WORKSHOP
Requested by the DEVE committee

European Parliament

Confronting debt, climate change and poverty: Global financial architecture reform and the fiscal space of developing countries

Authors:
Annalena OPPEL, Kyle McNABB, Sanjeev GUPTA,
Hannah BROWN, Mark PLANT, Bernat CAMPS ADROGUE

European Parliament coordinator:
Policy Department for External Relations
Directorate General for External Policies of the Union

EN

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Confronting debt, climate change and poverty: Global financial architecture reform and the fiscal space of developing countries

ABSTRACT

A workshop held on 19 March 2024 addressed issues affecting developing countries' economic situation, and how it is shaped by policies and global governance. Key subjects include the International Monetary Fund and its policies, taxes and sovereign debt.

Several experts addressed different facets of the subject to answer questions for the Committee on Development (DEVE): What aspects of the current system are being criticised? What are the proposals for change? And what can the EU and the European Parliament do to advance the Sustainable Development Goals (SDGs)?

This publication includes three of the four papers that were presented during the workshop. The first paper brings insights about policies with the potential to reduce poverty and inequality (SDG1 and SDG10). The second and third briefings (explanatory 'primers') clarify key elements of the public discussion: the concept of fiscal space of developing countries and the debate over IMF Special Drawing Rights.

The fourth paper, published separately, provides a comprehensive analysis of the debate about the reform of the global financial architecture, including the International Monetary Fund (IMF) and the World Bank.

EP/EXPO/DEVE/FWC/2019-01/LOT3/1/C/17
EP/EXPO/DEVE/FWC/2019-01/LOT3/1/C/18
June 2024 - PE 754.456

EN

AUTHORS

Briefing 1: 'Developing countries' fiscal space and its impact on reducing poverty (SDG1) and inequality (SDG10)'

- Annalena OPPEL, Research Fellow, International Inequalities Institutes, London School of Economics, Brazil;
- Kyle McNABB, TaxDev Uganda Country Lead and Research Associate, Overseas Development Institute, Uganda.

Briefing 2: 'Fiscal space in developing countries – A primer'

- Sanjeev GUPTA, Senior Fellow Emeritus, Center For Global Development, United States of America;
- Hannah BROWN, Research Associate, Center For Global Development, United States of America.

Briefing 3: 'IMF Special Drawing Rights – A primer'

- Mark PLANT, Senior Policy Fellow, Center for Global Development, United States of America;
- Bernat CAMPS ADROGUE, Research Associate, Center for Global Development, United Kingdom.

CONTRIBUTOR

Workshop proceedings

- Carolina FERREIRA GIL, trainee, Policy Department for External Relations

PROJECT COORDINATOR (CONTRACTOR)

- Trans European Policy Studies Association (TEPSA)

This paper was requested by the European Parliament's Committee on Development.

CONTACTS IN THE EUROPEAN PARLIAMENT

Coordination: Maciej JASTRZEBIEC-PYSZYNSKI, Policy Department for External Relations

Editorial assistant: Grégory DEFOSSEZ

Feedback is welcome. Please write to poldep-expo@europarl.europa.eu

Paper copies can also be requested from poldep-expo@europarl.europa.eu

VERSION

English-language manuscript completed in June 2024.

This paper is published on the European Parliament's online database, 'Think Tank'

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DIRECTORATE-GENERAL FOR EXTERNAL POLICIES

POLICY DEPARTMENT

BRIEFING

Developing countries' fiscal space and its impact on reducing poverty (SDG1) and inequality (SDG10)

ABSTRACT

This briefing discusses evidence on the links between policies that support developing countries' fiscal space and their potential to reduce poverty as well as inequality. Building fiscal space remains a key priority for developing countries, as has been underlined by recent shocks brought forth by the COVID-19 pandemic and ongoing challenges due to climate change. The different pathways discussed are external and domestic policies, directly or indirectly creating fiscal space, together with the circumstances under which observable impacts on SDG1 (End Poverty) and SDG10 (Reduced Inequalities) emerge. Establishing this cause-and-effect relationship is subject to an interplay of many actors and influences rendering the causal pathways less straightforward. In fact, it is often contingent on political economy dynamics, data and measurement as well as institutional structures. Steps towards creating a better understanding between fiscal space creation and the reduction of poverty and inequality include a commitment to horizontal collaboration, not only supporting the infrastructure needed for adaptive systems but also setting expectations within appropriate timeframes.

EP/EXPO/DEVE/FWC/2019-01/LOT3/1/C/18

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- Annalena OPPEL, Research Fellow, International Inequalities Institutes, London School of Economics, Brazil
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List of abbreviations

COST	European Cooperation in Science and Technology
CMSB	Collect More Spend Better
ECF	Extended Credit Facility
EU	European Union
IMF	International Monetary Fund
SDG	Sustainable Development Goal
UBI	Universal Basic Income
VAT	Value Added Tax

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1 How does fiscal space matter for poverty and inequality reductions?

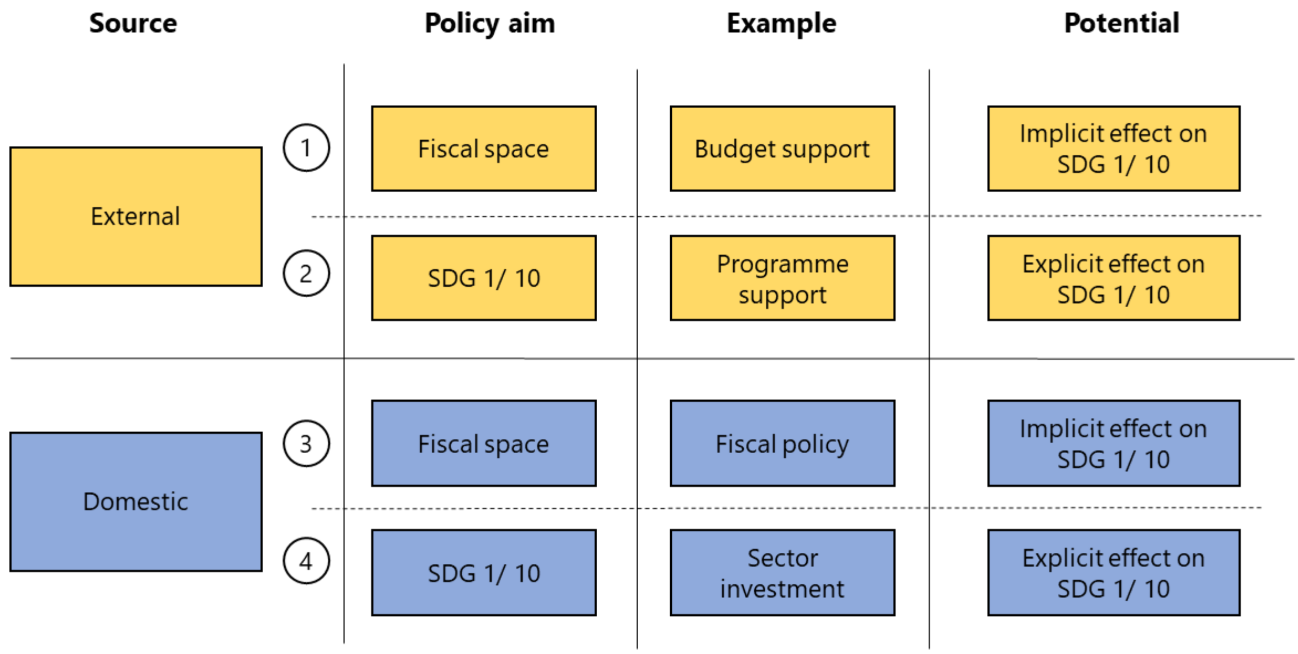
Fiscal space can be understood as 'room in a government's budget that allows it to provide resources for a desired purpose without jeopardizing the sustainability of its financial position or the stability of the economy' (Heller, 2005). The existence of fiscal space is a necessary and pivotal condition for countries to enact policies that work towards the achievement of the Sustainable Development Goals (SDGs). It also outlines a route to achieve this by means of national ownership. Fiscal space can enable governments to invest in social welfare, infrastructure and education, which are essential avenues for inclusive economic development. However, the latest trends show that many developing countries are facing a reduction in fiscal space (Songwe and Awiti, 2021; Organization for Economic Co-operation and Development, 2023a; Huidrom, Kose and Ohnsorge, 2018). This is due to factors such as high – and rising – debt levels, low domestic revenue mobilisation efforts and the economic fallout from recent external shocks such as the COVID-19 pandemic. Resulting constraints on fiscal space limit developing countries' abilities to allocate resources towards poverty and inequality reduction efforts and ultimately attainment of the SDGs.

Policies that can support the creation of fiscal space comprise a broad range encompassing different stakeholders, purposes and scope. With direct or indirect influences on fiscal space, these include tax and spending strategies, debt management and relief, external financing through development aid, strengthening public financial management, as well as improvements to macroeconomic stability and structural reforms (Eichacker, 2023; Gnangnon, 2023). The array of goals embedded in these policies becomes more intricate when they encounter inequality and poverty, which exhibit diverse manifestations and can vary across different contexts. This is likely to complicate not only the targeting and tracing of policies – as well as the extent and ways in which they directly affect poverty and inequality reductions – but also policy design more generally, including their technical, financial and political feasibility.

However, an example of where this *can* be more readily achieved is income inequality and poverty. Here, it is possible for certain government policies to play a role in either exacerbating or mitigating income disparities and poverty within a society. For instance, a more progressive allocation of fiscal resources through the design of tax and expenditure policies can reduce poverty and inequality under the right circumstances (Martinez-Vazquez, Moreno-Dodson and Vulovic, 2012; Clements et al., 2015). Nevertheless, even those more 'directly measurable' effects are set against the caveat that their actual realisation often depends on contextual factors, such as the presence of strong legal institutions (Duncan and Peter, 2016). More broadly, factors such as national political agendas, policy priorities and institutional capacities can shape the extent to which greater fiscal space can be achieved and subsequently utilised to address inequality and poverty.

Consequently, the way that initiatives supporting fiscal space can lead to subsequent poverty and/or inequality reductions, can be manifold and complex. In fact, a direct cause-and-effect relationship between policies that support the creation of fiscal space and their poverty and inequality-reducing impact has yet to be fully established. One reason is that the aim of poverty and inequality reduction often remains an anticipated or second-order effect in the design of policies and initiatives to generate fiscal space. To illustrate this from an institutional perspective, there can be two main pathways. These are external or domestic sources through which different types of policies can directly or indirectly create fiscal space with either explicit or implicit effects on poverty and/or inequality reductions. Explicit or implicit effects are here understood through a rationale of intention and prioritisation and thus concerning the aims reflected in policy design and its implementation as Figure 1 below illustrates:

Figure 1: Two pathways of policies affecting fiscal space and their poverty/inequality reducing potential



Source: Authors' own illustration.

Depending on the policy aim, additional resources' potential more broadly can result in either explicit or implicit effects on poverty or inequality. Those with the direct aim of fiscal space creation, such as budget support (Pathway 1) and domestic fiscal policies (Pathway 3), can be more open-ended concerning the use of additional resources generated. There is historical evidence that as fiscal space increased in European countries, governments increasingly shifted spending patterns toward relatively more social spending (Piketty, 2019), whilst (Long and Miller, 2017) found a positive relationship between tax revenues and social spending across a broad range of countries between 1980 and 2012. Ultimately, the potential for inequality and poverty reduction resulting from policies to create fiscal space is more implicit and largely dependent on contextual and political factors which will ultimately influence the range of policies enacted (such as increases in social spending).

Those with the direct aim of poverty and inequality reduction such as programme support or specific sector investments (Pathways 2 and 4, respectively), have a more targeted purpose concerning the use of resources and hence can potentially impact poverty and inequality more explicitly. At the same time, these outcomes are equally influenced by context and efficiency. While distinguished into two separate avenues in Figure 1, in practice external and domestic sources are often interwoven and interact as detailed below and further in Section 2.

1.1 External policies

Institutional sources can come in the form of budget support programmes that most directly influence fiscal space by transferring funds directly to a recipient country's budget. These include external financing through development aid, taking the form of concessional loans and grants, but also debt relief. All can provide immediate and direct support to government budgets under pressure (see Figure 1, row 1). A key aim here is thus the expansion of fiscal space. How additional resources are being spent is then often a second-order or implicit effect. This is not to say that the targeting of poverty and/or inequality reduction is absent, but rather that these issues may not feature as key priorities. At times, conditions of aid financing

– such as the International Monetary Fund (IMF)'s Extended Credit Facility (ECF)[1] – can address fiscal, monetary, institutional, or structural reforms that may even bring about regressive effects. Conditions are often designed to put developing countries on a path to fiscal sustainability in the medium/long term. Hence, an overarching goal is to bring their governments into positions where they can generate fiscal space through domestic means, for instance through improved tax collection.

With these goals in mind, aid conditionalities may not always reduce poverty and inequality in the short term. A recent survey found, for example, that IMF loans with attached structural reforms contributed to conditions whereby many became trapped in a poverty cycle, whilst loans that came attached with stabilising reforms (where recipient countries had more say over macroeconomic targets) had a less negative impact on poverty (Biglaiser and McGauvran, 2022). Similarly, (Forster et al., 2019) found that IMF conditionality contributed to increases in income inequality due to, *inter alia*, reforms that enacted restraints on public expenditure, related to inflation control and restricted external borrowing. A more specific recent example is the removal of fuel subsidies in Kenya which was set as a structural benchmark within the IMF's ECF (IMF, 2023). However, removing fuel subsidies can particularly worsen the welfare of low-income households[2]. Hence, within this realm, poverty and/or inequality reduction can remain a long-term anticipated rather than explicit target with its achievements being contingent on economic development as well as the effect and efficiency of possible future corrective measures.

While the above represents a direct targeting of fiscal space expansion, this can also materialise more indirectly via the external financing of programme support (see Figure 1, row 2). This occurs when donor agencies either fully or partially fund initiatives that might otherwise be publicly provided. Some of these programmes, such as social assistance, can have explicit poverty and inequality alleviation aims and effects. These include for example conditional cash transfer programmes, with successful and prominent examples in Brazil (such as the Bolsa Família) that show positive effects on educational and health outcomes (Son, 2008). One of the success factors contributing to Bolsa Família's success was the government's strong political commitment and prioritisation of the programme. This also achieved a high level of support and recognition both domestically and internationally, which not only showed that the policy was politically and operationally viable but has also been a driving factor in its continuation (Leite da Silva, Mafra and Oliveira, 2022).

The European Union (EU), as one of the largest donors of development aid, plays an active role in supporting fiscal space in developing countries through both budget and programme support. These include providing development assistance, promotion of debt sustainability as well as offering technical assistance for improving fiscal management and revenue generation. Those efforts, highlight a commitment to bolstering the economic capacities of developing countries by recognising a link between fiscal robustness and sustainable development (EU, 2019). Targeted funding for critical sectors such as infrastructure, healthcare and education as well as social welfare have been part of the endeavours aimed at being transformative in uplifting marginalised communities and combating poverty. Examples include Collect More Spend Better (CMSB) (European Commission, 2016) as well as the Neighbourhood, Development and International Cooperation Instrument – Global Europe (NDICI-Global Europe) (European Commission, 2021a)[3].

[1] IMF 'The Extended Credit Facility', website, n.d.

[2] Empirical evidence, however, suggests that fuel subsidies are often poorly targeted and mostly bring benefits to higher-income households (Coady, Flamini and Sears, 2014). Their removal can provide fiscal space to enact better-targeted policies in future, although this does not always happen in practice.

[3] It should be noted that these two initiatives (CMSB and NDICI-Global) are somewhat different in nature; whilst the former is a distinct programme, the latter is a multi-annual framework for budget allocation.

Evaluation of the CMSB programme, though, highlighted some challenges in creating meaningful synergies with country portfolios[4] (linked to the discussion in Section 2.1), that also limited meaningful influence on a country's strategic direction. The CMSB evaluation (European Commission, 2023a) highlighted that budget support programmes were at times overly optimistic about the pace of reform and the observable impacts on outcomes such as poverty reduction.

1.2 Domestic policies

Domestic sources pertain to those generated by national governments. Relevant examples here are fiscal policies (domestic tax and spending policies) or sector-specific investments (healthcare, education, or other social infrastructure). Depending on their aim, they show potential for either explicit or implicit effects on poverty and/or inequality reduction. Fiscal policies, such as budget support through external financing, are often enacted to expand fiscal space (see Figure 1, row 3). Hereby, an overview of findings from Commitment-to-Equity assessments in 29 low- and middle-income countries finds that whilst fiscal systems (tax and spending together) always lead to reductions in inequality, they are not always poverty-reducing (Lustig, 2023). In developing countries where the domestic tax base is often narrow due to, *inter alia,* high levels of informality, low levels of tax compliance or limitations in tax administration), governments can be more inclined to prioritise the creation of fiscal space without equity as a priority[5]. Consequently, many fiscal policies and policy reforms are designed without explicit poverty and inequality reduction in mind. In fact, an important tenet of IMF advice on tax reform in developing countries since the 1980s has been to resist using the tax system itself for achieving outcomes such as inequality or poverty reduction, but rather encourage a focus on revenue raising for fiscal sustainability (Moore, Prichard and Fjeldstad, 2018).

In part, this prioritisation can also be explained by the financial pressure created through large debt-servicing costs. Domestic policies aimed at expanding fiscal space may involve implementing tax reforms or rebalancing government spending towards more productive uses. Concerning tax reforms, progressive designs where higher-income individuals are taxed at a higher rate can support the reduction of income inequality and poverty. At the same time, reforms to progressive tax systems do not always produce positive outcomes in terms of income inequality in developing countries. For example, Gupta and Jalles (2022) and McNabb and Oppel (2023), find that reforms affecting the statutory incidence of personal income taxation in African countries, for example, have lessened its redistributive impact over the past three decades[6]. Yet it is important to also note that the statutory incidence of taxation in developing countries can translate into a starkly different *de-facto* or *economic* incidence (Bachas, Jensen, and Gadenne 2024) due to, for example, individuals' capacity to evade taxes or firms' ability to pass tax rises onto consumers, respectively.

