

# 2 Financing for sustainable development at a tipping point

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Although a major collapse of financing for sustainable development was avoided after the COVID-19 pandemic in 2020, developing countries' government revenue did drop significantly and the SDG financing gap got wider. In the wake of Russia's war against Ukraine, many of them face reduced access to financing, increased volatility of private investment, and limited fiscal space to invest in a just and sustainable recovery. Improved mobilisation of domestic resources, sustained efforts by official providers, and reducing illicit financial flows and public sector inefficiencies will be critical to avoid a prolonged divergence in countries' capacity to finance their development.

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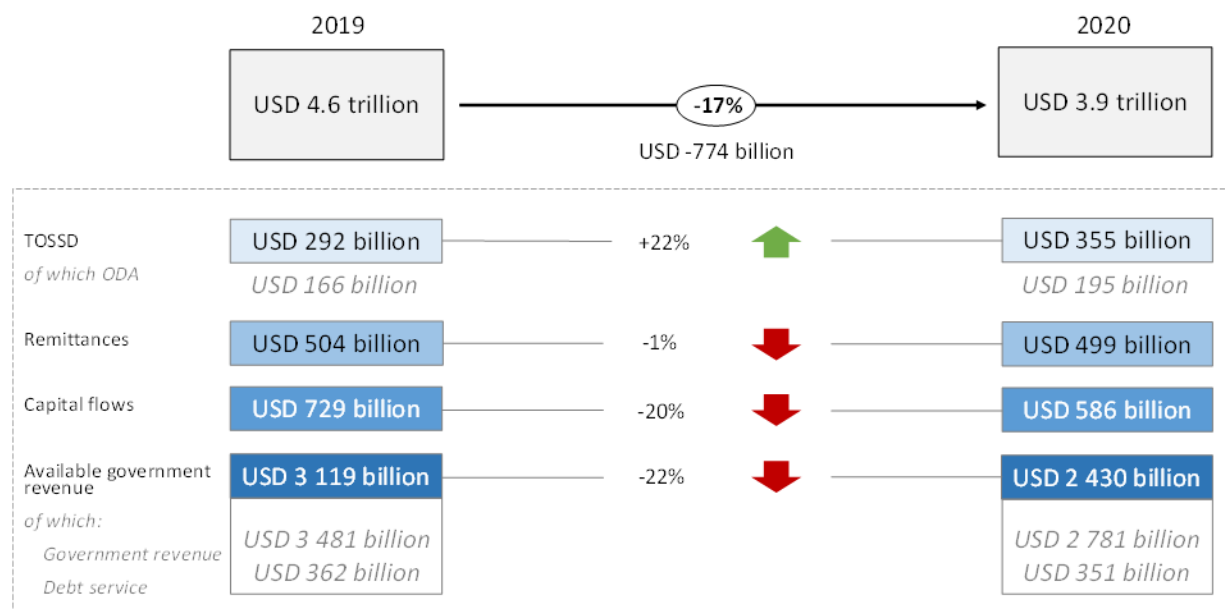
## 2.1. The financing for sustainable development landscape was on the brink of a major collapse during the COVID-19 crisis

### 2.1.1. *Despite swift policy responses, the COVID-19 pandemic triggered a significant drop in nearly all sources of financing for sustainable development in 2019-20*

The lockdowns put in place by some of the world's major economies in the first half of 2020 brought the global economy to a halt, with a direct and sudden impact on developing countries' revenue and financing sources. The total volume of financing for sustainable development (FSD) flows to developing countries, excluding the People's Republic of China (hereinafter China), declined by USD 774 billion, or 17%, from USD 4.6 trillion in 2019 to USD 3.9 trillion in 2020 (Figure 2.1). The largest drop in absolute terms was in available government revenue, which shrank by USD 689 billion, or 22%, from USD 3.1 trillion in 2019 to USD 2.4 trillion in 2020. (Subsection 2.1.2 discusses the drop in government revenues in greater detail.) Private capital flows including foreign direct investment (FDI), portfolio inflows and other investments declined by 20%, equivalent to USD 143 billion, the second largest fall in relative terms in 2019-20.

