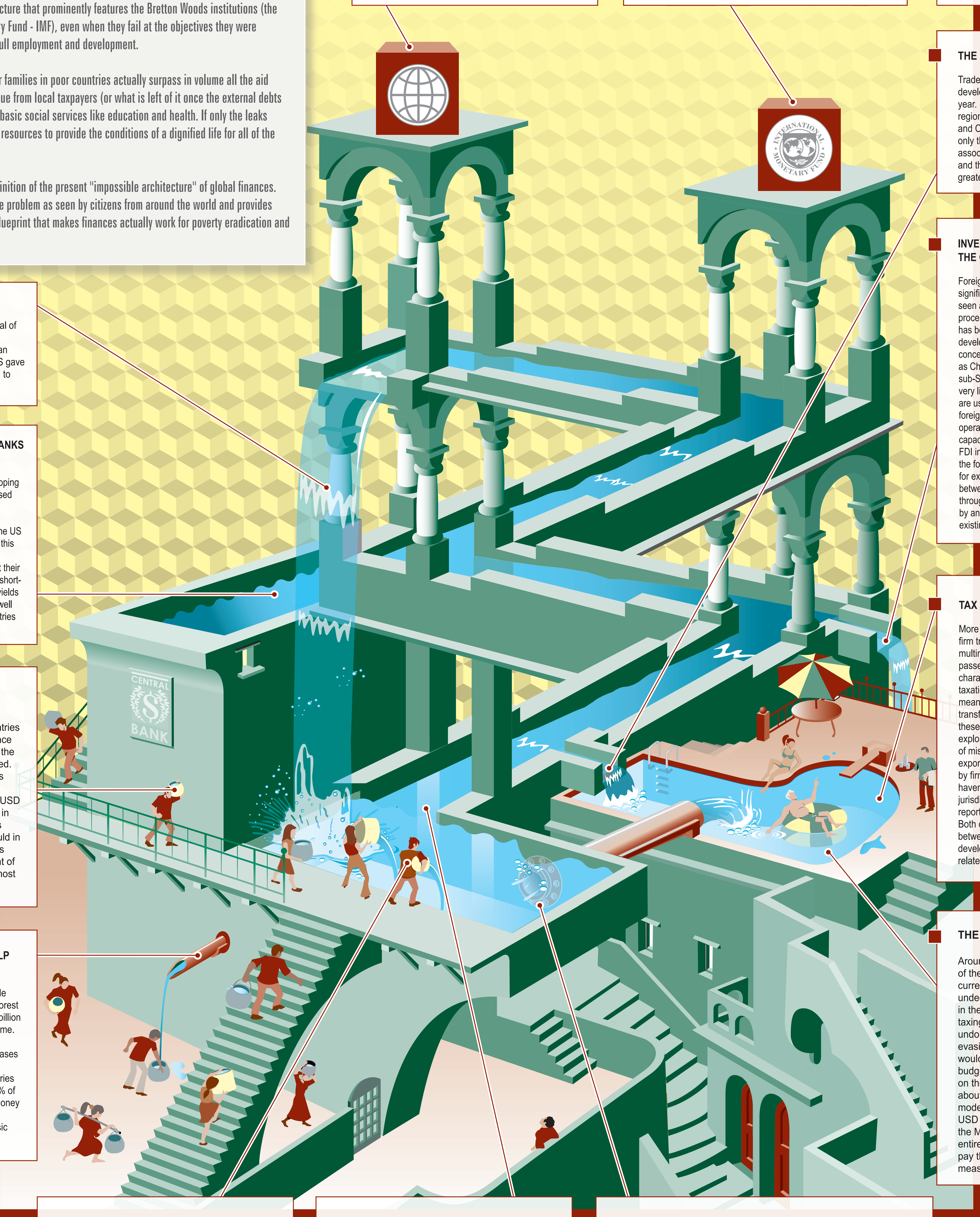
Finances are usually explained in water metaphors: money "flows", benefits from growth "trickle down" to the poor, capital "leaks" out of countries to tax havens . . .

From a first glance at this construction, most people will see a waterfall, in the very same way that most of the public in rich countries thinks there is an enormous flow of their tax contributions to poor countries, in the form of aid, loans, trade benefits and frequently talked about debt cancellations. If poverty still persists it must somehow be the fault of the poor people themselves or their governments.

Now look at the picture again. The water cascading down doesn't quite reach the poor . . . Instead it is diverted and —against all rules of logic— while always running down it still ends up at the top again in a futile cycle. The illustration, inspired by the famous "Waterfall" etching by MC Escher, is a good metaphor for the current "global financial architecture", an architecture that prominently features the Bretton Woods institutions (the World Bank and the International Monetary Fund - IMF), even when they fail at the objectives they were created for: to ensure financial stability, full employment and development.