Linked to types of taxation, necessities such as staple foods, education, medicines and the like are frequently Value Added Tax (VAT)-exempted in many countries. In the absence of an efficient cash transfer system, this presents one example of ensuring that domestic fiscal policies are not poverty- or inequality-worsening. Here it is important to mention that often through the nature of contextual conditions domestic policies or policy reforms can sometimes achieve both: the creation of fiscal space as well as poverty and inequality reductions. Recent evidence (Bachas, Gadenne and Jensen, 2023) highlights how in many low-income countries, the VAT – often thought of as regressive – is in practice progressive as the poor primarily purchase items from informal marketplaces often outside of the tax net.

[4] The evaluation noted that the synergies between performance indicators under budget support programmes were 'timid'. At the same time, a more flexible, country-specific approach might be appropriate where contexts differ.

[5] Recent research has shown, for example, that the capacity of the personal income tax to redistribute in African countries has fallen because of reforms over the past two-to-three decades (McNabb and Oppel, 2023).

[6] The statutory incidence refers to who bears the burden of a tax by law. It is possible, however, that the de facto incidence of the tax (who bears it in practice) differs, due to e.g. evasion or avoidance.

Progressive taxation is especially inequality- and poverty-reducing if it is paired with pro-poor spending and strong legal institutions (Duncan and Peter, 2016). Thus, the prioritisation of certain sectors for public investment also plays a role (see Figure 1, row 4). Pro-poor spending (targeting SDG1 'End Poverty' and/or SDG10 'Reduced Inequalities') can include expenditure on education, healthcare, social assistance and housing. Pro-poor public investment can also pair regional and sectoral prioritisation, such as agricultural extension services that promote the welfare of rural households (Adamu, Maribgore Nangena and Tetteh Anang, 2023). Depending on the sectors being prioritised and the extent to which they benefit different income groups and members of society, such investment can enhance inclusive growth and progress towards SDG1 and/or SDG10. Over time, they also have the potential to even out income disparities by promoting social mobility (Iversen, Krishna and Sen, 2021) and enabling access to essential services. Sector investments naturally require some outlay of funds and thus have the potential to reduce fiscal space depending on whether spending is based on the re-purposing of existing spending versus tapping into financial reserves, for example.

In sum, increasing fiscal space can be thought of as a necessary, but not sufficient condition for realising reductions in poverty and/or income inequality[7]. Various underlying conditions determine whether the additional fiscal space and enacted policies will achieve the desired results.

2 Three influences on fiscal space's ability to produce poverty and/or inequality reductions

While not exclusively attributed to the domains of political economy dynamics, methodology, measurements and timeframes, as well as shifting power dynamics, each can influence fiscal space's ability to bring about poverty and/or inequality reductions. These areas draw out important links to timely progress in both contexts and development agendas.

2.1 The political economy – choices and priorities

Each of the avenues discussed above, whether via the external or domestic route, is subject to political economy dynamics. Hence, whether their impact on poverty and/or inequality reduction is or will be successful often depends on design and consistent prioritisation by all parties involved, as well as the capacity to tailor and adapt in the light of experience. In addition, building bureaucratic capacity is often contingent on levels of corruption. To counter corruption, accountability institutions and measures spread. The EU, for instance, launched an anti-corruption strategy in 2023 at EU and national levels whereby the component of Common Foreign and Security Policy sanction regimes targets forms of corruption worldwide (European Commission, 2023b). In addition, recent evidence showed that countries with stronger bureaucratic capacities tend to have lower levels of corruption (Baig, Yenigun and Alam, 2022). Already by 2015, the EU had initiated an explicit strategy on capacity building of partner countries amidst crisis and political violence[8]. Despite accountability and integrated[9] capacity-building efforts in development efforts, bureaucratic capacity remains notably uneven across and within developing countries (for example, see Centeno et al., 2017; Niedzwiecki, 2018). An additional challenge worth mentioning is illicit financial flows, which divert financial resources from essential development

[7] It is worthwhile mentioning the alternative of creating specific global funds for target-specific SDG projects, similar to existing global health, climate or agriculture funds.

[8] The initiative's link to poverty, violent conflict, and lack of governance can be particularly relevant today with multiple crises unfolding which may additionally weaken institutional capacity and hence could lead to higher levels of corruption.

[9] Many development initiatives nowadays include elements of capacity building, such as the CSMB programme (European Commission, 2016).

programmes targeting poverty and socioeconomic progress, often facilitated by tax havens or sanction evasions (Tarp, 2023).

The extent to which SGD1 and SDG10 are indeed a guiding principle of policy formulation and implementation often boils down to the political preferences and agendas of elected leaders as well as policy-makers and the ideological orientations they represent. Governments with a commitment to social justice and equity are typically more likely to prioritise pro-poor spending and progressive taxation measures. They can also show a greater alignment and willingness to collaborate towards shared global agendas as has been shown by the re-commitment of President Lula's government to climate change-related inequality (Rannard, 2022).

What also matters are national political and social movements shaping the electorate, given that recent decades have witnessed the rise of right-wing populism. While some link this to ideological orientations, others have also argued that particularly in the Global South this can be a response to uneven developments of capitalism and skewed competition as a means to level the playing field (Kumral, 2023). A recent example of such a turn would be Argentina (Oliveros and Simison, 2023). Another related factor is the presence of interest groups such as wealthy elites and corporate lobbyists. In contexts where elite capture and rent-seeking behaviour exist, fiscal space is often used in ways that benefit privileged groups at the expense of the poor (David-Barrett, 2021). Again, this can create misalignment or even contradictions with global agendas, particularly goals concerning poverty and inequality.

Hence, inequality and poverty do not simply represent what is often reflected in differences across income, consumption, wealth, access and rights, but also who is being impacted, often referred to as horizontal inequalities (Stewart, 2014). This puts into focus which markers in a society, such as gender, race, ethnicity, sexual orientation, disability, or religion are salient, recognised and protected. While these categories are strongly anchored within the SDGs, in recent times one has witnessed countries turning away from anti-discrimination practices and recognition of rights, an example being Uganda's anti-homosexuality act (BBC, 2023). Conversely, there are policy frameworks such as affirmative action that seek to redress imbalances and historical disadvantages across societal groups. However, these frameworks are often met with political resistance amidst the contrasting interface of state intervention versus liberalisation that post-colonial states underwent in creating democratic economies (Ratuva, 2013).

Apart from ideological influences, a recognised constraint is also represented in institutional factors. Beyond issues concerning political will and prioritisation, national institutions' capacity to create more equitable fiscal systems and inclusive growth also matters. This includes legislative frameworks, budgetary processes and governance structures that affect the adaptiveness, capacity and ability of governments to implement redistributive fiscal policies, such as social sector spending (Murshed et al., 2022). That further presents a range of different conditions, including the tax administration's power, the extent of national accountability, as well as the strength of public financial management functions and legal institutions. **Weak institutions and governance deficiencies can hamper efforts to expand fiscal space for poverty reduction and inequality reduction.**

In many developing countries, the revenue authority's role is key in ensuring that taxes are collected efficiently and equitably. However, institutional constraints can often hamper these efforts. For example, **high-net-worth individuals are often hard to tax due to political barriers** (Prichard, Dom and Custers, 2022). Similarly, institutional capacity constraints may mean that a tax which is progressive by design fails to achieve much redistribution in practice. Regional fora such as the African Tax Administration Forum[10] provide a powerful platform for discussing key challenges and constraints being faced by tax administrations on the continent together with opportunities for knowledge exchange and designing solutions to ensure that tax systems achieve their intended objectives most efficiently. On a global level,

[10] African Tax Administration Forum, website, n.d.

the Africa Group has been instrumental in driving the United Nations Framework Convention on International Tax Cooperation, designed to elevate the voices of developing nations on international taxation matters. Another positive example is explicit EU capacity-building missions. Though not necessarily focussing on fiscal space *per se*, a general strengthening of the administrative system in other domains can yield positive spillover effects on tax administration and governance as well as spending regimes more broadly. This can be seen in the case of Somalia concerning maritime security (Finabel, 2023) or in Mali where security sector reforms contribute to preventing corruption and reinforcing the role of administrative authorities[11].

2.2 Methodology, measurements, and timeframes

An important methodological element, governing the extent to which policies that promote fiscal space have led to reductions in income inequality and poverty, concerns their measurement and dimensions. While the matter of general data scarcity in the Global South has long been acknowledged, additional arguments on the types of data, choice of measurements and timeliness must be presented.

A strong focus on quantifiable effects can lead to income inequality, which often takes centre stage in this debate. Hence, the extent of other dimensions' impact on inequality and poverty, such as rights-based or discrimination-based forms, can also fall behind in measurement and tracking[12]. Another concern is the measurement of incidence (Clements et al., 2015). Models that seek to understand the direct impact of tax and spending, often need to do so based on simple assumptions. For instance, personal income taxes can be fully borne by employees without any effect on their pre-tax received payments. The aforementioned work by (Bachas, Gadenne and Jensen, 2023), for example, highlights how different assumptions over where the burden of consumption taxes is borne, can strongly influence conclusions on measured redistributive effects. While certain ways of measuring effects are determined by data availability, the assumptions embedded in these exercises can sometimes represent political choices, in turn shaping political discourses and policy responses, thus reiterating the arguments of Section 2.1 (see, in particular, Cobham, 2019).

While often measurements and policy formulation are made at a particular point with a specific time horizon in mind, the trajectory of social, political and economic development becomes increasingly volatile. Unforeseen crisis events, their frequency, relevance and interconnectedness are on the rise, often culminating in recognition of the current state termed the *polycrisis* (Lawrence et al., 2023). This matters in various ways. Initially, as witnessed during the COVID-19 pandemic, governments are faced with rising demand for support to citizens and the economy. Policy responses to crises then often happen in a 'political vacuum' through the enactment of national disaster clauses giving governments more decision room to act quickly. These *ad-hoc* decisions often highlight existing gaps in data and digital infrastructures for a quick and meaningful upscaling of, for example, welfare support. A recognition of not knowing how and where crisis and needs unfold has, *inter alia*, highlighted how much the coverage of social registries has to be universal, covering all individuals and households in a country regardless of socioeconomic vulnerability (Berner and Van Hemelryck, 2021). Impromptu changes also pose a need for timely or even real-time data to recognise the extent and type of crisis support required. Lessons learned from recent crisis events culminated in the pledge to build adaptive systems, solutions and models which are still underway (Bowen et al., 2020).

In response to these unfolding crises, there has also been innovation in the type of financing instruments used. Innovative financing with direct implications for global inequality is hence increasingly being used

[11] EEAS, 'About EUCAP Sahel Mali', webpage, n.d.

[12] This typically excludes the dimension of gender inequality where there have been extensive efforts to measure gender wage gaps and associated income disparities.

to support fiscal space in developing countries whilst also targeting risks associated with crisis, particularly climate change. 'Debt-for-Climate swaps' provide an example where creditors provide debt relief in return for investments in the environment (see Zettelmeyer et al., 2022 for a discussion). This can also come in the form of direct payments for ecosystem services such as The Central African Forest Initiative. This has made payments to Gabon for reducing its emissions and keeping forests *in situ*, thus contributing to global efforts to tackle climate change (United Nations, 2021). Finally, the IMF's Resilience and Sustainability Trust provides support to many countries' fiscal space, thereby providing funds for coping with climate-related shocks[13]. Taken together, such initiatives will probably enable countries to enact policies that help to build resilience against income shocks (and subsequently, poverty and climate-induced inequalities) which might result from the adverse effects of climate change.

2.3 Continued disempowerment?

Existing power imbalances in decision-making may hamper and disincentivise developing countries from devising and tailoring new and alternative solutions. A key principle from the 2005 Paris Declaration (Organization for Economic Co-operation and Development, 2005) has been ownership and alignment in development cooperation, specifically Aid Effectiveness. On the one hand, ownership linked to the call for leadership by developing countries concerns the progression of their priorities and strategies, whereby donors in turn align their assistance with national development plans and systems. Alignment, on the other hand, takes on the perspective of donor countries reinforcing ownership. It states that donors should align their support with recipient countries' priorities, systems and procedures to avoid duplication or fragmentation of aid.

In 2016, the Grand Bargain, supported by the EU, followed an agreement between some of the largest donors and humanitarian organisations, particularly aiming at delivering more financial means to those in need (Inter-Agency Standing Committee, 2016). This agreement brought about the term of localisation with ambitious targets for allocating at least a quarter of the funds to national and local actors, harmonising reporting standards and inclusive decision-making processes. Specifically, for the European Commission, localisation refers to empowering local responders in affected contexts, particularly relevant during crises and regarding humanitarian aid.

While these aims may thus sound specific to certain circumstances and unforeseen crisis events, as mentioned in Section 2.2, the frequency and connectedness of crisis events have increased. The aims of ownership, alignment and localisation go beyond specific policy agendas and design principles, by being manifested in a larger political agenda of shifting power. Yet, evidence shows that whilst implementation of the agreed principles has seen some progress, there is still a long way to go before the anticipated targets are reached. More broadly, in a five-year review of the Grand Bargain, the main obstacles to achieving localisation have been identified as a lack of collective political interest, poor coordination, scarce data but also the unwillingness to delegate control amidst perceived risks (Matcalfe-Hough et al., 2021). Consequently, it has been argued that donors' aims to empower local actors can in practice reinforce problematic power structures by measuring the capacities of 'locals' by a Western yardstick (Ramachandran and Gisselquist, 2024).

In addition to uneven decision-making and agenda-setting, there is also a financial dependency reflected in debt structures. As highlighted earlier, it had already been stressed in the 1990s that external financing, particularly IMF-imposed conditionalities, can constitute an impediment to the Global South's economic expansion (Bradshaw and Huang, 1991). Here, a growing trend of trust-based philanthropy with flexible grant-making can be seen as a counter-response, giving agency back to the context[14]. There is also the

[13] IMF, 'Resilience and Sustainability Trust', webpage, n.d.

[14] Examples include the Global Greengrants Fund, the Global Fund for Children or the Trust-based Philanthropy project which is laying out principles of trust-based grant making.

promotion of a cautious shift towards domestic funding instead of foreign debt, giving fiscal responsibility, scrutiny and discipline to countries, thereby improving their dependencies (Panizza, 2008). Yet, a comprehensive review showed that foreign debt accumulation worsened after economic crisis events with rapid build ups in turn increasing the likelihood of financial crises with key contributing factors being a larger share of short-term external debt, higher debt service and lower reserves (Koh et al., 2020). This is a situation many developing countries find themselves in following the COVID-19 pandemic. It may have contributed to a rising prominence of debt relief in policy forums and discussions currently underway.

3 Thinking ahead

Policies that support fiscal space can be diverse, as can the forms and extent of poverty and inequality in different contexts. A 'go to' pathway establishing robust causal links between such policies and their poverty and/or inequality reducing potential or even effect, thus remains elusive. In sum, various challenges have been identified and discussed when exploring links between fiscal space and the reduction of poverty and inequality. Aspects mentioned range from policy design (targeting and tracing outcomes), narrow tax bases and informality and political will and power imbalances to measurement issues. While it would be impossible to address them all here, the following recommendations tackle some of these issues.

3.1 Horizontality and trust-based partnerships

A continual commitment to more horizontality in development cooperation across the global North and South is one essential pathway to (re-)building trust and more balanced engagement with global agendas. Horizontality is here set against historical power imbalances across the global North and South. It thus emphasises a commitment to thought leadership and shared decision-making with partners in the global South without there being a hierarchical relationship between actors or institutions (see also Chiasson and Ntezirembo 2012 for a more generic discussion). European Cooperation for Science and Technology (COST) launched a four-year action in 2020, funded by the EU, to decolonise research and practice in development. Concerning practice, this includes the item of 'overcoming paternalism' by avoiding forms of trusteeship, revisiting existing accountability mechanisms and rethinking pathways to find new structures in emerging fields such as energy transitions, digitisation and finance (COST, 2020).

Politically, the EU also represents a proactive stance in advocating for global policies that promote fiscal space expansion on a broader and more structural scale. This includes debt relief initiatives and advocating for fair-trade practices (EU, 2021). Through these initiatives, it is evident that the EU makes efforts to address systemic barriers and inequalities due to colonial backgrounds as well as uneven histories and development. Systemic barriers addressed are particularly those that impede the fiscal sovereignty and economic self-determination of developing countries, (see also Section 2.3). On the aspect of horizontality, related aspects are also included in the Global Partnership for Effective Development Cooperation of which the EU is a member and active supporter (European Commission, 2021b). Key aspects include the ownership of development priorities by developing countries, mutual accountability and inclusive partnerships, whereas the EU role described aligns more with an emphasis on adherence to effectiveness and monitoring as well as joint programming among Member States countries[15]. Another related platform is Capacity4Dev with 12 241 members at present, connecting development professionals for knowledge

[15] Yet monitoring and evaluation frameworks employed on many donor projects often show a misalignment brought forth by continued thought leadership in the Global North. So-called logical frameworks (or 'logframes') often fail to account for contextual factors and dynamics and at time presuppose solutions that may be inapplicable for the context in which the project operates. See Bakewell and Garbutt (2005) for a related discussion.

exchange concerning best practices, building connections and resources[16]. Taking more steps towards increasingly trust-based relationships with partners of developing countries, that further include and empower local actors and communities to find the most viable solutions, can be effective in targeting poverty and inequality. Viable insights and lessons learned can stem from networks and movements in the development space such as the International Alliance for Localization[17] as well as private philanthropy for development which grew to USD 11 billion in 2021[18] (Organization for Economic Co-operation and Development, 2023c). Hereby, private funders often **pioneer new approaches** in flexible long-term grant giving, given restrictive environments and rising uncertainties.

Proposed action: Adopt principles from pioneering approaches to include streamlined and simplified paperwork together with reporting guidelines as well as concrete practices of mutual and equitable accountability as well as long-term and more flexible funding. As has already been proved, these measures can successfully build more trust and sustained change, while creating more inclusive economies[19].