**Despite its steep decline as a consequence of the pandemic, government revenue remains the largest source of financing in developing countries.** In 2019, government revenue in developing countries excluding China amounted to USD 3.5 trillion (IMF, 2022<sup>[28]</sup>), of which USD 2.8 trillion came from tax revenue. This total is more than twice the amount of all major external finance flows combined (Total Official Support for Sustainable Development, or TOSSD, as well as cross-border capital inflows and remittances), which stood at USD 1.5 billion in 2019. Following the outbreak of the pandemic in 2020, government revenue amounted to USD 2.9 trillion, still more than double the total amount of all external financial flows (i.e. USD 1.4 trillion in 2020). Government revenue comprises different components, including tax and non-tax revenue, whose relative weights and structures vary widely with diverse policy implications – an example being how tax structures in developing countries can contribute to increased inequalities and impede the green transition.

**Figure 2.1. Available financing for sustainable development in developing countries shrank by USD 774 billion, or 17%, in 2019-20**



Note: TOSSD includes cross-border support to developing countries and global and regional expenditure for sustainable development (respectively, Pillars 1 and 2 of the TOSSD framework). Amounts mobilised from the private sector are not included in the TOSSD figures shown above. The definition and scope of Pillar 2 is currently under review and some of the activities contained may not be directly supporting developing countries. The increase observed in TOSSD flows between 2019 and 2020 is mainly due to an increase in the disbursements of multilateral organisations, in particular European Union (EU) institutions, the World Bank, the International Monetary Fund (IMF) (Concessional Trust Funds), and the Asian Development Bank Group and Asian Development Investment Bank as well as to better data coverage in 2020. All figures use the largest sample possible for official development assistance-eligible countries excluding China. The rationale to exclude China, as discussed, is based on its outlier status in terms of FSD landscape trends, particularly private capital flows.

Source: Authors' design. Data on official resources are based on OECD (2022<sup>[18]</sup>), *TOSSD Total Official Support for Sustainable Development/Data Visualisation Tool*, <https://tossd.online/>. Remittances are based on KNOMAD (2022<sup>[19]</sup>), *Remittance inflows* (database), <https://www.knomad.org/data/remittances>. Capital flows are from IMF (2022<sup>[20]</sup>), *Balance of payments* (database), <https://data.imf.org/bop>.

**The fear of a collapse in external private flows helped jolt global leaders into action, preventing even greater damage.** Without a strong policy reaction, a major collapse of external private flows (e.g. FDI, remittances, etc.) seemed likely, as demonstrated by the dire forecasts in the first months after the declaration of the pandemic. However, the unprecedented macroeconomic policy reaction led by the world's major economies supported to a great extent the global economy and financial markets, preventing the feared collapse from materialising. Central banks and governments of both developed and emerging countries mobilised large policy packages to ease financing conditions, provide income support, and protect domestic firms and sectors. In addition, China succeeded in stopping the spread of the first wave of the virus by mid-2020 and limiting the direct consequences to its economy. However, successive lockdowns and its subsequent zero-COVID approach are having protracted negative impacts on Chinese economic growth.

**As a result of the policy response, the drop in external private flows (including remittances) to developing countries was more moderate than anticipated.** The policy measures put in place by the world's major economies and the gradual lifting of containment measures contributed to the return of external private flows to developing countries in the second semester of 2020. Ultimately, external private flows to developing countries excluding China declined by 13% (USD 148 billion) thanks to a milder-than-anticipated decline of capital flows (-20%) and an almost complete recovery of remittance flows (-1%) by

the end of that year. These trends in external private flows during and after the outbreak of the pandemic are further detailed in section 2.2.