Remittances from migrant workers to their families in poor countries actually surpass in volume all the aid their countries receive. And it is the revenue from local taxpayers (or what is left of it once the external debts are paid for) that provides for most of the basic social services like education and health. If only the leaks could be plugged, there would be enough resources to provide the conditions of a dignified life for all of the people on the planet.

But that would require a substantial redefinition of the present "impossible architecture" of global finances. The Social Watch Report 2006 explains the problem as seen by citizens from around the world and provides new perspectives and ideas for a viable blueprint that makes finances actually work for poverty eradication and development.



WORLD BANK: TAKING FROM THE POOR...

In every year since 1991, net transfers (disbursements minus repayments minus interest payments) to developing countries from the International Bank for Reconstruction and Development (IBRD, the loan-making branch of the World Bank) have been negative. Since 2002 net disbursements have also become negative. In effect, taken as a whole, the IBRD is not making any contribution to development finance other than providing finance to service its outstanding claims. The situation is much the same for regional development banks. The problem here is that, for reasons related to conditionality and bureaucracy, countries which are eligible for IBRD loans are generally unwilling to borrow as long as they have access to private markets, even when this means paying higher rates. On the other hand, many poorer countries which need external financing are not eligible for IBRD loans.

THE IMF NEEDS A CRISIS TO SURVIVE

The International Monetary Fund (IMF) lends from its Poverty Reduction and Growth Facility (PRGF) a very small proportion of the financing made available to developing countries. At the end of 2004 outstanding PRGF loans were less than USD 9,900 billion or 10% of total outstanding IMF credits. In 2005 the total PRGF lending approved was less than USD 500 million.

The IMF is also being marginalized in the provision of finance and liquidity to developing countries. All major emerging market economies, except Turkey, have now paid off what they owed and exited from IMF supervision, leaving only the poorest countries as its sole regular clientele - barely a strong rationale for an institution established to secure international economic stability. This situation also creates a problem for the IMF. Poverty lending does not generate enough income to pay the staff and run the institution, and the Fund relies primarily on crisis-lending to emerging markets to generate some USD 800 million per annum to meet its administrative expenses. Ironically, the financial viability of the IMF has come to depend on financial instability and crises in emerging markets.

PRIVATE PHILANTHROPISTS ARE MORE GENEROUS

The International Development Association (IDA) is the grant-making branch of the World Bank. IDA disbursements are small, in the order of USD 4-5 billion a year, for the entire group of the poorest countries. Putting IDA and the International Bank for Reconstruction and Development (IBRD) together, the contribution of the World Bank to the external financing of developing countries is negative by some USD 1.2 billion. Net flows to sub-Saharan Africa are also negative from the IBRD. From the Bank as a whole they are positive but less than USD 2 billion, about 10% of what is needed. For a sample of the poorest developing countries, financing provided by the World Bank is in the order of USD 3 billion compared to private grants of some USD 10 billion.

THE HIDDEN COST OF UNFAIR TRADE

Trade restrictions in rich countries cost developing countries around USD 100 billion a year. Sub-Saharan Africa, the world's poorest region, loses some USD 2 billion a year, India and China in excess of USD 3 billion. These are only the immediate costs. The longer-term costs associated with lost opportunities for investment and the loss of economic dynamism are much greater.

INVESTMENT FLOWS THE OTHER WAY AROUND

Foreign direct investment (FDI) can contribute significantly to development and it is increasingly seen as the most important link in the development process by many policy makers. Since 1992 FDI has been the largest source of inflows into developing countries, but it has been highly concentrated within a small group of countries such as China, India, Brazil and Mexico. Countries in sub-Saharan Africa, the most in need of capital, get very little FDI. Moreover, increasing amounts of FDI are used for mergers and acquisitions where a foreign firm acquires an ongoing domestic operation, therefore not adding to productive capacity or bringing about technology transfer. FDI inflows are accompanied by large outflows in the form of profit repatriation. In sub-Saharan Africa, for example, the average rate of return on FDI is between 24% and 30% and the inflow of funds through new FDI is currently exceeded or matched by an outflow of funds as profit remittances on existing FDI.

TAX HAVENS

More than 60% of international trade is now intra-firm trade between various subsidiaries of multinational enterprises. A large portion of this passes through tax havens, which are characterized by secrecy and low or zero rates of taxation for non-domestic enterprises. This means that firms have massive opportunities to transfer profits out of developing countries into these low tax jurisdictions. The easiest and most exploited way of doing this is through the practice of misinvoicing and of transfer mispricing, when exports are underpriced and imports overpriced by firms so that higher profits are declared in tax havens and other non-developing country jurisdictions at the cost of a serious under-reporting of earnings in developing countries. Both domestic and international firms shift between USD 200 billion to USD 350 billion out of developing countries every year through this and related mechanisms.