3.2 Supporting comprehensive digitisation

Another important consideration is the re-ignited debate concerning universality in welfare design and digital infrastructure requirements. As discussed earlier, this can be vital in an increasingly volatile world. With the 1990s dominated by targeted approaches, universality was often deemed too expensive; yet this also applied to trade-offs from the costs of targeting such as inclusion and exclusion errors (Besley, 1990). In response to the recent COVID-19 pandemic, universal basic incomes (UBIs) gained prominence especially in policy debates (Oppel, 2022). In addition, the largest UBI study (to date) covering about 200 villages in rural Kenya, documented early findings which showed that a long-term UBI (12-year monthly basic income) was particularly effective in improving economic agency and savings, did not disincentivise hours worked and increased self-employment in non-agricultural activities (Banerjee et al., 2023). Setting up universal welfare systems more broadly also requires universalism in digitalisation, such as comprehensive social registries, as mentioned earlier, with positive advancements realised in Brazil, Ecuador and Mexico. These often still lag behind in developing countries, further hindering a swift upscaling of welfare benefits during a crisis. The EU, under Sweden's rotating Presidency of the Council, recently held an important event recognising the need for financing digitisation to achieve the SDGs (European Development Finance Institutions, 2023). Hereby, insufficient funding for digital infrastructure has been mentioned, further emphasising the need for collaboration between public and private partners in this endeavour.

Proposed action: Help countries to **invest in digitisation** through public-private partnerships to establish **universal social registries**, say, covering all individuals regardless of socioeconomic vulnerability, which can be vital for universal service provision and adaptive crisis response alike. As has been recently stressed, social registries can be a gateway to social and economic inclusion (European Development Finance Institutions, 2023).

[16] European Commission, 'Capacity4Dev', webpage, 2024.
[17] Local Futures, 'International Alliance for Localization', webpage, n.d.
[18] With overseas development assistance standing at USD 245 billion received by developing countries in 2022 (Organization for Economic Co-operation and Development, 2023b), this constitutes just around 5 % overall. However, the only Development Assistance Committee members who met or exceeded the recommended 0.7 % of Gross National Income target were Germany, Luxembourg and Sweden, in that all other countries were USD 186 billion short of their collective commitment. Potential shortages, over time, could thus be taken up by alternative actors who provide more attractive frameworks.
[19] 'Trust-Based Philanthropy, website, n.d.

3.3 Understanding and setting expectations

A key issue that cuts across much of the preceding discussion is that of *timing*. Policies originating either from internal or external sources that support the creation of fiscal space in the near term might well lead to impacts on SDG1 or SDG10 over the medium or longer term. For example, investments in infrastructure or education today will likely contribute to inclusive economic growth in the medium term, which in turn can foster longer-term reductions in poverty and inequality. However, if the monitoring and evaluation framework of a particular programme or policy is relatively short, these effects might not be immediately observable.

When thinking about inequality in particular, a similar concern is whether one considers the level of inequality in a society at one point in time, or over an individual's lifetime. Policies that affect, for example, the tax treatment of savings and pensions might appear progressive when viewed through the former, but not the latter lens. Finally, there is an important time dimension to consider with domestic budget or programme support. Where budget support to provide fiscal space is provided in the form of a loan, the recipient country has a future obligation regarding repayment. However, if fiscal space remains tight over the medium term, the burden of repayment may necessitate fiscal tightening in the future which could have negative effects on income inequality or poverty. Citizens are increasingly aware of this issue. Kenyans, for example, protested heavily upon the agreement of the most recent IMF programme over fears that higher taxes would accompany the loan (BBC, 2021).

Proposed action: It could be worthwhile thinking about **redefining outcomes and/or targets** of programmes that are designed to create fiscal space, building in a greater understanding of the fact that effects take time to play out. This might include more **explicitly targeting intermediate outcomes** (e.g. in processes), rather than expecting impacts such as those discussed here.

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DIRECTORATE-GENERAL FOR EXTERNAL POLICIES

POLICY DEPARTMENT

European Parliament

BRIEFING

Fiscal space in developing countries – A primer

ABSTRACT

Discourse surrounding fiscal space in developing countries has assumed significance on both international and European fronts, notably reflected in the United Nations Statement to the International Monetary Fund (IMF) and Board of Governors' Financial Committee during the IMF-World Bank Annual Meetings in Marrakech. This briefing starts by discussing the concept of fiscal space in developing nations, delineating influencing factors, before exploring its relationship with demography, pandemics and climate change. The impact of policy levers available to policymakers is also considered, including: expanding domestic resource mobilisation; enhancing expenditure efficiency; and refining debt management. The briefing concludes with a set of recommendations that hold potential relevance for policy-makers in the European Union.

EP/EXPO/DEVE/FWC/2019-01/LOT3/1/C/17

EN

June 2024 - PE 754.456

AUTHORS

- Sanjeev GUPTA, Senior Fellow Emeritus, Center For Global Development, United States of America
- Hannah BROWN, Research Associate, Center For Global Development, United States of America

PROJECT COORDINATOR (CONTRACTOR)

Trans European Policy Studies Association (TEPSA)

This paper was requested by the European Parliament's Committee on Development.

The content of this document is the sole responsibility of the authors, and any opinions expressed herein do not necessarily represent the official position of the European Parliament.

CONTACTS IN THE EUROPEAN PARLIAMENT

Coordination: Maciej JASTRZEBIEC-PYSZYNSKI, Policy Department for External Relations

Editorial assistant: Grégory DEFOSSEZ

Feedback is welcome. Please write to poldep-expo@europarl.europa.eu

Paper copies can also be requested from poldep-expo@europarl.europa.eu

VERSION

English-language manuscript completed in June 2024.

This paper is published on the European Parliament's online database, 'Think Tank'

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List of abbreviations

AE	Advanced Economies
EMEs	Emerging Market Economies
EU	European Union
G77	Group of 77
GDP	Gross Domestic Product
IMF	International Monetary Fund
LIC	Low-Income Countries
LIDCs	Low-Income Developing Countries
NDICI – Global Europe	Neighbourhood Development and International Cooperation Instrument – Global Europe
SDGs	Sustainable Development Goals
UN	United Nations
V20	Vulnerable Group of 20
VAT	Value Added Tax

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1 Definition and assessment

Fiscal space concerns a nation's capability to implement fiscal policies. These include increasing expenditures or reducing taxes, while at the same time: (a) maintaining access to financial markets for budget funding; and (b) fulfilling all existing and future payment obligations without default or reliance on extraordinary financial assistance, such as support from international organisations or the governments of wealthy countries and their agencies (International Monetary Fund, 2018).

When evaluating a country's fiscal space, it is crucial to consider various issues (International Monetary Fund, 2016 and 2018):

- current economic conditions – the country is in recession, say;
- the external economic environment – for instance, the global economy's position;
- the level and trajectory of fiscal deficits and public debt over the medium and long term;
- the size of government assets;
- government liabilities related to past transactions that may be payable in future (contingent liabilities);
- the economy's revenue potential;
- future spending commitments – for instance, pension and health care obligations;
- and planned fiscal adjustment strategies as well as their credibility.

The credibility and implementation capacity of policy-makers in these countries are key factors in this assessment. Furthermore, given that developing nations are more vulnerable to external shocks, such as fluctuations in commodity prices – a large proportion of earnings for the Least Developed Countries (LDCs) come from commodities (United Nations Conference on Trade and Development, 2023) – it is advisable to allow for buffers in their fiscal spaces (Kose et al, 2018).

Some countries may lack or have limited access to financial markets, compelling them to depend on international organisations and/or wealthy governments and their agencies for financing specific investments. In this context, it is worth noting that during 2023 countries in Sub-Saharan Africa were precluded from securing new loans in international financial markets (The Economist, 2023). This exclusion stemmed not only from heightened interest rates but also creditors' apprehensions regarding these countries' capabilities to fulfil both current and future payment obligations related to interest and principal on loans (that is, ability to service debt). As a result, this constraint has reduced fiscal space in these nations, impacting their ability to allocate resources toward the attainment of the Sustainable Development Goals (SDGs). Consequently, this development adversely affected their overall economic growth.

1.1 Growth and productive spending and their impact on fiscal space

Robust economic growth plays a crucial role in expanding fiscal space by generating higher revenues. This, in turn, empowers a country to invest more in its social sectors, infrastructure and climate transitions. Given that developing countries generally possess a smaller capital base, they stand to gain a greater growth dividend from productive capital investments. This dynamic presents an opportunity for fiscal policy to expand fiscal space steadily over time.

It is crucial to remember, though, that there might be a temporary gap between revenue generation and debt servicing, given that projects and investments need time to reach full fruition. Conversely, unproductive investments funded solely through borrowing limit a country's fiscal space by adding the burden of repaying loans and associated interest.

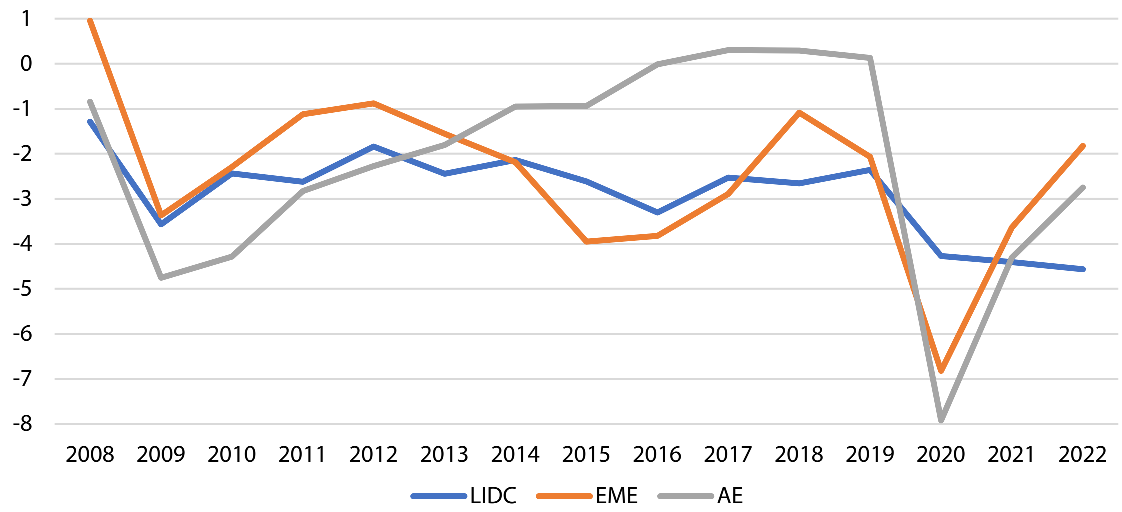
The following discussion will delve into the interplay between fiscal space and the dynamics of pandemics, demographic shifts, and climate change.

1.2 Pandemics and fiscal space

Examining recent experience with the COVID-19 pandemic provides insights into the intricate relationship between pandemics and fiscal space in developing countries, particularly when compared with advanced economies.

Throughout 2020, countries worldwide escalated public spending on healthcare and instituted economic support programmes to alleviate repercussions from the pandemic, thereby safeguarding lives and livelihoods. This upswing in public expenditure resulted in higher fiscal deficits – defined as the excess of public spending over revenues – across all economies, as depicted in Figure 1. The extent of these fiscal deficits varied contingent on each country's fiscal space, with more pronounced deficits observed in advanced economies. Developing countries, defined as both low-income developing countries (LIDCs) and emerging market economies (EMEs), encountered additional challenges in their fiscal space due to dwindling revenues stemming from reduced economic activity (See Appendix 1 for country income classifications). In Figure 1 and the following, AE stands for 'Advanced Economies'.

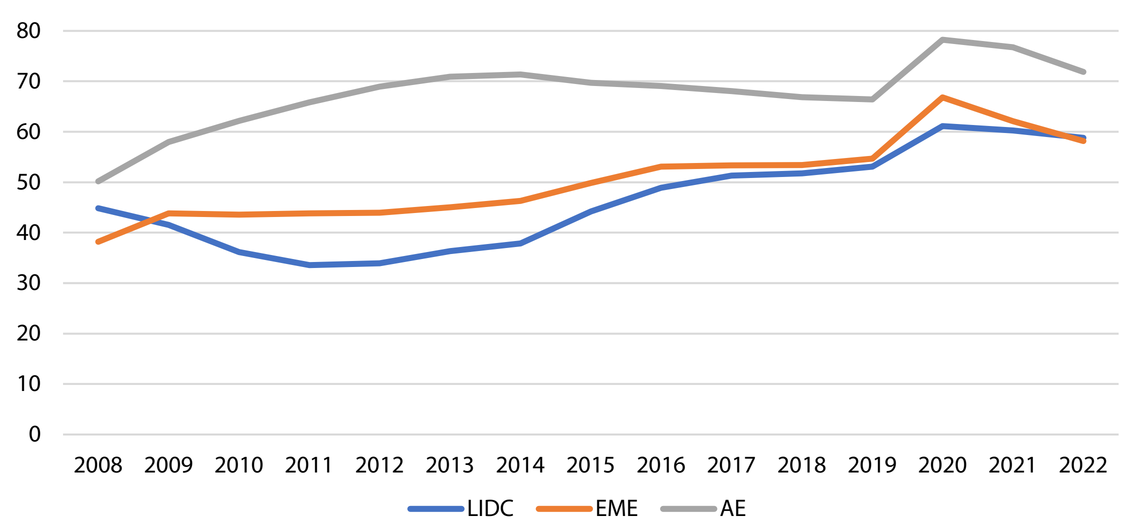
Figure 1: General government fiscal deficit (percentage of gross domestic product)



Authors' elaboration based on data from 'IMF World Economic Outlook database', assessed in July 2023.

Subsequently, the increased fiscal deficits translated into elevated debt-to-gross domestic product (GDP) ratios (Figure 2 below). Although on average this ratio rose less in developing countries compared to advanced economies, it nevertheless posed a constraining effect on their fiscal capacity moving forward. This was due to the necessity of allocating an increasing portion of their revenues to cover interest payments on both domestic and external debt, as well as to make provisions for repaying the principal on borrowed funds. The normalisation of monetary policy in advanced economies led to higher interest rates for developing countries. Coupled with currency depreciation following Russia's invasion of Ukraine, interest payments in local currency on loans surged significantly. Furthermore, the prolonged period of elevated oil prices in 2022–2023 further strained these countries' debt-servicing ability.

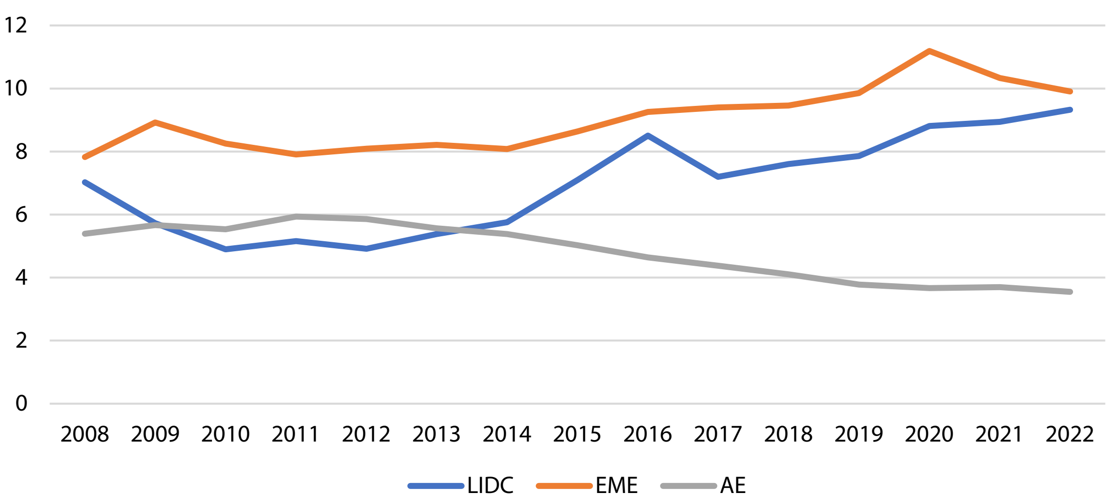
Figure 2: General government gross debt (percentage of fiscal year GDP)



Authors' elaboration based on data from 'IMF World Economic Outlook database', assessed in July 2023.

Since 2011, developing countries have witnessed a rise in interest payments as a percentage of revenues, in stark contrast to advanced economies (Figure 3). This increase is particularly pronounced for certain nations. In Ghana and Zambia, for instance, the ratio of interest to revenues stood at a staggering 50 % and 30 % respectively in 2020, severely limiting these countries' fiscal capacity to fund essential social services (Clements et al, 2023).

Figure 3: General government interest expense (percentage of total revenues)



Authors' elaboration based on data from IMF World Economic Outlook database, assessed in July 2023.

Lessons learnt from the COVID-19 pandemic underscore how important it is not only to appreciate that fiscal buffers in developing countries must be maintained, as discussed in Section 1 above, but also to understand that any room for manoeuvring within fiscal space in many developing countries has been considerably constricted. This is apparent, with 60 % of low-income countries (LICs), a subset of developing nations, facing a significant risk of either failing to meet their obligations or already having done so

(World Bank, 2023a). Over the past three years alone, the number of sovereign debt defaults in these countries has surged to 18, thereby surpassing the previous two *decades*' total (World Bank, 2023a). At the same time, as noted above, a significant number of developing countries with market access find themselves effectively priced out of international capital markets, with one in every four currently grappling with this challenge (World Bank, 2023a).

1.3 Demographics and fiscal space

Demographic shifts in developing countries present both challenges and opportunities for fiscal space development in the foreseeable future. Namely, anticipated increases in life expectancy and declines in fertility rates will have far-reaching implications for expenditures on education, health and pensions. The share of people over 65 years old in developing countries' populations (labelled as the dependency ratio) is projected to more than double by 2050 (Clements et al, 2017). An ageing population will necessitate higher spending on healthcare (Coady et al, 2012; Clements et al, 2017) and pensions for retired workers (Clements et al, 2014), thereby exerting pressure on fiscal space.