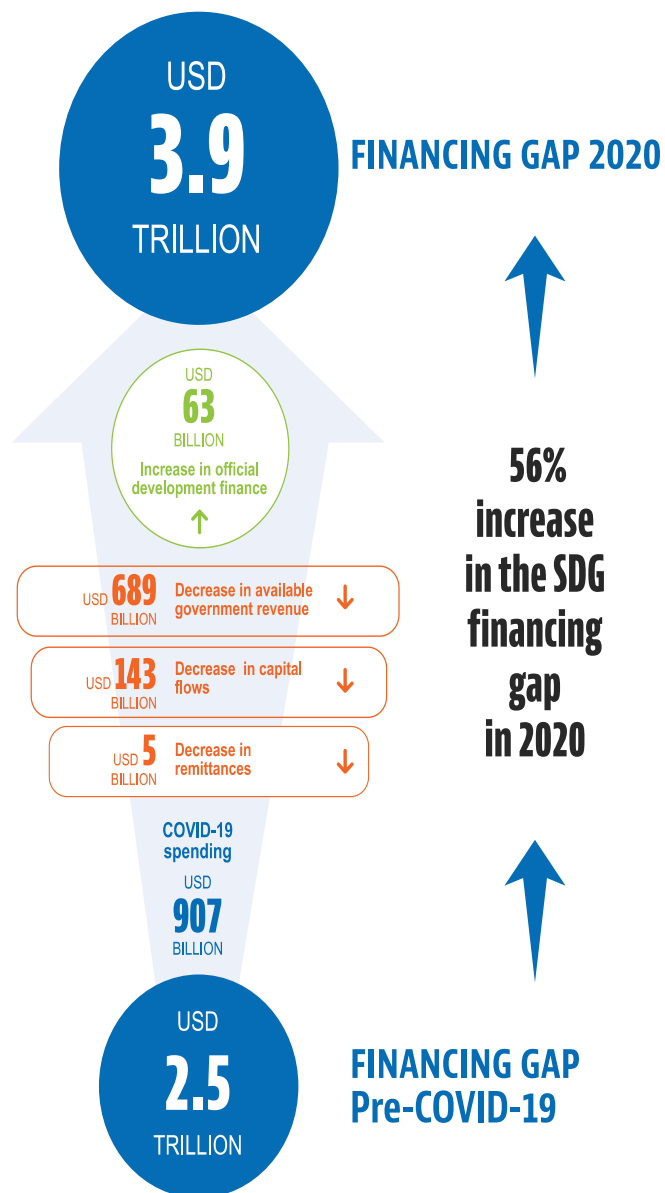
**The countercyclical response of official development finance (ODF), including official development assistance (ODA), counteracted the shortfall of other external financing flows but could not fully compensate for losses.** Between 2019 and 2020, TOSSD, a new measure of resources that are provided by public sector actors in support of developing countries, grew by 22%, reaching a total of USD 355 billion, of which total bilateral and multilateral ODA is estimated at USD 195 billion in 2020. The TOSSD figure, based on the two pillars of the TOSSD framework, includes bilateral, multilateral and South-South cross-border support to developing countries (Pillar 1) as well as global and regional expenditure with substantial benefits to developing countries (Pillar 2). As its name indicates, the TOSSD framework aims to provide a more comprehensive picture of official resources, including actors beyond the Development Assistance Committee (DAC), in support of sustainable development and is therefore particularly relevant in the analysis of total FSD. These trends in ODF are further explored in section 2.2.

### ***2.1.2. The Sustainable Development Goal financing gap increased due in large part to the severe decline in government revenues***

**Recent FSD data confirm the forecasted 56% increase in the Sustainable Development Goal (SDG) financing gap in 2020.** Due to the unprecedented magnitude of the COVID-19 pandemic, which increased financing needs and decreased available financing flows, the impact of the crisis was difficult to anticipate accurately. Looking back with the benefit of hindsight, initial forecasts tended to overestimate the impact on capital flows (which recovered swiftly in the second half of 2020) and did not account for the extent of the drop in available government revenue (for which there were no estimates at the time). However, the annual SDG financing gap in developing countries did indeed widen by 56%, to USD 3.9 trillion, in 2020 (Figure 2.2). Taking into consideration the expected tightening of global financing conditions, projections by the UN Conference on Trade and Development and the IMF suggest that the SDG financing gap could reach USD 4.3 trillion per year from 2020 to 2025, an increase of USD 400 billion over OECD estimates in 2019-20 (UNCTAD, 2022<sup>[25]</sup>).

**Two factors drove the growth in the SDG financing gap over 2019-20.** First, government revenue in developing countries suffered the most severe decline of any FSD source. Available government revenue (i.e. government revenue after debt service repayment) fell by USD 689 billion in 2020, accounting for more than 80% of the overall decline in FSD. This drop reflects the importance of government revenue, which represented over 50% of developing countries' financing mix before the COVID-19 crisis. Once the debt service of developing countries is factored in, the volume of government revenue available to finance sustainable development is reduced by 8%. Second, the USD 907 billion increase in developing countries' government expenditure in response to the COVID-19 emergency represents nearly 30% of total government revenues available in developing countries in 2019. Emergency spending added to the financing burden in countries already struggling to mobilise domestic revenues as well as other external private flows.