THE VERY RICH DO NOT PAY TAXES

Around USD 11.5 trillion of the private wealth of the richest men and women in the world is currently held in tax havens, largely undeclared - and therefore probably untaxed - in their country of residence. The benefits from taxing just this individual wealth - let alone the undoubtedly larger sums lost through tax evasion and avoidance by corporations - would far outweigh any realistic increase in aid budgets. The annual worldwide income earned on these undeclared assets is likely to be about USD 860 billion. Taxing this income at a moderate 30% rate would produce around USD 255 billion annually: enough to finance the Millennium Development Goals in their entirety. Put simply, making just the very rich pay their due taxes could immediately fund measures to halve world poverty.

STINGY COUNTRIES

In 1970, the wealthy nations agreed to a goal of spending 0.7% of GNP on development assistance. In 2005, these countries spent an average of just 0.3% of GDP on aid. The US gave the smallest percentage of its wealth, 0.2%, to poor countries.

SHORT OF MONEY... BUT KEEPING TANKS FILLED OF IT

Due to the instability of world finances, developing countries have to keep huge reserves of unused money just to defend their currencies from speculation. To build up those reserves, poor countries are borrowing hard currency from the US at interest rates as high as 18%, and lending this back to the US (in the form of interest on US Treasury bonds) at 3%. Most countries invest their foreign-exchange reserves in relatively safe, short-term assets, such as US Treasury bills. The yields on such instruments are currently very low - well below the interest rates that developing countries pay on their debt.

REMITTANCES

Remittances have become the second largest capital inflow to developing countries behind foreign direct investment and since 1995 contribute more money than all of the official development assistance combined. In Mexico remittances sent by emigrants have become indispensable for 21% of families. These money flows went from USD 1 billion in 1982 to some USD 22 billion in 2006. Although emigrants earn 10 times more in the United States than they would in Mexico, more than 80% of their earnings remain in the United States. The amount of money that actually reaches Mexico almost equals what they would earn there.

ONLY DROPS OF AID ACTUALLY HELP THE POOR

Real aid, the aid money that is actually made available for funding development in the poorest countries, is running at only about USD 30 billion a year or less than 40% of the total aid volume. Administrative costs, technical assistance, accounting for debt relief, tying aid to purchases from the donor country, and aid to geo-strategically important but less needy countries are some of the reasons that more than 60% of the current aid volume is not available as money that can be spent on real and urgent development needs such as health and basic education.

SMALL TAXPAYER IN POOR COUNTRIES CARRY THE BURDEN

If low-income countries were to revise their taxes, strengthen their financial administrations and abolish tax exemptions for transnational investors so that the proportion of public revenues within gross domestic product (which was 12% in 2003) was brought to the average level of the rich countries (26% in 2003), their governments' income would increase by approximately USD 140 billion per year.

The tax income of the developing countries would increase by over USD 285 billion per year if the informal economy could be integrated completely into the formal economy and taxed accordingly. Even if this is unrealistic, partial integration would already bring in many billions in additional income.

DEBT SLAVERY

Low-income countries received grants of about USD 27 billion in 2003 and paid almost USD 35 billion as debt service. Sub-Saharan Africa has seen its debt stock rise by USD 220 billion despite having paid off USD 296 billion of the USD 320 billion it has borrowed since 1970.

In fact, since 1984, net transfers to developing countries through the debt channel (the net result of inflows as new borrowing and outflows in the form of debt service) have been negative in all but three years. So debt, instead of providing a source of funding for development, has become a major source of leakage of scarce resources from developing countries.

CAPITAL FLIGHT

For every dollar of aid that goes into developing countries, ten dollars comes out as capital flight. It has been estimated that developing countries lose more than USD 500 billion every year in illegal outflows which are not reported to the authorities and on which no tax gets paid.

The largest channel for capital flight is trade, where mispricing of transactions with the help of tax havens and banking secrecy undermines the tax and domestic resource mobilization ability of developing country governments.

Wealthy individuals and other domestic elites piggyback on the institutional apparatus of secrecy, private banking and tax havens to transfer billions of dollars out of poor developing countries, depriving their fellow citizens of even the most basic needs such as health care. Western multinational corporations, financial institutions, accounting firms, lawyers and financial centres have all been complicit in perpetrating, facilitating and actively soliciting this capital flight.

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