Within the realm of education, any impact on fiscal space will be contingent on fluctuations in the school-age population (Bend et al, 2023). Notably, certain countries such as India and Sri Lanka are expected to experience declines in their school-age populations, thereby enhancing fiscal space with existing allocations for education spending (Bend et al, 2023). In contrast, Sudan foresees an almost 30 % increase in its school-age population over the next decade. Without corresponding increases in education allocations, the country is likely to face a sustained decline in *per-capita* education spending.

1.4 Climate change and fiscal space

The green transition would entail significant fiscal costs, especially if developing countries were to rely heavily on expenditure-based strategies to achieve net-zero goals by 2060 (International Monetary Fund, 2023). This will be problematic if these countries already have limited fiscal space in their budgets. With a relatively low carbon price, an initiative that put an explicit price on GHG emissions (World Bank, 2023c), a substantial increase in green investment and subsidies could lead to a heightened debt-to-GDP ratio for these nations, creating an unsustainable financial burden. Conversely, a higher carbon price might alleviate the financial strain, but could be politically unpalatable.

In addition to emphasising mitigation, developing economies must also prioritise their resilience building and adapting to climate change. This is particularly pertinent for small developing states, which confront the highest demands for climate adaptation, averaging an estimated 2.7 % of GDP annually until 2030 (International Monetary Fund, 2023). These requirements add to their existing need for investments to achieve other SDGs in education and healthcare. Already grappling with fiscal constraints due to external shocks and the impact of COVID-19, substantial demands for mitigation and adaptation measures would further exacerbate their fiscal challenges.

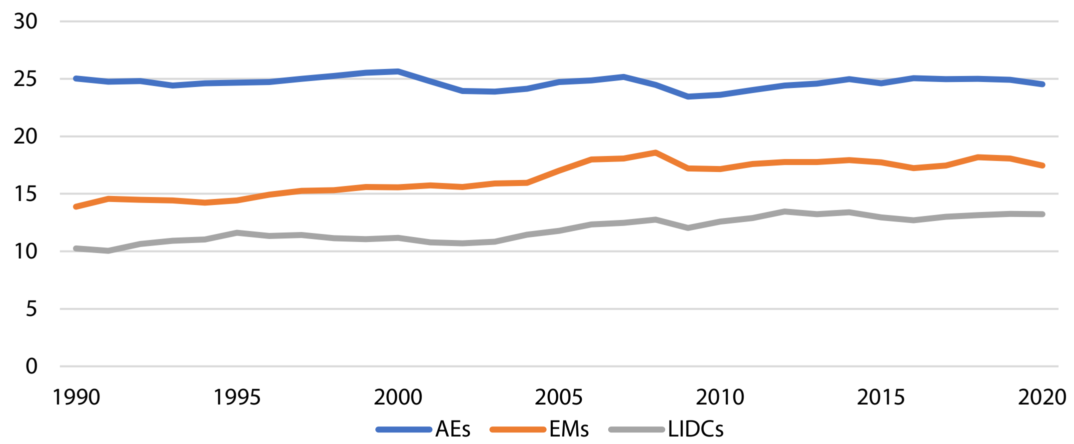
Essentially, developing countries need to generate fiscal room by implementing revenue and expenditure measures, as elaborated below. Additionally, they should explore grant financing or financing with concessional terms to bolster support for climate transition. This might encompass resources mobilised within the framework of a loss and damage fund, as discussed during COP28 (United Nations Framework Convention on Climate Change, 2023).

2 Expanding fiscal space

2.1 Collect more revenues

In LIDCs and EMEs, collectively representing developing countries, revenues exhibited an average increase of 2-4 % of GDP between 1990 and 2011 (Benitez et al, 2023). However, a concerning trend emerged between 2012 and 2020, as revenues stagnated, with the tax-to-GDP ratio hovering around 13 % in LICs and 17 % in EMEs (Figure 4). This stagnation, highlighted by certain LICs collecting less than 10 % of revenues in relation to GDP, has hindered the crucial funding needed for social sectors and overall development.

Figure 4: Tax revenue, 1990-2020 (percentage of GDP)

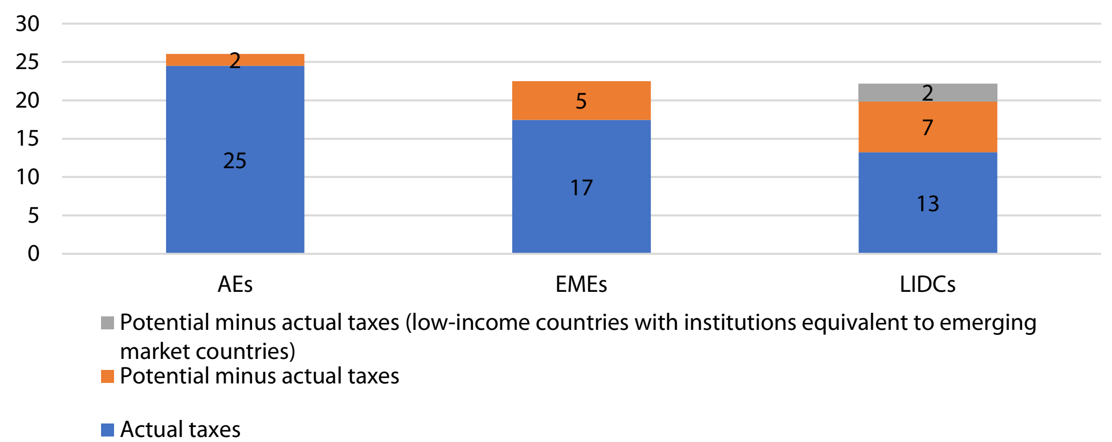


Authors' elaboration based on data from Benitez et al, "Building Tax Capacity in Developing Countries".

In the short term, governments should focus on 'low-hanging fruit' to raise more revenues, including eliminating unnecessary tax exemptions and subsidies (Berensmann et al, 2023). In the longer term, developing countries require reforms which promote revenue collection and expenditure improvements (Berensmann et al, 2023). As outlined by the Organization for Economic Cooperation and Development (OECD), the objective of tax reform should be to establish a tax system that is efficient, growth-oriented and equitable as well as one that incorporates political commitment, and local leadership(OECD, 2014).

The International Monetary Fund (IMF) (Benitez et al, 2023) estimates that LIDCs could elevate the tax-to-GDP ratio by an additional 9 % through the tax system and institutional reforms, while EMEs could achieve a 5 % increase (Figure 5).

Figure 5: Tax potential and tax effort, 2020 (percentage of GDP)



Authors' elaboration based on data from Benitez et al, 'Building Tax Capacity in Developing Countries'.

Central to this effort is the Value Added Tax (VAT), which has faced challenges due to exemptions and reduced rates that have diminished its effectiveness. Simultaneously, applying VAT to the import of digital services and online-purchased parcels would broaden the taxable base. To enhance the progressivity of the VAT, one approach is to establish a higher minimum threshold for filing. This adjustment would exempt numerous small-scale sellers, from whom individuals with lower incomes often make purchases, thereby simplifying VAT administration.

Considerable revenues are lost due to tax expenditures (Gupta and Jalles, 2023). In certain instances, VAT exemptions are granted for products heavily consumed by the poor, such as food. However, in many countries, these exemptions have not effectively reduced inequality, given the substantial consumption of these products by middle and upper-income groups (Granger et al, 2022). Even if applying VAT to some exempted products makes the tax more regressive, this impact can be mitigated by increasing pro-poor spending. Additional opportunities for revenue generation also exist through excise duties on petroleum products, alcoholic beverages, tobacco, unhealthy foods (e.g., sugary drinks) and plastic waste.

Furthermore, there is potential not only to enhance the design of personal income taxes to boost revenues, but also to introduce higher rates for capital income (such as interest, dividends and capital gains). Adjusting the threshold for personal income tax can be instrumental. In certain countries, a relatively small percentage of workers are subject to income tax because of the high threshold (Abdel-Khader and de Mooij, 2021) and a relatively low top rate (Benedek et al, 2022). Moreover, given the prevalence of informality in many developing countries, implementing simplified regimes for the self-employed and micro-enterprises can enhance compliance. However, realising these objectives demands a comprehensive approach that navigates carefully through vested interests and may progress slowly, as evidenced by the two-decade timeline for a modest 2 % increase in the tax-to-GDP ratio from 1990 to 2012 in LICs.

2.2 Rationalise expenditures

On average, governments in developing countries, including both LIDCs and EMEs, allocate approximately 7-9 % of GDP to education and health, with an additional expenditure of up to 8 % of GDP on public investment (Gupta, 2018). It is anticipated that social sector spending will increase as countries strive to meet the SDGs and allocate resources for climate transitions. However, prevailing evidence suggests that many developing countries' governments are not achieving these objectives at the lowest feasible cost.

Some nations, notably in Africa, expend 20-35 % more resources in both education and health sectors to achieve similar goals in more efficient countries (Gupta and Verhoeven, 2001; Herrera and Pang, 2005). For instance, in India six states have the potential to reduce education and health spending by 50 % or more without compromising service provision (Mohanty and Bhanumurthy, 2020).

Among a group of 80 developing countries studied, the least efficient 25 % could potentially extend life expectancy by up to 5 years by emulating the spending patterns of the most efficient countries (Herrera and Pang, 2005). The efficiency of public spending in Africa was found to be higher in health when compared with education (Sikayena et al 2022). Developing countries lose over one-third of their public investment due to inefficient spending practices, a significant setback given the extensive infrastructure gaps that these nations face (IMF, 2015; Barhoumi et al, 2018). Inefficient spending diminishes the impact of public investment on growth, estimated to be only half as much as that experienced by countries with efficient investment spending (IMF, 2015).

Energy subsidies, particularly those designed to provide income support to low-income households, prove to be inefficient, with most of the benefits disproportionately favouring wealthier households (Gupta, 2018). There are two categories of energy subsidies: explicit and implicit. The former denotes undercharging in comparison to production costs, while the latter refers to the estimated costs of externalities (for instance, pollution and congestion) associated with the consumption of fossil fuels.

In 2023, the IMF estimated that fossil fuel subsidies were USD 7 trillion in 2022 or 7.1 % of global GDP (Black et al, 2023). Explicit subsidies have more than doubled since 2020, comprising 18 % of the total subsidy, while nearly 80 % is due to undercharging for global warming and local air pollution (Black et al, 2023). Remarkably, these implicit subsidies persist despite the existence of 73 carbon pricing schemes in around 50 countries, with the average carbon price standing at a mere USD 5 per ton (World Bank, 2023b).

Shifting towards efficient fuel pricing could generate substantial revenues, equivalent to 3.6 % of global GDP and in doing so prevent 1.6 million premature deaths annually attributed to local air pollution (Black et al, 2023). However, eliminating subsidies can be socially disruptive and requires implementation of targeted social safety nets to protect the vulnerable (Drabo et al, 2023).

2.3 Strengthening debt management

Debt management plays a crucial role in shaping a country's fiscal space, influencing its capacity to allocate resources effectively and sustain economic growth. This involves meticulous planning to ensure that the level of debt remains within manageable limits. While prudent use of debt is an important part of any effective development strategy, excessive reliance on debt or its use for unproductive purposes poses serious risks to economic growth and stability (IMF and World Bank, 2022). Countries adept at managing debt are better positioned to create fiscal space, enabling them to respond to economic shocks, invest in critical infrastructure and implement social programmes.

Effective debt management requires policy-makers to focus on debt composition, maturity structure, as well as interest rates and their impact on the overall fiscal stance (Brun et al, 2006; Ostry and Kim, 2018). It is imperative that debt instruments are diversified to mitigate risks. Striking a proper balance between domestic and external debt, as well as long-term and short-term obligations, helps minimise a country's vulnerability to market fluctuations. Maintaining a balance between short-term and long-term debt maturities ensures a smoother debt service schedule, avoiding concentrated repayment pressures. Monitoring interest rates on borrowed funds prevents heavy reliance on variable interest rates that could expose a country to volatility. By contrast, fixed-rate debt provides stability, albeit potentially at a higher initial cost.

Any decision to pursue additional borrowing should be considered if the overall debt remains sustainable and a government retains its capacity to service the debt in the long term (Brun et al, 2006). However, excessive borrowing negatively affects the sustainability of public finances. As the level of debt rises, the fiscal space shrinks, thereby limiting a government's ability to borrow more without escalating borrowing costs or risking a sovereign debt crisis (United Nations Convention on Trade and Development, 2023). Persistent deterioration in fiscal space poses a threat to the well-being of future generations. A sustainable balance is achieved when expenditures financed by borrowing generate government revenues sufficient to cover the costs of borrowing (Brun et al, 2006).

Ultimately, enhancing the credibility of public finances hinges on improving the efficiency of public spending, including shifting the reallocation of expenditures away from less efficient expenditures toward those that are more growth-enhancing or better-targeted (Kose et al, 2018), bolstering domestic resource mobilisation (Culpeper and Kappagoda, 2007) and implementing policies that foster private sector growth. These concerted efforts will generate fiscal space, enabling the financing of sustainable growth and development (IMF and World Bank, 2022).

3 Development policy, global economic governance and fiscal space

3.1 The European Union and key Member States' stance

With only six years remaining until the 2030 deadline for the SDGs, it is increasingly evident that current levels of financing for development are falling short. The existing financing mechanisms are neither sustainable nor transformative enough to instigate the necessary changes. In light of this, it is crucial for the European Union (EU) and its Member States to endorse and actively support measures that propel the development agenda closer to the deadline of the 2030 Agenda for Sustainable Development.

In this context, the EU's development policy underscores the pivotal role of domestic public finance in delivering crucial public goods and services in developing countries (European Commission, 2016). Consistent with this perspective, the EU actively supports initiatives aimed at fortifying the tax systems of developing nations. The goal is to enhance revenue generation by expanding the tax base and strengthening tax administration without imposing additional burdens on the poor. The EU emphasises that taxes play a crucial role in establishing state legitimacy, ensuring macroeconomic stability and fostering sustainable development (EU, 2010).

Enhanced domestic resource mobilisation, coupled with more efficient public expenditure and sound debt management, forms the cornerstone of efforts to enlarge fiscal space in developing countries (European Commission, 2016). Leveraging its aid instruments, the EU not only actively backs tax system reforms and bolsters public financial management in these nations, but also engages in technical cooperation with their tax administrators, sharing expertise to build capacities (EU, 2010). Concurrently, the EU also collaborates with oversight bodies, national parliaments and non-state actors to strengthen governance structures.

Established in 2021 after merging a number of former EU external financing instruments, the Neighbourhood, Development and International Cooperation Instrument – Global Europe (NDICI – Global Europe) serves as the EU's main financing tool for contributing to eradicating poverty and promoting sustainable development, prosperity, peace and stability (European Commission, 2021). The NDICI – Global Europe not only supports fiscal decentralisation and contributes to the international fight against tax fraud, tax evasion, corruption as well as money laundering, but also supports reforms to ensure fair, just, efficient and sustainable tax policies (European Parliament and Council of the EU, 2021).

The policies of EU Member States align with broader EU objectives. For instance, Germany recognises the pivotal role of fiscal policy in achieving the 2030 Agenda, within which governments are urged to utilise fiscal measures not only to alleviate poverty and address hunger, but also to enhance education and healthcare (Federal Ministry for Economic Cooperation and Development, 2019). Developing countries are encouraged to augment tax revenues and mitigate tax avoidance as well as evasion; furthermore, they are urged to explore innovative taxation methods such as those related to aviation fuel or carbon.

France has highlighted the interconnected nature of vulnerability to climate risks, reduced fiscal space and increased debt, hence it is stressing the imperative of expanding fiscal capacity through targeted debt relief (Kachenoura and Mansart Monat, 2023). Creating new fiscal space in high-debt countries and providing debt relief during crises are essential aims for sustainable development, as unsustainable debt levels pose a significant impediment to progress (Agence Française de Développement, 2023).

3.2 Perspectives of the Global South

The United Nations (UN) system sees fiscal space as an important factor in determining the growth and development prospects of developing countries and essential in the fight against poverty (United Nations

Convention on Trade and Development, 2023). For these countries, external financial flows are critical for fiscal space, while domestic resource mobilisation plays a larger role over the medium term (UN Convention on Trade and Development, 2023).

Because of multiple global crises in recent years, developing countries are facing an erosion of their fiscal space, which not only increases their vulnerability to future shocks, but also threatens their growth and development prospects. Although developing countries have contributed only marginally to the climate crisis, they are among the worst affected by climate change. As a result, they require more fiscal space for investments in adaptation and expenditures to address climate-related loss and damage. They need international support to expand their fiscal space so that they can invest in green structural transformation, develop resilience and bolster their efforts towards achieving the SDGs. Over the medium term, fiscal policy frameworks in developing countries must become more resilient to shocks and volatility emanating from global economic conditions, geopolitical crises as well as commodity price fluctuations.

Similar views are held by the Group of 77 (hereafter G77) at the UN, a coalition of 135 developing countries. To bridge an increasing financing gap, G77 Ministers see necessary measures as: debt restructuring; innovative financing mechanisms; fulfilment of official development assistance (ODA) commitments; access to concessional finance; and greater foreign direct investment (G77, 2023). The G77 in the recent IMF/World Bank meetings at Marrakesh has advocated a reform of the global financial architecture. Recognising the growing influence of developing countries in international trade and investment flows, increased participation in the decision-making processes of international financial institutions is deemed essential. This is particularly crucial considering the substantial impact that these reforms will exert on developing nations (G77, 2023).

The Vulnerable 20 (hereafter V20), a global partnership of countries disproportionately impacted by the consequences of climate change including 68 countries from Africa, Asia, the Caribbean, Latin America and the Pacific, recognise that many of their countries have insufficient fiscal resources to finance much-needed responses to the health and social crises caused by the pandemic, let alone make crucial investments in climate adaptation (V20 Presidency, 2021). For many countries, public debt service costs crowd out crucial investments needed to climate-proof economies and establish a resilient, sustainable, and equitable recovery. As a solution, the V20 has proposed debt restructuring for countries overburdened by debt to free up resources for investing in climate resilience and prosperity (V20 Presidency, 2021).