Figure 2.2. The Sustainable Development Goal financing gap increased by 56% in 2020 due to the combined effect of the drop in available financing for sustainable development and an increase in government expenditure



Source: Authors' design. ODF data are based on OECD (2022<sup>[18]</sup>), *TOSSD Total Official Support for Sustainable Development/Data Visualisation Tool*, <https://tossd.online/>. Remittances are based on KNOMAD (2022<sup>[19]</sup>), *Remittance inflows* (database) <https://www.knomad.org/data/remittances>. Capital flows are from IMF (2022<sup>[20]</sup>), *Balance of payments* (database), <https://data.imf.org/bop>.

The following sections examine the uneven impact of COVID-19, first, on all external sources of FSD that demonstrated relative stability, and second, on the larger drop in domestic public and private resources.

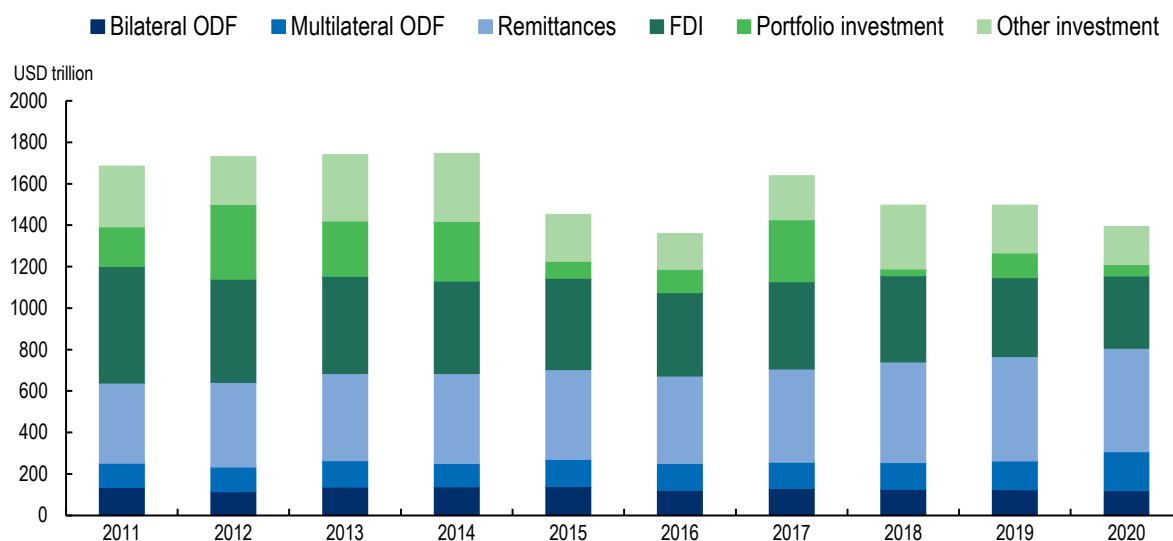
## 2.2. The recovery in advanced economies and the countercyclical role of official resources helped sustain external financing flows

**In the first half of 2020, the pandemic threatened to halt private capital flows to developing countries.** In May 2020, the OECD had estimated, based on several outside forecasts, that external private flows might decline by up to 40% (or about USD 700 billion) in 2020 compared to the previous year. The experience of previous crises suggested that external flows were particularly vulnerable to adverse shocks to the global economy, as was the case in 2014-15 when portfolio and other investments dropped to their lowest level since the 2008-09 global financial crisis due to the oil price collapse and subsequent end of the commodity price boom. Figure 2.3 illustrates the evolution of external finance since 2011.

**The rebound of private capital flows in the second part of the year and the surge in ODF contributed to keeping external finance afloat.** Total external flows remained relatively stable year on year, decreasing only slightly from USD 1.5 trillion in 2019 to USD 1.4 trillion in 2020 (-7%). However, the magnitude of the impact differed considerably across the various sources of external finance. For example, external private investment to developing countries excluding China declined by 12% between 2019 and 2020, while ODF grew by 22% over the same period.