4 Recommendations

This briefing suggests that EU policy-makers, encompassing the European Parliament, Member States and EU institutions, should consider the following considerations when engaging in discussions about fiscal space in developing countries:

1. **Support policies to enhance revenue**: The EU should champion tax reforms aimed at strengthening tax systems to broaden the tax base and enhance tax administration without imposing a burden on the poor. Particular attention should be given to VAT, excise duty on specific goods and efficient income tax designs. As previously mentioned in Section 3, the EU is currently backing initiatives designed to strengthen developing nations' tax systems by offering technical assistance and advice, for instance on the implementation of digital technologies. This support is extended either directly or through multilateral institutions, such as the IMF and World Bank. Additionally, exploring fuel pricing adjustments can contribute to generating additional revenues with adequate provision of a social safety net for the poor affected by price reforms.

2. **Emphasise streamlining of current spending**: The EU should underscore the need for streamlining public expenditures, especially in key areas such as education, health and public investment. Identifying inefficiencies and reallocating resources more effectively should be a priority. Collecting

additional revenues serves little purpose if spending is not optimised. As with its involvement in the tax domain, the EU offers substantial assistance in public expenditure management, which should be sustained. Additionally, it should promote and encourage countries to conduct spending reviews, thereby identifying inefficiencies within their programmes.

3. **Prioritise effective debt management:** EU policies should consistently emphasise the goal of ensuring public finance sustainability in developing countries. This involves diversifying debt instruments, maintaining a proper balance between domestic and external debt versus short-term and long-term debt, as well as continual monitoring of interest rates.

4. **Encourage developing countries to maintain fiscal buffers**: The EU should recommend that developing countries maintain fiscal buffers as a proactive measure to withstand external shocks, especially those heavily reliant on commodity exports. Lessons from the COVID-19 experience underscore the significance of maintaining reserves to address unforeseen challenges.

5. **Promote global cooperation on expanding fiscal space**: In this context, the EU should actively promote international support and cooperation. This can include advocating for debt restructuring, innovative financing mechanisms, fulfilling ODA commitments and facilitating access to concessional finance, including the involvement of international institutions such as the IMF and World Bank in these initiatives.

6. **Provide grant or highly concessional financing to support climate change**: Recognising the substantial fiscal costs associated with climate change mitigation and adaptation for developing countries, the EU should consider providing grant financing or financing at highly concessional terms. This support would play a crucial role in facilitating the transition to climate-friendly practices in developing countries. In this context, the EU should endorse initiatives launched by the IMF and World Bank aimed at delivering increased climate finance at concessional rates, extended over a longer period.

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DIRECTORATE-GENERAL FOR EXTERNAL POLICIES

POLICY DEPARTMENT

European Parliament

BRIEFING

IMF Special Drawing Rights – A Primer

ABSTRACT

Special Drawing Rights (SDRs) came to the fore in international discussions on development finance after the International Monetary Fund (IMF) issued USD 650 billion SDRs in response to the COVID-19 pandemic. Since then, many policy-makers and advocates have seized on SDRs as a possible source of development finance, but often such discussions betray a misunderstanding of such assets' nature and purpose. Hence, this briefing provides key information needed for a more informed discussion of SDRs' use as an international finance tool. Through historical analysis, different ways are considered in which such assets could be used to foster global development. This results in three proposals being presented for the European Parliament's Committee on Development to consider. Firstly, a resolution should be promoted calling for EU Member States to fulfil their Group of 20 SDR recycling pledge. Secondly, unlocking the untapped potential of SDR recycling to multilateral development banks should be considered, an innovative approach to channelling resources for development financing. Finally, a resolution should be issued encouraging EU Members States to advocate regular periodic SDR allocations, consistent with the role envisaged in the IMF Articles of Agreement.

EP/EXPO/DEVE/FWC/2019-01/LOT3/1/C/17

EN

June 2024 - PE 754.456

AUTHORS

- Mark PLANT, Senior Policy Fellow, Center for Global Development, United States of America
- Bernat CAMPS ADROGUE, Research Associate, Center for Global Development, United Kingdom

PROJECT COORDINATOR (CONTRACTOR)

Trans European Policy Studies Association (TEPSA)

This paper was requested by the European Parliament's Committee on Development.

The content of this document is the sole responsibility of the authors, and any opinions expressed herein do not necessarily represent the official position of the European Parliament.

CONTACTS IN THE EUROPEAN PARLIAMENT

Coordination: Maciej JASTRZEBIEC-PYSZYNSKI, Policy Department for External Relations

Editorial assistant: Grégory DEFOSSEZ

Feedback is welcome. Please write to poldep-expo@europarl.europa.eu

Paper copies can also be requested from poldep-expo@europarl.europa.eu

VERSION

English-language manuscript completed in June 2024.

This paper is published on the European Parliament's online database, 'Think Tank'

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List of abbreviations

AfDB	African Development Bank
DEVE	European Parliament's Committee on Development
ECB	European Central Bank
EMs	Emerging Markets
EP	European Parliament
EU	European Union
G20	Group of 20
HICs	High-Income Countries
IDB	Inter-American Development Bank
IMF	International Monetary Fund
LICs	Low-Income Countries
LMICs	Lower-Middle Income Countries
MDBs	Multilateral Development Banks
PRGT	Poverty Reduction and Growth Trust
RST	Resilience and Sustainability Trust
SDRi	Special Drawing Rights Interest Rate
SDRs	Special Drawing Rights
UN	United Nations
USA	United States

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1 Special drawing rights: History, issuance and allocation

Special Drawing Rights (SDRs) are a special kind of 'money' issued to countries by the International Monetary Fund (IMF)[1]. SDRs count as international reserve assets on central bank balance sheets and can be used by countries to make payments to the IMF, to each other and a limited list of global financial institutions. They can also be exchanged for freely useable currencies (for example, the euro or the dollar). These exchanges take place between countries and are brokered by the IMF. SDRs are based on a basket of currencies: the US dollar, the euro, the Chinese renminbi, the Japanese yen and the British pound (Table 1). The IMF reviews the SDR basket at least every five years to ensure that it accurately reflects the relative significance of currencies within the global trading and financial system (IMF, 2021b). The exchange rate is SDR 1 to USD 1.33 with effect from 3 March 2024[2].

Table 1: Board-approved SDR basket currency weights at past quinquennial reviews

Year	USD	EUR	JPY	GBP	CNY
2000	44.2	29.4	14.8	11.6	-
2005	42.92	34.13	11.48	11.46	-
2010	41.94	37.36	11.26	9.44	-
2015	41.73	30.93	8.33	8.09	10.92
2022	43.38	29.31	7.59	7.44	12.28

Source: IMF, 'IMF Financial Data Query Tool', January 2024a.

1.1 Context and historical overview

The SDR's origins are rooted in the global monetary system's establishment after the Second World War. From its inception at the end of 1945, the international monetary system operated under fixed exchange rates linked to the US dollar, which in turn was convertible to gold at a fixed parity. Under the gold standard, the quantity of reserve assets was determined by the availability of gold, creating a scenario where insufficient international liquidity 'could jeopardize growth and establish a contractionary bias in the global economy' (Perez Caldentey, Cerón Moscoso and Ianni, 2022: 13). As the post-war global economy grew, thanks to expansionary fiscal policy and the elimination of trade restrictions, international reserves were feared to be inadequate. Hence, the SDR was created in 1969 to address this potential shortfall of reserves, with a first general allocation the following year[3].

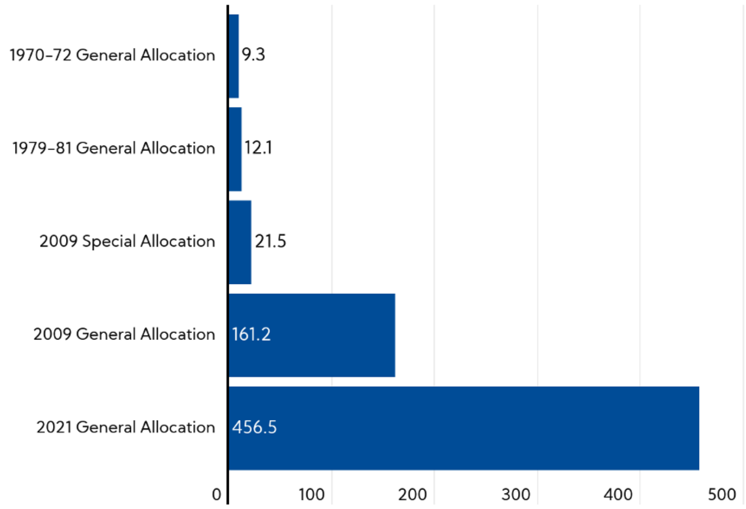
1.2 Issuance and allocation

The IMF Articles of Agreement give the IMF authority to allocate SDRs needed to supplement its members' existing reserve assets, considering two scenarios: (i) regular allocations that can be made every five years; and (ii) an extraordinary allocation at any time, if the IMF finds it desirable to do so because of unexpected major developments[4]. To issue and allocate SDRs, an 85 % majority vote from the IMF's Board of Governors is required. Since the SDR's creation in 1969, the IMF has allocated a total of SDR 660.7 billion, with a significant portion of this total (almost 70 %), amounting to SDR 456.5 billion, having been allocated on

[1] IMF, 'Special Drawing Rights (SDR): What is the SDR?', webpage, 2023.
[2] IMF, 'SDR Valuation', webpage, nd.
[3] For an extensive review of the historical context of the SDR see Pérez Caldentey, Cerón Moscoso and Ianni (2022) and Paduano (2022).
[4] See United Nations Monetary and Financial Conference, 'Articles of Agreement of the International Monetary Fund', Bretton Woods, 22 July 1944, Article XVIII, Section 2 and 3.

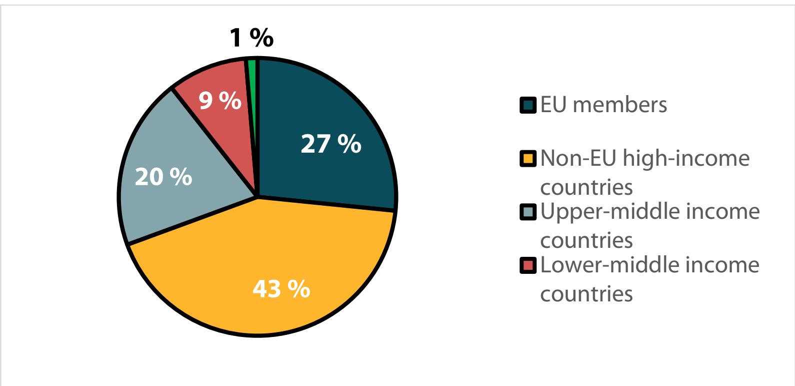
23 August 2021 (Figure 1). The Board has not chosen to allocate SDRs every five years, but rather on an occasional basis. Once approved, the IMF distributes general or special allocations to member countries in proportion to their IMF quota shares. As shown in Figure 2, this system results in most allocations being assigned to high-income countries (HICs), which receive 69 % of the allocation, with European Union (EU) Member States[5] receiving 27 % of the global allocation. Upper-middle-income countries receive a 20 % share, while lower-middle-income countries (LMICs) receive 9 % of every allocation. Low-income countries (LICs) receive about 1 %.

Figure 1: SDR allocations: General and special (in billions of SDRs)



Source: IMF, '[IMF Webpage on Special Drawing Rights](#)', January 2024b.

Figure 2: Distribution of SDR allocations per income category



Source: '[IMF Financial Data Query Tool](#)', January 2024a[6].

SDR allocations are 'cost-free' for countries, they do not require contributions from countries' budgets and do not add to any country's public debt burden. However, *using* the SDR allocation (exchanging SDRs for hard currency or making a payment in SDRs), *does* come at a cost. Any country that decides to use some of its SDRs will have holdings of SDRs less than the amount allocated by the IMF. Interest will then be payable

[5] All EU Member States are HICs, except for Bulgaria which falls into the upper-middle-income countries category.
[6] See annex for a complete table of EU members holdings and allocations of SDRs and for complete list of countries per income classification.

on the shortfall of holdings relative to allocation at a rate (the SDR interest rate – or SDRi[7]) that varies over time – 4.1 % annually with effect from 24 January 2024. Conversely, any country that holds more SDRs than its original IMF allocation will earn interest on this excess at the same rate. Since the pool of SDRs is fixed, the total interest that countries in deficit pay equals the amount that countries with surpluses earn (Camps Adrogue and Plant, 2023a).

Only IMF members, the IMF itself and certain prescribed holders, including regional central banks, monetary funds and multilateral development banks (MDBs) can hold SDRs[8]. Prescribed holders must be approved by the IMF Executive Board (IMF, 2023). Both participating members and prescribed holders have the capacity to buy and sell SDRs. However, prescribed holders do not receive SDR allocations.

1.3 The role of SDRs in development finance

The 2021 allocation fuelled considerable interest in the SDR as a possible development finance tool. The fact that SDRs can be issued directly to countries without conditions makes them particularly appealing to developing countries (Plant, 2020). Unlike traditional IMF arrangements, SDR allocations provide crucial flexibility to all IMF member countries. As a result, many experts have called for the use of SDRs in expanding development finance for a variety of purposes, including (but not limited to) the pandemic response (Cashman, Arauz and Merling, 2022), climate finance (Ghosh, 2023) and food security (Rampa, Bilal, D'Alessandro and Karaki, 2023). They argue that SDRs are a financial asset that is sitting idle on central bank balance sheets and could be put to better use. However, SDRs are not a currency and thus their use is somewhat constrained (Obstfeld and Truman, 2023). Furthermore, as noted above, if countries 'spend' their SDRs either by making payments with them or exchanging them for useable currencies they incur interest costs.

Issuing SDRs fortifies the external positions of recipient countries by expanding their international reserves (Plant, 2022c). This expansion not only strengthens recipient countries' payment capacity but also serves to alleviate country-risk perceptions and lower borrowing costs in the international capital markets for developing nations (Arauz and Amsler, 2024).

Furthermore, one notable feature contributing to the attractiveness of SDRs in development finance is their lack of prescribed use (Andrews and Plant, 2021). This inherent flexibility allows countries to deploy SDRs across a broad spectrum of operations, aligning them with diverse development needs, primarily in three different ways:

- Firstly, countries may exchange SDRs for hard currency, which they can then use in any manner they see fit;
- Secondly, SDRs can be used to make payments to the IMF or other institutions that are prescribed holders (for example, for interest or repayments of outstanding loans).
- Thirdly, recent efforts have focused on utilising SDRs as hybrid capital (Plant, 2023) or SDR-denominated bonds (Setser and Paduano, 2023) to expand lending from MDBs that can hold SDRs[9].

The IMF staff has issued guidance on the use of SDRs, urging countries to use their allocations 'consistent with macroeconomic sustainability and in a transparent manner, and to not delay the need for macroeconomic adjustment, reforms, and debt restructuring, nor prolong unsustainable macroeconomic

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[7] The SDRi, provides the basis for calculating the interest rate charged and paid to members. It is determined weekly based on a weighted average of interest rates on three-month debt in the money markets of the SDR basket currencies (USD, EUR, CNY, JPY and GBP). See IMF, 'SDR Interest Rate Calculation', webpage, nd.
[8] As of January 2024, there are 20 prescribed holders of SDRs. For a complete list of prescribed holders, see Annex.
[9] A complete list of MDBs that are prescribed holders of SDRs is in the Annex.

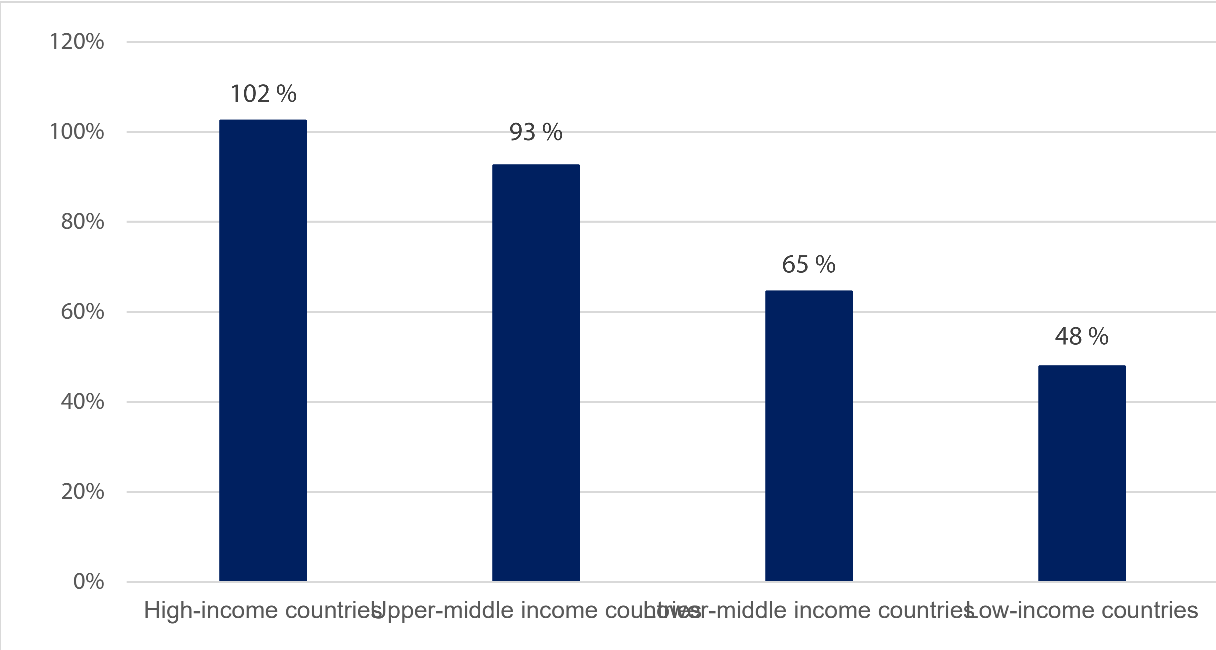
policies' (IMF, 2021a: Executive Summary). At the same time, throughout the guidance notes it is stressed that the SDR is a reserve asset and must be used as such.

The next section will explore how countries have used their SDRs to recover from the pandemic's impacts and how HICs, including EU members, could recycle their SDRs to MDBs thereby unlocking billions of dollars in development finance.