**Figure 2.3. Total external flows to developing countries remained relatively stable in 2020**

Evolution of external finance (2011-20)



Note: The largest sample possible for ODA-eligible countries excluding China was used for each year.

Source: ODF flows are measured as a sum of ODA and OOF and accessed from OECD DAC Table 2a (OECD, 2022<sup>[22]</sup>), *Aid (ODA) disbursements to countries and regions [DAC2a]*, *OOF and export credits - disbursements [DAC2b]*, <https://stats.oecd.org/Index.aspx?DataSetCode=Table2A> and Table 2b (OECD, 2022<sup>[23]</sup>), *OOF and export credits - disbursements [DAC2b]*, <https://stats.oecd.org/Index.aspx?DataSetCode=TABLE2B#>. Remittances are based on KNOMAD (2022<sup>[19]</sup>), *Remittance Inflows* (database), <https://www.knomad.org/data/remittances>. FDI, portfolio investment and other investment data refer to net incurrence of liabilities and are from IMF (2022<sup>[20]</sup>), *Balance of payments* (database), <http://data.imf.org/bop>. Missing data on FDI are imputed using World Bank (2022<sup>[119]</sup>), *World Development Indicators* (database), <https://datacatalog.worldbank.org/dataset/world-development-indicators>.

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### **2.2.1. External capital flows were a major channel of transmission of the COVID-19 shock to the financing for sustainable development landscape**

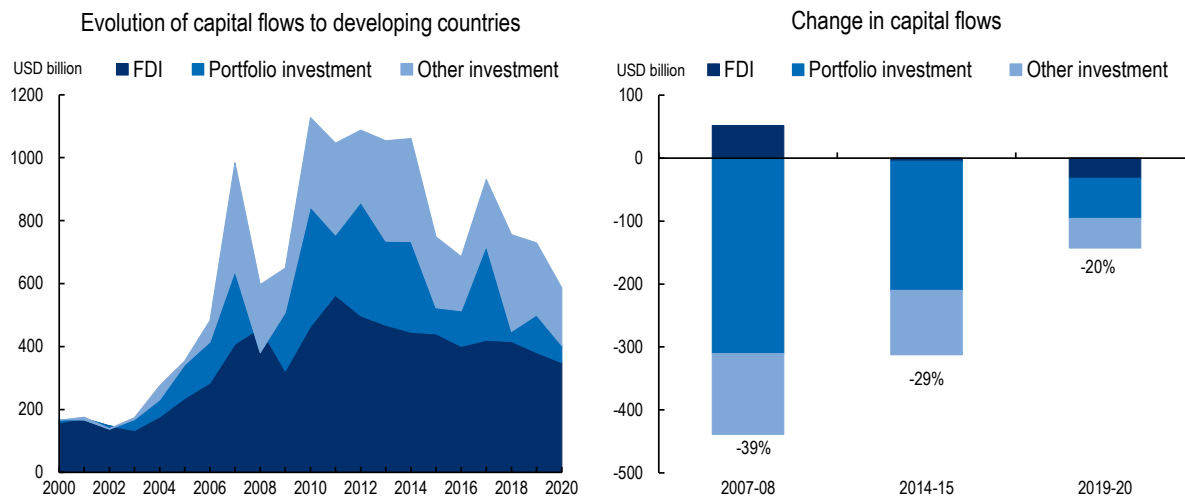
The COVID-19 crisis resulted in a sharp but temporary retrenchment of capital flows to developing countries excluding China in the first half of 2020 (Box 2.1). Despite their sudden stop in the first semester of 2020, capital flows were able to rebound once governments started easing the stay-at-home orders in the second semester of that year. The peculiar nature of the 2020 global recession, which was mainly transmitted to the economy by governments' containment measures (unlike the 2008-09 recession, which started as a financial crisis), explains the relatively swift recovery of cross-border capital flows by end 2020.

#### **Box 2.1. An outlier in the financing for sustainable development landscape, China registered record inflows of external private investment in 2020**

**More than USD 544 billion in external private investment flowed to China in 2020 compared to only USD 313 billion in 2019.** This increase of about USD 231 billion in inflows to China is larger than the decline observed in the inflows to all other developing countries. In other words, external private investment flows to developing countries including China increased by 10%, from USD 1 trillion in 2019 to USD 1.1 trillion in 2020. This is the reason that the analyses in this chapter exclude China unless explicitly stated otherwise. The main explanatory factor for the Chinese exception is the strong rebound of the Chinese economy in 2020, which itself was due in large part to the control of the domestic health situation in early 2020. The effects of the pandemic on cross-border capital flows to China were further mitigated by China's policy efforts to increase capital inflows and to allow the Yuan renminbi to appreciate after China had kept the currency comparatively low for years to retain export competitiveness.


**From a historical perspective, the decline in external capital flows observed in 2020 was sharp but not unprecedented.** Since 1980, the FSD landscape evolved in a cyclical manner, with sharp declines often linked to economic and financial crises. These include the debt crisis of the 1980s, the economic crisis in emerging markets in the 1990s (Asia, Mexico and Russia), the global financial crisis of 2008-09, and the combination of the appreciation of the US dollar and China's slowdown in 2015, which led to a fall in commodity prices. The 20% decline in capital flows observed in 2020 is lower than the 39% and 29% shocks experienced by the same group of countries in 2008 and 2015, respectively (Figure 2.4). Following the pattern observed in previous crises, portfolio equity presented a high volatility and was the most impacted among external capital flows to developing countries. In 2020, portfolio investment to developing countries dropped by USD 64 billion (-54%) compared to the previous year. However, the decline in portfolio investment between 2019 and 2020 was less pronounced than in the 2008-09 period.

**Figure 2.4. The drop in capital flows in 2020 was less pronounced than in previous sudden stop episodes**



Note: The data show cross-border capital flows to developing countries excluding China.

Source: IMF (2021<sub>[21]</sub>), *Balance of Payments and International Investment Position Statistics* (database), <https://data.imf.org/?sk=7A51304B-6426-40C0-83DD-CA473CA1FD52>.

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**Even a temporary decline in external capital flows impedes progress in developing countries towards achieving the SDGs.** External capital flows include FDI, portfolio investments and other investments. FDI – investment that establishes a substantial stake or lasting interest in a foreign company – is generally perceived as a factor of economic development and modernisation that brings various benefits to host countries, including in the form of enhanced productivity, job creation, technology transfer and improved integration in global value chains. Recent research suggests that policy practices can help strengthen the positive impact of FDI on key areas of sustainable development such as human capital development, gender equality, job quality and the green transition (OECD, 2022<sub>[120]</sub>). Portfolio investments – stock investments in a foreign business – are another type of foreign investment, although their benefits to the host economy are usually deemed to be relatively small due to the passive nature of their ownership and their more volatile and cyclical nature. The COVID-19 pandemic, as discussed elsewhere in this chapter, affected other investments including a residual category of countries' balance of payments consisting primarily of bank loans and trade credits.

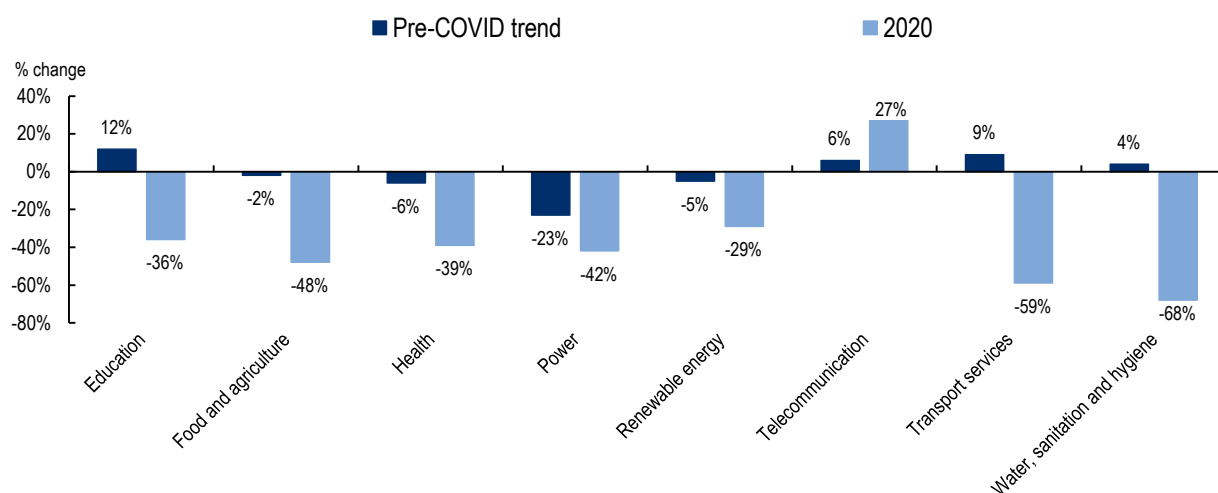
**FDI flows to developing countries, while less volatile than other sources of external capital flows, were already on a downward trend in the decade leading up to the COVID-19 crisis and shrank by a further 8% in 2020.** After increasing markedly between 2000 and 2011 from USD 159 billion to USD 563 billion, equivalent to a yearly average increase of 15%, annual FDI flows to developing countries experienced a slow but steady decline in the decade leading up to the outbreak of the COVID-19 pandemic, standing at USD 381 billion in 2019. FDI flows dropped by a further 16% in the first semester of 2020 compared to the previous year, mainly due to a slowdown in the implementation of existing investment projects and the reassessment of new ones (UNCTAD, 2020<sub>[121]</sub>). The relatively modest 8% decline in FDI flows to developing countries in the second half of 2020 contrasts with the more dire 35% drop in FDI initially predicted in the early stages of the pandemic (Institute of International Finance, 2020<sub>[122]</sub>) and with the 30% drop in FDI to developing countries observed in 2009.