1.4 Applications of SDR allocations: how did countries use their SDRs to recover from the pandemic?

Following the 2021 allocation, it became clear that SDRs were essential for macroeconomic management in times of financial and economic crisis, particularly for LICs (Plant, 2022c). As illustrated in Figure 3 below, LICs spent more than half of their allocations, with some utilising over 90 %. LMICs directed 35 % of their allocations towards various needs, while upper-middle-income countries used only 7 %. Finally, as the number of SDRs is fixed, HICs as a group accumulated SDRs expended by others, with holdings surpassing their initial allocation by 2 %.

Figure 3: SDRs holdings as % of allocation on 31 December 2023



Source: IMF, 'IMF Financial Data Query Tool', January 2024a.

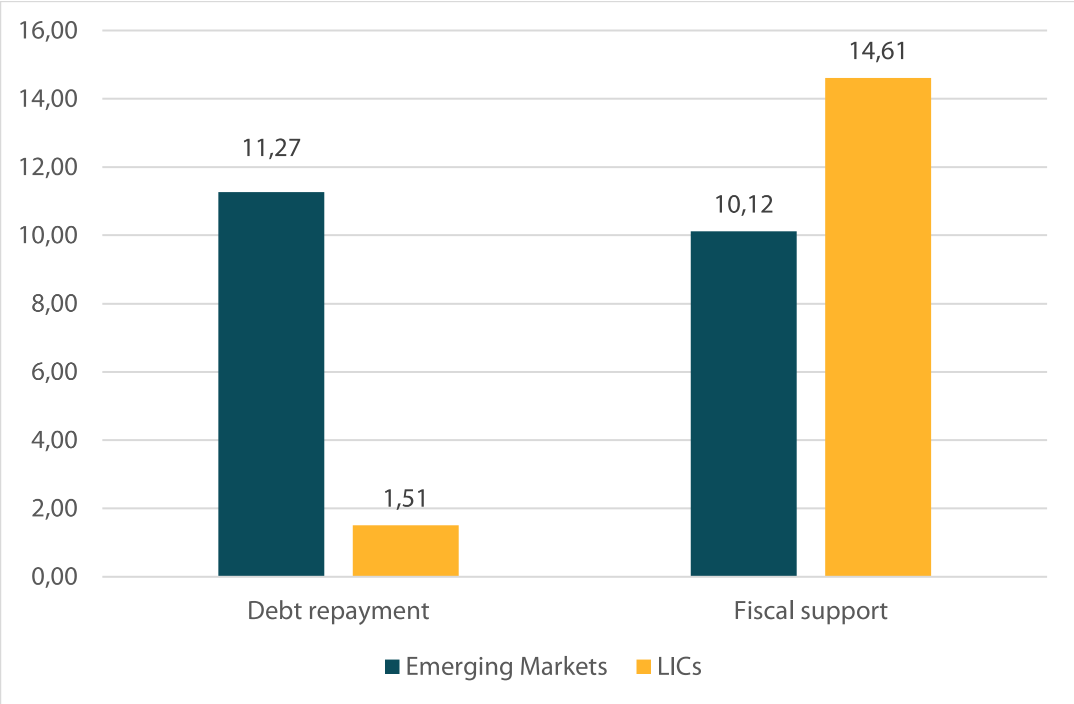
As highlighted above, the use of SDRs by LICs and LMICs is a complex yet significant aspect of their economic recovery strategies. Tracking the use of SDRs poses challenges, particularly once these funds are converted into hard currency (Plant, 2021). Some governments announced that the 2021 SDR allocation would be used to buy vaccines or pay off debts, but no unified dataset of SDR uses was created. To address this issue, the IMF has developed an innovative dataset designed to track the utilisation of SDRs by examining IMF country reports[10]. This tracker promotes transparency and accountability in the allocation and use of SDRs by countries[11].

[10] IMF, 'Tracker on the Use of Allocated SDRs Promoting Transparency and Accountability in the Use of the 2021 SDR Allocation', webpage, nd.

[11] Certain caveats should be mentioned. Firstly, the dataset lacks information for some countries where the mandated annual review of economic policies by the IMF (the Article IV consultation) was delayed or non-existent. Secondly, some countries did not consent to the publication of their data in staff reports. Finally, categories for SDR use can be ambiguous and have been simplified, making an in-depth analysis complex.

A notable distinction emerges in SDR utilisation patterns between Emerging Markets (EMs) and LICs. Figure 4 below illustrates that EMs primarily directed their SDRs towards debt repayments, with a slightly smaller amount allocated for fiscal support. In stark contrast, LICs predominantly used their SDR allocation for fiscal support. This divergence in strategies underscores the different economic priorities and challenges faced by EMs and LICs, with the former enhancing their fiscal stability and creditworthiness through debt repayments and the latter using SDRs as a tool for expanding fiscal space directly.

Figure 4: SDR usage by income category (in billions of SDRs)



Source: IMF, 'IMF Tracker on the Use of Allocated SDRs', January 2024c. And author's calculations[12].

1.5 The recycling to MDBs proposal

While only LICs and LMICs have used SDRs, most of the 2021 allocation was assigned to HICs, which did not need the new SDRs. In light of this, the international community has explored alternative avenues for leveraging SDRs, particularly those of HICs, beyond the conventional applications we have seen (Plant, 2022b). As previously discussed, as each SDR allocation is distributed based on member countries' quotas at the IMF, most of the 2021 allocation was assigned to wealthier countries that did not need it; the Group of 20 (G20) members and other advanced economies received collectively over USD 500 billion SDRs of the USD 650 billion SDRs allocated. At the end of October 2021, two months after the 2021 allocation and recognising the dire financial challenges faced by vulnerable nations, the G20 – comprising the world's major economies – pledged that USD 100 billion worth of SDRs would be recycled (G20, 2021). 'SDR recycling' amounts to transferring the 'idle' SDRs of HICs in a way that would assist vulnerable countries in recovering from the economic turmoil and rebuilding their financial stability (Andrews, 2021). More than two years later, the recycling pledge by G20 countries has yet to be met, falling short by more than USD 10 billion[13] (Plant and Camps Adrogue, 2023).

[12] See Annex for complete list of countries in EM category.
[13] One, 'Special Drawing Rights', webpage, 26 March 2024.

Almost all pledges to recycle SDRs have been directed to two IMF trusts that make loans to vulnerable LMICs: the Poverty Reduction and Growth Trust (PRGT)[14] together with the Resilience and Sustainability Trust (RST)[15] (Plant, Hicklin and Andrews, 2021). Only low-income countries can access the PRGT, which currently charges no interest and has a 10-year maturity, with a 5-year grace period. The RST is aimed at helping low- and middle-income countries deal with climate change and pandemic preparedness costs. The RST has a 20-year maturity with a 5-year grace period and charges positive interest rates on a scale that varies in line with the country's income. The IMF has ramped up loans from these trusts, although disbursements are slow. Recent analysis suggests that both the PRGT and RST have reached their capacity and thus for the moment cannot accommodate additional recycled SDRs. The PGRT's size is constrained by the availability of subsidy resources to allow concessional lending (Andrews and Plant, 2023) and the current RST lending limits imply that there is no immediate need for more resources SDRs (Camps Adrogue and Plant, 2023b). It is worth noting that all recycling to date has been in the form of loans from HICs to the trusts, which are remunerated at the SDR interest rate. In some instances, the lending country has agreed to forego interest payments (Plant and Ghattas, 2023).

In light of the recycling pledges, MDBs that are prescribed holders of SDRs and numerous experts (Setser and Paduano, 2023; Plant, 2023), considering the full capacity of IMF trusts, viewed this commitment from the G20 as an opportune moment for innovative financing mechanisms. The current focus revolves around two proposals which will be explored below.

1.5.1 African Development Bank and inter-American Development Bank hybrid capital

A joint proposal by the African Development Bank (AfDB) and Inter-American Development Bank (IDB) suggests using SDRs as hybrid capital, which will allow the leveraging of SDRs, thereby multiplying their lending power by three to four times. MDBs would then use recycled SDRs as a form of capital, which they would then leverage to mobilise more loanable funds, which would lead to the banks increasing loans to support sustainable transition in LMICs. A recent brief by Plant (2023) gives three reasons why countries should recycle their SDRs in line with the hybrid capital proposal:

- Firstly, MDBs have the regional expertise and connections to make these loans effective to support sustainable transition in vulnerable countries. Every SDR 1 billion recycled to an MDB will be multiplied thereby increasing loans to vulnerable countries by SDR 3-4 billion.
- Secondly, the SDRs themselves are never spent but instead will be held as capital in the MDB's SDR account at the IMF. They would be removed from that account only if the MDB is at risk of failure. However, with the MDB's sound financial management practices, the chances of that happening are virtually nil. For example, the AfDB has a AAA rating. The rating agencies have understandably welcomed this new form of capital. Underlying the hybrid capital fund is a Liquidity Support agreement to ensure that if recycling countries need their SDRs, they can reclaim them.
- Thirdly, countries recycling SDRs to an MDB could make a small profit on their investment. Recycling SDRs is costly to advanced-economy countries because they must pay the SDR interest rate to the IMF. However, as part of the agreement to lend any MDB its SDRs for hybrid capital, the MDB will reimburse the interest owed and in some instances pay slightly above the SDR interest rate, more than covering the cost of recycling.

IMF staff engaged closely with both MDBs in developing the proposal together with other IMF representatives (Center for Global Development, 2023; AfDB, 2023) have stated that SDRs recycled as MDB

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[14] IMF, 'Poverty Reduction and Growth Trust (PRGT)', webpage, nd.
[15] IMF, 'Resilience and Sustainability Trust', webpage, nd.

hybrid capital could continue to be counted as monetary reserve assets. To date countries have been hesitant to commit firmly to this proposal, reflecting in part the central bank's hesitancy to use reserve assets in such a manner. However, there have been expressions of interest, the most recent being at the time of the IMF/World Bank annual meetings in Marrakech (Rockefeller Foundation, 2024). In addition, the Asian Development Bank Executive Board approved the use of hybrid capital and asked its staff to explore the use of SDRs to this end. No concrete proposals have yet been put forward. The proposal has also been supported by a wide variety of academics and advocates (for example, Raj, 2023; Latif, 2023).

1.5.2 SDR-denominated bond

The proposal for an SDR-denominated bond envisions an MDB (for example, the World Bank) issuing bonds in a manner similar to those denominated in currencies such as USD or EUR (Financial Times, 2023). Under this scheme, countries would lend to the World Bank any surplus SDRs deposited at the IMF. The World Bank, in turn, would then convert these SDRs into usable currencies through the IMF. In exchange for lending their SDRs, the contributing countries would receive an SDR-linked bond. The suggestion is to have such a bond settled in dollars or euros, thus enhancing its tradability and facilitating its recognition as a reserve asset. This innovative approach aims to broaden the scope of SDR utilisation and create a new avenue for international financial instruments (Setser and Paduano, 2023). While no formal opposition to the proposal has been voiced, no MDB has expressed interest in moving forward with the proposal.

2 SDRs as a development policy tool

As discussed earlier, SDRs emerged as a crucial lifeline for post-COVID pandemic recovery efforts. EU Member States can play a pivotal role in harnessing SDRs as a potent development policy tool. Firstly, EU Member States *en bloc* hold a voting share of approximately 22 % in the IMF, compared with the US share of 16.5 %. Given the many benefits associated with SDR allocations and the recognition of regular allocations in the IMF Articles of Agreement, advocacy and support from EU members together with their executive directors at the IMF Executive Board could yield significant advantages for developing countries.

Furthermore, SDRs can serve as an effective development policy tool through their strategic recycling to MDBs. As stated earlier, these banks have the capacity to leverage every recycled SDR by three to four times in the case of the IDB and AfDB hybrid capital proposal, amplifying the impact of the original allocation. Importantly, MDBs possess the expertise to channel SDRs into lending initiatives tailored for vulnerable LMICs. Additionally, with their AAA rating MDBs stand as stable and reliable financial institutions, further enhancing their capability to drive impactful development projects.

The SDR's role as a development policy tool could be reinforced by more regular allocations of SDRs, which are permitted by IMF rules, consistent with the IMF rules that permit regular allocations every five years and special allocations as needed (Bretton Woods Project, 2023; Truman, 2022).

The following Section will explore the EU and Member States' stance on both the allocation of SDRs and the recycling of SDRs to MDBs.

2.1 The EU and Member States' stance on IMF and SDRs in development policy

EU and Member States have given consistent and vocal support to the use of SDRs in development policy. Primarily, EU Member States and the European Commission endorsed the 2021 SDR allocation. Ursula von der Leyen, President of the European Commission, explicitly stressed the EU's support for SDR allocation (European Commission, 2021). Additionally, the EU[16], and its Member States (Council of the EU, 2022)

[16] Council of the EU, 'G20 summit, Rome, Italy, 30-31 October 2021', webpage, 2021.

alongside G20 leaders, have welcomed the issuing of SDRs and have supported their recycling to benefit vulnerable countries. Furthermore, the EU has encouraged its Member States to contribute to the global effort[17].

At the European Parliament (EP) level, a resolution on global economic governance in 2011 asked for 'the IMF to explore further allocation as well as a broader use of Special Drawing Rights (SDR) in particular to enhance the multilateral exchange rate system' (EP, 2011). More recently, in the report of 5 June 2023 on the implementation and delivery of the Sustainable Development Goals, the EP 'Points out the need to rechannel IMF Special Drawing Rights (SDRs) to developing countries and Multilateral Development Banks (MDBs), with a view to increasing SDG investment capacity without creating additional debt; underlines the need to improve the lending terms of MDBs, including lower interest rates and longer-term loans' (EP, 2023).

However, the stance of the European Central Bank (ECB) on SDRs is more nuanced. While the ECB has not issued a formal ruling against recycling SDRs to MDBs, President Christine Lagarde voiced opposition to the concept (ECB, 2021). Her comments in October 2022 indicated concerns that such recycling might not adequately preserve the SDR's reserve asset characteristic. Despite extensive support from EU Member States such as France for initiatives such as the AfDB Hybrid Capital, the ECB, citing EU rules (EU, 2008: Article 123), currently prevents the recycling of SDRs to MDBs, while allowing recycling through the IMF. However, the IMF has clarified that such recycling to MDBs would be recognised as reserves (AfDB, 2023). Moreover, recent studies indicate that SDRs can be recycled to MDBs while complying with ECB rules (Paduano and Maret, 2023). This divergence within the EU framework underscores the complex dynamics surrounding SDRs' utilisation for development finance. Changing EU rules would require not only legislation to be passed by the EP, but also regulatory changes by the ECB's governing council. At this stage, there is a wide divergence of views on whether recycling SDRs outside the IMF constitutes an appropriate use of reserve assets.

2.2 Reforms suggested by the United Nations High-Level Advisory Board on Effective Multilateralism

In 2023, the United Nations (UN) Secretary-General convened a High-Level Advisory Board on Effective Multilateralism. The report they produced recommended a 'fundamental review of the Fund's SDR mechanism' (High-Level Advisory Board, 2023: 34). They urged that there be regular annual allocations of SDRs and that the IMF amend its Articles of Agreement to allow selective SDR allocations that could be targeted directly at countries in need, with some provision to trigger such allocations without IMF Executive Board approval. They also supported the use of SDRs to strengthen MDB balance sheets.

The IMF's Articles of Agreement mandate an Executive Board review of SDRs' allocation every five years. Except for the three examples noted above, the Board has chosen not to increase the overall allocation. Truman (2022) calls for this review to be more routine, with decisions being based more on the global economy's growth than the Board's judgment. This depoliticisation of the allocation decision makes good sense and would strengthen the SDR's role in the global financial system. The UN High-Level Advisory Board advocates an annual allocation, which is probably too frequent given the global economy's vicissitudes. It would also require an amendment to the Articles of Agreement, which in turn requires an 85 % majority vote from the IMF Executive Board, which would be difficult to attain given today's fractured global politics. Nonetheless, the idea of a more automatic, rules-based periodic SDR allocation has considerable merit.

[17] Council of the EU, 'European Union – African Union summit, 17-18 February 2022', webpage, 2022.

Allowing for better-targeted *ad hoc* SDR allocations makes good sense too, in light of experience from the recent allocation where many SDRs went to countries that did not have a pressing need for them. However, deciding on an allocation formula will again be a fraught political exercise, given that it too would need an amendment to the Articles of Agreement and an 85 % majority vote from the IMF. Nonetheless, it is an idea worth keeping 'on the table'.

3 Recommendations for the EP and the DEVE Committee

The above analysis suggests that EU policy-makers and the EP's Committee on Development (DEVE) should consider the following recommendations:

1. **Issue a resolution calling on Member States to ensure fulfilment of their G20 recycling pledge:** While Spain and France, for instance, have exceeded their 20 % recycling pledge, other countries such as Denmark, Portugal, Malta and Belgium are falling short. Moreover, 12 other countries have yet to recycle any SDRs. The EP and DEVE should continue to encourage EU Member States to meet their SDR pledges and participate in the recycling efforts, ensuring a collective and comprehensive effort to maximise the positive impact of SDR allocations.

2. **Unlock SDR recycling to MDBs:** The ECB should reevaluate its stance on recycling SDRs to MDBs, as EU Member States cannot recycle SDRs to MDBs under current ECB rules and regulations. As noted above, the IMF has clarified that such recycling to MDBs would be recognised as reserves and recent studies indicate that SDRs *can* be recycled to MDBs while complying with ECB rules (Paduano and Maret, 2023). As EU Member States engage with MDBs to explore avenues for contribution to these mechanisms, the EU should reconsider its position and unlock the potential of SDR recycling to MDBs. This strategic move could yield substantial funds for development, aligning with the EU's commitment to sustainable and impactful development initiatives. Countries such as France have already registered their commitment to the AfDB hybrid capital instrument's Liquidity Support Agreement with hard currency contributions as they cannot do so in SDRs. Other Member States have indicated informally that they would consider contributing with SDRs if the ECB would not oppose. The DEVE Committee could invite the ECB to discuss which rules currently prevent the recycling of SDRs to MDBs and whether a treaty change is the only route.

3. **Issue a resolution calling on EU Member States to advocate for and support regular SDR allocations:** EU Member States (through IMF Executive Directors) should support and encourage regular SDR allocations, as outlined in the IMF Articles of Agreement. These allocations have proven to be a crucial lifeline for LICs and MICs in their efforts to recover from the pandemic. The EU and its Members States should champion regular allocations every five years and, if necessary, endorse special allocations in response to unexpected major developments.

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5 Annexes

Annex 1: EU Member States' holdings of SDRs, allocation and recycling commitments (in billions of SDRs, as of 31 December 2023)

Country	SDR Holdings	SDR Allocation	Recycling pledge
Austria	5.74	5.50	-
Belgium	10.83	10.47	0.95
Bulgaria	1.49	1.47	-
Croatia	0.99	1.03	-
Cyprus	0.43	0.42	-
Czech Republic	2.56	2.87	-
Denmark	5.04	4.83	0.16
Estonia	0.30	0.30	0.03
Finland	3.58	3.50	0.32
France	28.99	29.45	8.22
Germany	40.11	37.59	5.48
Greece	0.80	3.11	0.19
Hungary	1.83	2.85	-
Ireland	4.20	4.08	-
Italy	21.63	21.02	3.07
Latvia	0.44	0.44	-
Lithuania	0.57	0.56	0.09
Luxembourg	1.56	1.51	0.27
Malta	0.26	0.26	0.02
The Netherlands	14.14	13.21	1.81
Poland	4.24	5.23	-
Portugal	2.69	2.78	0.28
Romania	2.74	2.72	-
Slovak Republic	1.32	1.30	-
Slovenia	0.79	0.78	-
Spain	12.37	11.97	4.86
Sweden	6.83	6.49	0.84

Source: IMF data query for holdings and allocations. Recycling pledge data from the ONE campaign.

Annex 2: World Bank Classification of Countries for the 2024 fiscal year

Income categories are defined using GNI per capita, calculated using the World Bank Atlas Method (see here)

Low-Income Economies (USD 1 135 or less)

Afghanistan	Guinea-Bissau	Sierra Leone
Burkina Faso	Korea, Dem. People's Rep	Somalia
Burundi	Liberia	South Sudan
Central African Republic	Madagascar	Sudan
Chad	Malawi	Syrian Arab Republic
Congo, Dem. Rep.	Mali	Togo
Eritrea	Mozambique	Uganda
Ethiopia	Niger	Yemen, Rep.
The Gambia	Rwanda	

Lower-Middle Income Economies (USD 1 136 to USD 4 465)

Angola	Honduras	Pakistan
Argelia	Jordan	Papua New Guinea
Bangladesh	India	Philippines
Benin	Iran, Islamic Rep.	Samoa
Bhutan	Kenya	São Tomé and Principe
Bolivia	Kiribati	Senegal
Cabo Verde	Kyrgyz Republic	Solomon Islands
Cambodia	Lao PDR	Sri Lanka
Cameroon	Lebanon	Tanzania
Comoros	Lesotho	Tajikistan
Congo, Rep.	Mauritania	Timor-Leste
Côte d'Ivoire	Micronesia, Fed. Sts.	Tunisia
Djibouti	Mongolia	Ukraine
Egypt, Arab Rep.	Morocco	Uzbekistan
Eswatini	Myanmar	Vanuatu
Ghana	Nepal	Vietnam
Guinea	Nicaragua	Zambia
Haiti	Nigeria	Zimbabwe

Upper-Middle Income Economies (USD 4 466 to USD 13 845)

Albania
Argentina
Armenia
Azerbaijan
Belarus
Belize
Bosnia and Herzegovina
Botswana
Brazil
Bulgaria
China
Colombia
Costa Rica
Cuba
Dominica
Dominican Republic
El Salvador
Equatorial Guinea
Ecuador
Fiji
Gabon
Georgia
Grenada
Guatemala
Indonesia
Iraq
Jamaica
Kazakhstan
Kosovo
Libya
Malaysia
Maldives
Marshall Islands
Mauritius
Mexico
Moldova
Montenegro
Namibia
North Macedonia
Palau
Paraguay
Peru
Russian Federation
Serbia
South Africa
St. Lucia
St. Vincent and the Grenadines
Suriname
Thailand
Tonga
Türkiye
Turkmenistan
Tuvalu
West Bank and Gaza

High-Income Economies (USD 13 846 or more)

American Samoa
Andorra
Antigua and Barbuda
Aruba
Australia
Austria
Bahamas, The
Bahrain
Barbados
Belgium
Bermuda
British Virgin Islands
Brunei Darussalam
Germany
Gibraltar
Greece
Greenland
Guam
Hong Kong SAR, China
Hungary
Iceland
Ireland
Isle of Man
Israel
Italy
Japan
Oman
Panama
Poland
Portugal
Puerto Rico
Qatar
Romania
San Marino
Saudi Arabia
Seychelles
Singapore
Sint Maarten (Dutch Part)
Slovak Republic

Canada
Cayman Islands
Channel Islands
Chile
Croatia
Curaçao
Cyprus
Czech Republic
Denmark
Estonia
Faroe Islands
Finland
France
French Polynesia
Guyana
Korea, Rep.
Kuwait
Latvia
Liechtenstein
Lithuania
Luxembourg
Macao SAR, China
Malta
Monaco
Nauru
Netherlands
New Caledonia
New Zealand
Northern Mariana Islands
Norway
Slovenia
Spain
St. Kitts and Nevis
St Martin (French part)
Sweden
Switzerland
Taiwan, China
Trinidad and Tobago
Turks and Caicos Islands
United Arab Emirates
United Kingdom
United States
Uruguay
Virgin Islands (U.S)

Annex 3: List of prescribed holders of SDRs (20 members as of January 2024)

Central Banks

European Central Bank

Bank of Central African States

Central Bank of West African States

Easter Caribbean Central Bank

Intergovernmental Monetary Institutions

Bank of International Settlements

Latin American Reserve Fund

Arab Monetary Fund

Development Institutions

African Development Bank

African Development Fund

Asian Development Bank

Caribbean Development Bank

Development Bank of Latin America

European Bank for Reconstruction and Development

European Investment Bank

Inter-American Development Bank

International Bank for Reconstruction and Development

International Development Association

Islamic Development Bank

Nordic Investment Bank

International Fund for Agricultural Development

Annex 4: IMF emerging markets list of countries

Albania
Algeria
Angola
Antigua and Barbuda
Argentina
Armenia
Aruba
Azerbaijan
Bahamas, The
Bahrain
Barbados
Belarus
Belize
Bolivia
Bosnia and Herzegovina
Botswana
Brazil
Brunei Darussalam
Bulgaria
Cabo Verde
Chile
China
Colombia
Costa Rica
Dominica
Dominican Republic
Ecuador
Egypt
El Salvador
Equatorial Guinea
Eswatini
Fiji
Gabon
Georgia
Grenada
Guatemala
Guyana
Hungary
India
Indonesia
Iran
Iraq
Jamaica
Jordan
Kazakhstan
Kosovo
Kuwait
Lebanon
Libya
Malaysia
Maldives
Marshall Islands
Mauritius
Mexico
Micronesia
Mongolia
Montenegro
Morocco
Namibia
Nauru
North Macedonia
Oman
Pakistan
Palau
Panama
Paraguay
Peru
Philippines
Poland
Qatar
Romania
Russian Federation
Samoa
Saudi Arabia
Serbia
Seychelles
South Africa
Sri Lanka
St. Kitts and Nevis
St. Lucia
St. Vincent and the Grenadines
Suriname
Thailand
Tonga
Trinidad and Tobago
Tunisia
Türkiye
Turkmenistan
Tuvalu
Ukraine
United Arab Emirates
Uruguay
Vanuatu
Venezuela
West Bank and Gaza

DIRECTORATE-GENERAL FOR EXTERNAL POLICIES
POLICY DEPARTMENT

European Parliament

WORKSHOP PROCEEDINGS

Confronting debt, climate change and poverty: Global financial architecture reform and the fiscal space of developing countries

EP/EXPO/DEVE/FWC/2019-01/LOT3/1/C/17

EP/EXPO/DEVE/FWC/2019-01/LOT3/1/C/18

June 2024 - PE 754.456

EN

CONTRIBUTOR

Workshop proceedings

- Carolina FERREIRA GIL, trainee, Policy Department for External Relations

PROJECT COORDINATOR (CONTRACTOR)

- Trans European Policy Studies Association (TEPSA)

This paper was requested by the European Parliament's Committee on Development.

CONTACTS IN THE EUROPEAN PARLIAMENT

Coordination: Maciej JASTRZEBIEC-PYSZYNSKI, Policy Department for External Relations

Editorial assistant: Grégory DEFOSSEZ

Feedback is welcome. Please write to poldep-expo@europarl.europa.eu

Paper copies can also be requested from poldep-expo@europarl.europa.eu

VERSION

English-language manuscript completed in June 2024.

This paper is published on the European Parliament's online database, 'Think Tank'

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List of abbreviations

ADB	African Development Bank
AE	Advanced Economies
EU	African Union
BWI	Bretton Woods Institutions
CELAC	Community of Latin American and Caribbean States
CRA	Credit Rating Agencies
CSO	Civil Society Organisations
DG INTPA	Directorate General for International Partnerships
DSA	Debt Sustainability Analysis
DSSI	Debt Service Suspension Initiative
ECB	European Central Bank
EMDE	Emerging Markets and Developing Economies
EP	European Parliament
EPP	European People's Party
EU	European Union
GDP	Gross Domestic Product
GFA	Global Financial Architecture
GPG	Global Public Goods
Greens/EFA	Greens/European Free Alliance
IMF	International Monetary Fund
LIC	Low Income Countries
MDB	Multilateral Development Banks
MoU	Memoranda of Understanding
PRGT	IMF Poverty Reduction and Growth Trust
RST	IMF Resilience and Sustainability Trust
SDG	Sustainable Development Goal
SDR	Special Drawing Rights
S&D	Socialists & Democrats

1 Workshop programme

For the Committee on Development

WORKSHOP:

CONFRONTING DEBT, CLIMATE CHANGE AND POVERTY:

GLOBAL FINANCIAL ARCHITECTURE REFORM

AND FISCAL SPACE OF DEVELOPING COUNTRIES

Tuesday, 19 March 2024, 15.40 to 17.00

Interpretation: TBD

Brussels, SPAAK building, room 5B1

PROGRAMME

15.40-15.45 **Introductory remarks**

Welcome by **Tomas TOBÉ**, MEP, Chair of the Committee on Development

15.45-16.00 **Presentation of the in-depth analysis 'Reform of the global financial architecture in response to global challenges. How to restore debt sustainability and achieve SDGs?' by the expert and responses**

Dr Abel GWAINDEPI, Senior Researcher at the Danish Institute of International Studies

16.00-16.20 **Presentation of workshop briefings: Fiscal space of developing countries**

1. Fiscal space in developing countries – a primer

Dr Sanjeev GUPTA, Senior Fellow Emeritus, Center for Global Development

2. International Monetary Fund Special Drawing Rights – a primer

Professor Mark PLANT, Senior Policy Fellow, Center for Global Development

3. The fiscal space of developing countries and its impact on poverty (SDG 1) and/or inequality (SDG 7) reduction

Dr Annalena OPPEL, London School of Economics

16.20 – 16.25 **Comments from the Commission**

Peter KOVACS, Head of Macroeconomics Division at DG INTPA

16.25-16.45 **Debate with Members**

Intervention by **Tomas TOBÉ**, MEP, European People's Party (EPP)

Intervention by **Mónica Silvana GONZALEZ**, MEP, Socialists and Democrats (S&D)

Answers from the panel

16.45-16.50 **Concluding remarks**

Tomas TOBÉ, MEP, Chair of the Committee on Development

2 Introduction

Opening remarks were given by Tomas Tobé, MEP (EPP, SE, Chair of the Committee on Development (DEVE)). He highlighted the lack of financing as one of the main reasons why the world is not on track to achieve the Agenda 2030. It is estimated that the SDG financing gap is around USD 4 trillion. Moreover, many least developed countries suffer from unsustainable debt. Against this background, Mr Tobé pointed to the ongoing discussion on how to reform the global financial architecture for development, with a particular focus on Multilateral Development Banks (MDB), such as the World Bank, and the IMF. He underlined that there are other aspects to the discussion, such as domestic resource mobilisation, fiscal space, leveraging funds from the private sector and the fight against corruption, which would also be addressed in the workshop.

3 Presentation by academic experts

3.1 Dr Abel Gwaindepi, Senior Researcher at the Danish Institute of International Studies

Dr Abel Gwaindepi presented the in-depth analysis 'Reform of the global financial architecture in response to global challenges. How to restore debt sustainability and achieve SDGs?'

Dr Abel Gwaindepi emphasised the pressing need for reforming the Global Financial Architecture (GFA) amidst the rapidly evolving challenges of globalisation, climate change, and debt-financing. He highlighted how the GFA has lagged behind in keeping pace with the demands of a highly integrated financial world, emerging economic powers, and the essential provision of Global Public Goods (GPGs). Dr Gwaindepi commended the efforts of MEPs and the DEVE Committee for initiating a critical study to explore potential reform proposals, their rationale, and the significant role both the EU and its Member States play in this process.

In his presentation, Dr Gwaindepi distinguished two aspects of the GFA: the **political** and the **operational** side. He described the political aspect as the domain of global power brokers, including the G7, G21, and member states, who exert substantial influence over the Bretton Woods Institutions (BWIs), potentially unlocking reforms or stalling them amidst geopolitical tensions. The operational side, as he outlined, involves sectorial issues spanning international taxation, trade, finance, and economy, alongside their respective institutions and treaties.

Dr Gwaindepi argued that the GFA reform is fraught with geopolitical and technical challenges, necessitating a re-evaluation of foundational treaties and the operational ethos of the core institutions. He highlighted 5 elements in that regard:

1. Inadequate financing capabilities of the GFA: estimates of required financing to support SDGs vary from USD 5.4 to USD 6.3 trillion annually for Emerging Markets and Developing Economies (EMDEs).
2. The nature of shocks has changed. Shocks are no longer localised but involve global externalities, which require collective responses and unprecedented financial resources.
3. Donor priorities have shifted, leaving significant financing gaps as aid funds are redirected, especially on unlocking private sector financing but also in-donor expenses.

4. The current debt architecture is failing many Emerging Markets and Developing Economies, with public debt soaring by 224 % when indexed in 2010 values compared to 53 % for Advanced Economies (AEs). The debt architecture is pro-creditors with power imbalances and perpetuates misery in debtor countries.

5. The GFA's flaws extend beyond financial inadequacies. It is rooted in colonialism and has remained blind to justice, inclusivity, and democratic principles that can give leaders in Emerging Markets and Developing Economies the right to participate in discussions on issues of international importance. The system fails to provide safety nets for all nations in the event of crisis.

Dr Gwaindepi then highlighted the two substantive issues in this research:

1. Achieving SDGs:

- There are significant challenges to the attainment of SDGs in the Low Income Countries (LICs) and Emerging Markets and Developing Economies, primarily due to financial constraints and institutional capacity issues.
- The COVID-19 pandemic has notably reversed and slowed progress, underscoring the urgency of addressing these setbacks.
- Africa's need for substantial funding, requiring USD 213.4 billion annually for climate action and USD 1.3 trillion for SDGs, highlights the extensive financial gap.
- Additional challenges include climate risks and the impact of natural disasters and conflicts, which have exacerbated financial and developmental vulnerabilities, with natural disasters costing about USD 1.3 trillion over the past decade.

2. Achieving Debt Sustainability:

- The current debt architecture fails to adequately serve Emerging Markets and Developing Economies, with debt often mirroring deeper developmental issues linked to historical extractive practices.
- Debt Sustainability Analysis (DSA)'s pro-creditor bias overlooks the adverse effects of debt servicing on funding essential services, suggesting a need for a framework that guarantees minimum essential service expenditure.
- Constraints in concessional lending, coupled with the G20's Common Framework for debt restructuring's implementation challenges, reveal significant shortcomings as regards a viable global debt resolution mechanism. These challenges are compounded by quota-based limits and LICs' increasing reliance on private and commercial debt, underscoring the systemic inadequacies in addressing debt sustainability for vulnerable nations.

In addressing the reform matrix, Dr Gwaindepi presented the divergent reform proposals from two main perspectives:

- On one side, **MDBs advocate for modest enhancements** and better resource mobilisation through innovative financial instruments like blended finance and political risk insurance, aiming to attract private capital and improve operational efficiency to address global challenges. Despite these efforts, such incremental changes are deemed insufficient for the significant resource needs identified.

- Conversely, **Civil Society Organisations (CSOs), think tanks, and politicians from the Global South call for more radical, comprehensive reforms**—akin to a "Bretton Woods 2.0." They argue for a fundamental overhaul of the current system to ensure more equitable resource distribution for concessional lending, improved debt resolution mechanisms, and a fairer international tax system. Additionally, they emphasise the importance of debt cancellation for financially distressed EMDEs and the creation of new resources for the Loss and Damage Fund, advocating for a climate justice approach.

Dr Gwaindepi concluded his speech by outlining the vital role of the **European Union and its member states in driving forward the reform agenda**. The need to reorient certain aspects of the EU's financial architecture, particularly for MDBs, to ensure a coherent approach stands as a cornerstone of these reforms. Mobilisation of resources for development and GPGs is highlighted as a crucial component across all proposed reforms.

In the short term, it is recommended that the EU and its Member States:

- Actively support international tax system reforms, including promoting intergovernmental cooperation through the **United Nations** system to raise the global corporate income tax rate, aligning it with rates of the developed countries.
- Lead the discussions on debt cancellation for highly distressed countries, establishing clear modalities for such cancellations.
- Advocate for reforms to secure additional resources for the Loss and Damage Fund and support climate justice initiatives.
- Spearhead global efforts to increase green and sustainable funding, specifically targeting assets for adaptation and mitigation projects in LICs.