**The decline in FDI particularly affected greenfield projects in developing countries and FDI to SDG-relevant sectors.** New greenfield project announcements, which are considered one of the most beneficial forms of investment for development, were down by 46% in 2020, compared to the drop of only -7% for international project finance and just -4% for cross-border mergers and acquisitions (UNCTAD, 2021<sup>[43]</sup>). The swift recovery of greenfield projects in OECD countries contrasts with the situation in developing countries, where recovery still lags. In addition, SDG-relevant sectors appear to have been highly impacted by the crisis (Figure 2.5), as demonstrated by the severe contraction from the pre-pandemic trend in the volume of announced greenfield projects in water, sanitation and hygiene (-68%); transport services (-59%); food and agriculture (-48%); health (-39%); and education (-36%). The pandemic also negatively affected job creation by diverting FDI away from labour-intensive industries that were the most impacted by the restrictions (e.g. manufacturing or tourism) and towards more capital-intensive investments.

**Figure 2.5. Foreign direct investment to Sustainable Development Goal-relevant sectors contracted substantially in 2020**

Percent change in volume of announced greenfield projects to SDG-relevant sectors in developing countries



Note: The pre-COVID-19 trend refers to the compound annual growth rate for the period 2015-19. Figures shown for the power sector exclude investments in renewable energy.

Source: UNCTAD (2021<sup>[123]</sup>), *World Investment Report 2021: Investing in Sustainable Recovery*, [https://unctad.org/system/files/official-document/wir2021\\_en.pdf](https://unctad.org/system/files/official-document/wir2021_en.pdf).

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**The global FDI recovery masks important declines across regions and countries.** Latin America registered the largest drop in FDI flows (-37%) of any region in 2020, followed by Africa (-18%). Asia experienced a milder contraction (-4%). FDI to Africa was trending downward before the pandemic, and in 2020, the African continent's global share of FDI shrank to its lowest level since 2004 (AUC/OECD, 2022<sup>[124]</sup>). The performance of China and India, which attracted significant inflows of FDI during the COVID-19 crisis, explains in part the milder contraction observed in Asia. In 2020, FDI flows to China increased by 4%, to USD 163 billion, largely thanks to the rebound of the Chinese economy in the second semester (UNCTAD, 2021<sup>[43]</sup>). China surpassed the United States in 2020 as the first destination for new FDI. New FDI to India, another notable exception, increased 13% in 2020, reflecting increased foreign investment in the digital economy, mainly in the form of cross-border mergers and acquisitions.