For the long term, it is advised that the EU and its Member States:

- Engage in or lead discussions on GFA governance reforms to ensure democratic representation, ensuring that the expansion of MDB balance sheets fairly benefits poorer countries.
- Support the creation of a long-term sovereign debt resolution mechanism, potentially through establishing a supranational body that operates equitably and follows a rule-based approach.
- Assist regional MDBs in developing innovative green assets for market, thus contributing to the project pipeline in developing countries.
- Play a key role in establishing new funding mechanisms to enhance private sector engagement in climate finance and SDG achievement, acknowledging the significant investment required.
- Back regulatory reforms and the establishment of guiding principles, with a focus on reviewing how credit rating agencies (CRAs) evaluate developing countries.

The conclusion stressed the balance between evolutionary and revolutionary reform ambitions, with a particular emphasis on the necessity for fundamental change in the debt architecture. It highlighted the slow progress and the resulting mistrust in unscripted reforms, cautioning against inaction that could lead to 'forum shopping' by EMDE leaders seeking alternative solutions.

3.2 Dr Sanjeev Gupta, Senior Fellow Emeritus, Center for Global Development

Dr Sanjeev Gupta presented the briefing entitled 'Fiscal space in developing countries – a primer', the first briefing, of three, regarding Fiscal space of developing countries.

He began by defining fiscal space as 'a country's capacity to implement fiscal policies, such as increasing expenditures or reducing taxes, while maintaining access to financial markets for budget funding and meeting all current and future payment obligations without resorting to extraordinary financial assistance'.

Dr Gupta elaborated on how the COVID-19 pandemic, demographic shifts and the green transition significantly impact, or have impacted, fiscal space in developing countries:

Impact of COVID-19 on fiscal space:

- The COVID-19 pandemic significantly reduced fiscal space in developing countries, causing increased public spending on healthcare and support programs, surging budget deficits, declining revenues, and higher debt-to-GDP ratios.
- Rising interest rates exacerbated the debt servicing cost, with examples from Ghana and Zambia in 2020 showing a significant portion of revenues consumed by interest payments, restricting fiscal space for essential services.

Demographic shifts:

- The expected doubling of the population aged 65 and older by 2050 will increase demand for healthcare and pensions, adding pressure on fiscal resources.
- Educational expenditures will also be impacted by the fluctuations in the school-age population.

Green transition:

- The fiscal challenges posed by the green transition for countries with limited fiscal space include the need to explore revenue and expenditure measures and seek grant or concessional financing for climate transition initiatives.

To expand fiscal space, Dr Gupta underscored the following strategies:

Enhancing revenue collection:

- Developing countries could increase their tax-to-GDP ratios by 5 to 9 percentage points through reforms, including VAT reforms, excise duties, improving personal income tax design, and higher rates on capital income.

Rationalizing expenditures:

- Many governments are not efficiently utilising public resources in education and health sectors
- Countries need to reassess the energy subsidies, which mainly benefit wealthier households and contribute to global environmental issues.

Effective debt management:

- Countries need to balance debt maturities and monitor interest rates to prevent reliance on volatile financial conditions.

By adopting these strategies, developing countries can overcome fiscal challenges and allocate resources more effectively towards achieving SDGs and climate objectives.

3.3 Professor Mark Plant, Senior Policy Fellow, Center for Global Development

Professor Mark Plant presented the briefing entitled 'International Monetary Fund Special Drawing Rights – a primer'.

Professor Mark Plant began by highlighting that Special Drawing Rights (SDRs) are a unique form of international reserve asset distributed by the IMF. SDRs serve as a component of central bank reserves, allowing countries to make payments within the IMF system, exchange them for freely usable currencies, but not directly purchase goods or services. He emphasised the significant issuance of SDRs in 2021, amounting to USD 650 billion, aimed at providing countries with additional financial flexibility to navigate the economic challenges posed by the COVID-19 pandemic. This issuance was the largest in history, increasing the total SDRs in the global balance sheet to nearly USD 1 trillion.

Professor Plant detailed the distribution criteria for SDRs, which are allocated based on countries' IMF quotas, resulting in a disproportionate allocation favouring advanced economies. While advanced countries, with their robust economic management tools, had less need for the newly issued SDRs, low- and middle-income countries found them crucial for bolstering their financial stability and government spending on essential services.

He also discussed the G20's pledge on SDR recycling:

- G20's pledged to recycle USD 100 billion of SDRs from advanced to more vulnerable economies, with about USD 60 billion already loaned to the IMF to aid low-income countries and climate transition efforts.
- Challenges in the full implementation of this pledge include technical hurdles and reluctance from central banks, especially the European Central Bank's opposition to recycling SDRs to institutions outside the IMF.

Furthermore, Professor Plant pointed out calls for the IMF to issue SDRs more regularly, arguing that periodic allocations could provide a consistent buffer for countries, reflecting the growth of global GDP and increasing global reserves in a stable manner.

Professor Plant concluded with the following recommendations:

- EU Member States should fulfil the G20 recycling pledge. An EP resolution could be instrumental for this objective.
- The EU should reconsider its position and unlock the potential of SDR recycling to MDBs. The DEVE Committee could invite the ECB to discuss which rules currently prevent the recycling of SDRs to MDBs and whether a Treaty change is the only route.
- The EU members (through IMF Executive Directors) should support and encourage regular SDR allocations, as outlined in the IMF Articles of Agreement.

3.4 Dr Annalena Oppel, London School of Economics

Dr Annalena Oppel presented the Briefing entitled 'Enabling Stronger Policies against Poverty and Inequality in Developing Countries through supporting their Fiscal Space'

The intervention started by discussing the connection between fiscal space and the reduction of poverty and inequality, offering insights into the challenges and opportunities within developing countries' fiscal capacities and their impacts on societal disparities. She noted that establishing a direct cause-effect relationship between policies aimed at enhancing fiscal space and their impact on poverty and inequality remains elusive, proposing a broader dialogue on global development strategies in light of changing economic and political landscapes

Dr Oppel highlighted the fundamental role of fiscal space—defined as a government's ability to generate revenue, allocate resources, and manage finances effectively—in underpinning social programs, infrastructure projects, and efforts to reduce poverty and inequality. Developing countries **often struggle with limited fiscal space**, which limits their ability to implement transformative policies. These constraints are exacerbated by various factors:

- Power imbalances in decision-making processes across the global North and South, a lack of unified focus on poverty and inequality reduction, institutional frameworks that hinder effective governance and impede progress.
- The time dimension complicates matters further, as seen in the case of infrastructure investments or education reforms, which may take years to yield tangible benefits.

Dr Oppel referred to principles like ownership, alignment, and localisation, as outlined in international agreements, as a foundation for new collaborative efforts, despite obstacles such as political misalignment and coordination challenges stemming from risk aversion or a lack of trust.

Dr Oppel also discussed how financial dependency, through debt and conditionalities, continues to make developing countries vulnerable; a situation exacerbated by the COVID-19 pandemic. This underscores the urgency for global debt relief initiatives, previously highlighted in discussions on the future of the European Financial Architecture for Development.

Looking forward, Dr Oppel underscored inclusive, innovative and accountable approaches.

- The speaker emphasised the role of horizontal partnerships and trust-building to foster inclusive and innovative approaches. In her view, the development world needs to learn from more agile innovators in community-based and trust-based development, often championed by private philanthropies. The speaker also underlined the critical role of comprehensive digitisation in creating effective welfare systems, with references to studies on universal income and the importance of universal social registries for adaptive crisis response.

In conclusion, Dr Annalena Oppel emphasised two main points: (1) meaningful change requires a re-evaluation of cooperation approaches and policies that consider the intricate relationship between economic, social, and political factors; and (2) the need for outcome-oriented policies that prioritise long-term, flexible, and locally driven commitments.

4 Debate with members

Comments from the Commission

Peter Kovacs, Head of Macroeconomics Division at DG INTPA

Mr Peter Kovacs began by outlining the compounded challenges faced by developing countries in recent years, marked by the pandemic, inflation caused by the war in Ukraine, and a global financial squeeze. These challenges have exacerbated the funding gap for crucial needs such as climate adaptation, energy transition, poverty reduction, and achieving SDGs, against a backdrop of high debt and fiscal vulnerabilities. He noted the stark difference in fiscal response capabilities between low-income countries and advanced economies, with the former only able to afford less than 2% of their GDP in response to the pandemic, compared to almost 10% by the latter.

In reaction to these difficulties, the EU has taken significant steps to offer support. The EU backed the G20's Debt Service Suspension Initiative (DSSI), allowing 45 countries to defer USD 13 million in debt, and disbursed EUR 3 billion in emergency budget support in 2020. The EU also supported the IMF allocation of

USD 650 billion in SDRs and contributed significantly to the goal of rechannelling USD 100 billion from advanced economies to vulnerable nations, as achieved at the Global Financing Pact Summit in Paris in June 2023.

Further, the EU has supported the funnelling of resources to the IMF's Poverty Reduction and Growth Trust (PRGT) and the Resilience and Sustainability Trust (RST). It also advocates for debt relief under the G20's Common Framework for Debt Treatments, pushing for its extension to middle-income countries and supporting the establishment of the IMF and World Bank Global Sovereign Debt Roundtable.

Mr Kovacs highlighted the progress in developing countries towards improving fiscal frameworks and policies, including the establishment of credible fiscal strategies and boosting domestic revenues. Despite these advancements, he pointed out that challenges such as expensive borrowing and high interest payments still loom, threatening to restrict fiscal space in the future.

The EU remains committed to supporting developing nations through reforms and capacity-building initiatives aligned with the 'collect more, spend better' agenda. Through its Global Gateway strategy, the EU aims to drive transformative investments to boost economic potential and fiscal revenues in partner countries, emphasizing the essential role of continued international cooperation in overcoming the persistent challenges faced by the developing nations.

Questions from MEPs

Tomas Tobé, MEP (EPP, SE) started by focusing on **how the EU could enhance national tax systems**, asking how that support could be provided.

He then addressed the consensus among researchers regarding the inadequacy of current reforms in MDBs, and **asked what crucial reforms the researchers would single out as being the most pertinent**.

Mr Tobé ended his intervention with a **request for comments regarding corruption**. Highlighting a recently communicated stance by the Council on corruption, Mr Tobé emphasised its significant impact on development efforts, citing a claim that its estimated value equals around nine times the amount of global official development assistance. Recognizing an opportunity here, he asked for inputs from the experts.

Mónica Silvana González, MEP (S&D, ES) started by raising a question regarding the omission of the Barbados government's Bridgetown Initiative in the discussions about modernizing the global financial architecture and crisis management after natural disasters. She highlighted the Community of Latin American and Caribbean States' recognition of the initiative as good practice and inquired about the appropriate utilisation of green bonds within the EU's strategic framework.

On the topic of SDRs, Ms González addressed the EU's current restriction on recycling SDRs to MDBs, **asking how this limitation could be overcome.**

Ms González also delved into the crucial issue of reforming tax systems in developing countries and the international cooperation on this issue. She sought clarity on the EU's capacity to support these reforms.

Responses from the panel

Dr Annalena Oppel emphasised the necessity of focusing on specific areas for improvement within the European Union's strategies. Highlighting the importance of backing regional initiatives, such as the African Tax Administration Forum, she advocates for capacity building, particularly in tax reform, with an emphasis on equity considerations. Furthermore, she pointed out the significance of developing adaptive systems for crisis management, including the integration of digitisation to enhance responsiveness and efficiency. Lastly, Dr Oppel stressed the importance of the EU's commitment to horizontal partnerships, exemplifying this with a call for more support for initiatives like the Grand Bargain. She noted that the EU's current efforts in allocating resources to local actors are insufficient and highlighted the need not just to meet indicators but to also engage in dialogues with new actors in development, to better understand the complexities of various contexts and realities.

Professor Mark Plant discussed the challenges and opportunities in mobilizing financial pledges for development, particularly emphasizing the gap between pledges made by European and other countries and the actual realisation of these funds. He noted the slow process of transferring pledged SDRs to developing countries, highlighting that of the USD 100 billion pledged, less than a billion has reached low and middle-income countries. Professor Plant called for the active participation of the European Parliament and the European Commission to encourage countries to mobilise their pledges effectively.

He pointed out that of the USD 100 billion pledged, the IMF intends to use about USD 60 billion , leaving USD 40 billion to be potentially recycled into low-income countries through MDBs, which he views as the best avenue for further recycling. Professor Plant explained the mechanism by which SDRs could be leveraged as capital through the African Development Bank (ADB), i.e, they would not be spent but used to increase the bank's lending power. This approach, he argued, should be appealing to central banks, as it offers a return on investment and supports a well-regarded international institution with extensive lending programs in Africa.

Dr Sanjeev Gupta addressed the European Union's efforts to enhance national tax systems, particularly in developing countries, by providing technical assistance through direct support or via institutions like the IMF and the World Bank.

Dr Gupta also highlighted the importance of addressing equity through tax and spending systems. He pointed out the potential for improving the design of income taxes in developing countries, where exemptions are often disproportionately high in relation to capital incomes.

Furthermore, Dr Gupta criticised the inequitable impact of large subsidies on fossil fuel consumption, which disproportionately benefits higher-income groups over the poor. He advocated for improving the quality of government spending by targeting it more effectively to support equity.

Lastly, Dr Gupta remarked on the disparity in fiscal response to the COVID-19 pandemic between developing and advanced economies, noting that developing countries spent only 2% of their GDP on pandemic response compared to 10% by advanced economies. He attributed this discrepancy to the limited fiscal space available to developing countries, restricting their ability to undertake significant financial measures in response to the crisis.

Dr Abel Gwaindepi expressed concerns about the sufficiency of ongoing reforms to address global challenges by 2030, particularly in the contexts of SDGs and the climate crisis. Despite acknowledging the European Union's efforts and initiatives like the Climate Bank and the EU Global Gateway, he highlighted a significant risk related to the timeliness and resource adequacy for these reforms. Dr Gwaindepi emphasised the need for a **balance between incremental and fundamental reforms**, pointing out the necessity for operational efficiency, scaling up financing, and unlocking private sector finances, while also stressing the importance of addressing deeper issues like **governance reforms**.

He raised concerns about the representation of African countries in the Bretton Wood institutions that were formed during colonial times. These institutionsneed to be reshaped to better reflect the interests of countries in the Global South. Furthermore, Dr Gwaindepi underscored the importance of continuously monitoring the capital requirements of MDBs to ensure they can meet current and future challenges in climate and development.

He also commented on the unique challenges faced by small island developing states, like the case of Barbados, in comparison to other regions, such as landlocked African countries, emphasizing the need for climate change programs tailored to their specific needs. Additionally, he mentioned the potential of green bonds as important financial instruments for specific projects, especially for mitigation, while addressing the misconception that developing countries lack bankable projects for green bonds. Dr Gwaindepi suggested that MDBs could play a role in identifying and curating bankable projects within developing countries to make green bonds more effective in these regions.

5 Concluding remarks

In his closing remarks, **Tomas Tobé, MEP (EPP, SE)** thanked all speakers and participants for the fruitful exchange, highlighting that the DEVE Committee to be constituted after the elections should act upon the recommendations proposed by the authors of the papers.

Annex 1 – Speakers' bios

Dr Abel Gwaindepi - Senior Researcher at the Danish Institute of International Studies (DIIS). Dr Gwaindepi is also a Senior Researcher at Lund University's Department of Economic History, an external Teaching fellow at Copenhagen University's Centre of African Studies and an Affiliated researcher at Stellenbosch University's Economics Department. He is primarily interested in economic history and the political economy of development in Africa. Dr Gwaindepi is working on development finance, focusing on historical and current developments in domestic revenue mobilisation and green debt for sustainable development. Dr Gwaindepi has actively participated in several policy dialogues with the Ministry of Foreign Affairs of Denmark and the United Nations (UN) city in Copenhagen on matters related to the Sustainable Development Goals (SDGs) and financing mechanisms.

Dr Sanjeev Gupta is a senior fellow emeritus in the Center for Global Development. His research interests are in fiscal policy in developing and resource-rich economies as well as in fragile states, aid, corruption, energy subsidies, digitalisation and public finances, age-related spending, global health, and inequality. Previously, he was deputy director of the Fiscal Affairs Department of the International Monetary Fund (IMF) and has worked in its African and European Departments. Prior to joining the IMF, Gupta was a fellow of the Kiel Institute of World Economics, Germany; professor in the Administrative Staff College of India, Hyderabad; and Secretary of the Federation of Indian Chambers of Commerce and Industry. Gupta has authored/co-authored over 300 papers, many of which are published in well-known academic journals, and has authored/co-authored/co-edited 13 books.

Professor Mark Plant is the Chief Operating Officer, CEO of the Center for Global Development Europe. Professor Plant worked at the International Monetary Fund, where he was director of human resources and deputy director of the IMF's African Department. He also held a range of senior positions in the Strategy, Policy and Review Department, where he had oversight of the IMF's policies towards low-income countries, including its work on the Multilateral Debt Relief Initiative (MDRI) and the Heavily Indebted Poor Countries (HIPC) Initiative. Before joining the IMF, Professor Plant held senior positions in the US Department of Commerce and at the General Motors Corporation. He began his career teaching economics at the University of California, Los Angeles.

Dr Annalena Oppel is a Researcher at the International Inequalities Institute, London School of Economics and Political Science as well as the Atlantic Fellows for Social and Economic Equity programme. Her work involves interdisciplinary approaches to inequality research in developing countries, particularly those that focus on political preferences and redistribution. She further works on policy matters linked to social protection and public finance in the global South. Prior to joining LSE, she collaborated with the United Nations University World Institute for Development Economics Research (UNU WIDER), Harvard University, Deutsche Gesellschaft für Internationale Zusammenarbeit, Overseas Development Institute, the Organisation for Economic Co-operation and Development and the Global Development Network. She holds a PhD from the Institute of Development Studies, the University of Sussex.

Annex 2 – Photos from the workshop

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PE 754.456
EP/EXPO/DEVE/FWC/2019-01/LOT3/1/C/17
EP/EXPO/DEVE/FWC/2019-01/LOT3/1/C/18

Print ISBN 978-92-848-1966-9 | doi: 10.2861/204492 | QA-05-24-475-EN-C
PDF ISBN 978-92-848-1965-2 | doi: 10.2861/775020 | QA-05-24-475-EN-N