### **2.2.2. Remittances demonstrated resilience in the face of the pandemic**

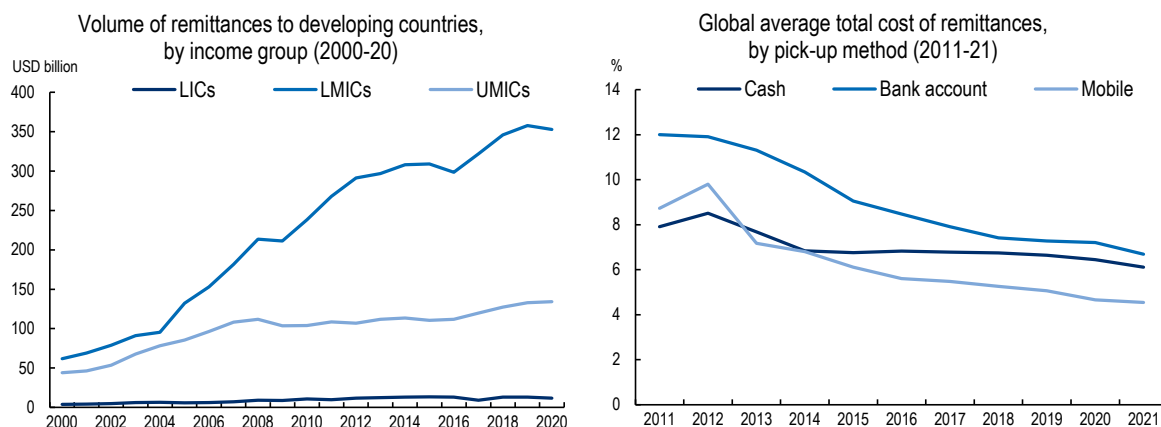
**Remittances recovered quickly after the onset of the pandemic.** In the first months, lockdowns in host countries and closure of remittance services severely hit the flow of migrants' remittances. Initial estimates published in the first half of 2020 predicted a 20% drop in remittances, corresponding to a loss of USD 110 billion (World Bank, 2020<sup>[125]</sup>). However, the gradual lifting of restrictions by host governments in the second half of the year allowed year-on-year remittance inflows to remain stable. Between 2019 and 2020, remittance flows to developing countries registered only a slight decrease of USD 5 billion (-1%), from USD 504 billion to USD 499 billion. Low-income countries (LICs) registered the largest decrease (-9%), while remittance inflows to lower middle-income countries (LMICs) and upper middle-income countries (UMICs) remained stable at -1% and 1%, respectively (Figure 2.6, left side).

**Migrants' remittances benefitted from positive spillovers from unprecedented fiscal policy support in advanced economies.** The deployment of fiscal stimulus by host countries, discussed in Chapter 1, helped safeguard migrants' income and contributed to the resilience of remittance flows to their countries of origin. Another contributing factor to the stability of remittance flows to developing countries in 2020 was the shift to more formal and often digital channels. For example, over the course of 2020, the use of mobile technology to send remittances increased by 65% (International Fund for Agricultural Development, 2021<sup>[126]</sup>).


**The resilience of remittances also helped safeguard consumption-related investments and shield some populations from poverty.** The recovery of remittance flows in the second half of 2020 provided a welcome lifeline to many developing countries and acted as a stabiliser, partly mitigating the drop in other external private resources such as cross-border capital flows. This effect is in line with earlier assessments of remittances as a countercyclical economic stabilising force. Thanks to their rising trend in recent years and the resilience they exhibited during the COVID-19 crisis, remittance flows to developing countries have surpassed FDI in volume terms since 2016.

**Despite a steady decline over the past decade, the transaction cost of remittances remains more than double the SDG target, depleting the resources of both households and governments.** At the global level, the average cost of sending USD 200 in remittances stood at 6.5% in 2020, more than double the 3% target in SDG 10 (reduce inequalities within and among countries). The cost of sending can be significantly higher in certain remittance corridors. Since 2015, the use of mobile technology offers a slightly lower-cost alternative, bringing down the average cost in 2020 to 4.66% of the amount sent versus 6.45% for cash and 7.21% for bank accounts and, by the end of 2021, to a record low of 4.03% of the amount sent (Figure 2.6, right side). While some of the factors driving the cost of remittances are structural, among them the scale of a remittance market or the distance between the sending and receiving country, specific policy action to promote digitalisation and increase competition among service providers could yield substantial results. According to the World Bank, bringing down the cost of remittances by a further 2 percentage points could generate an additional USD 12 billion per year for migrants from low- and middle-income countries (World Bank, 2022<sup>[127]</sup>).

**Figure 2.6. Remittances to developing countries remained relatively stable across all income groups**



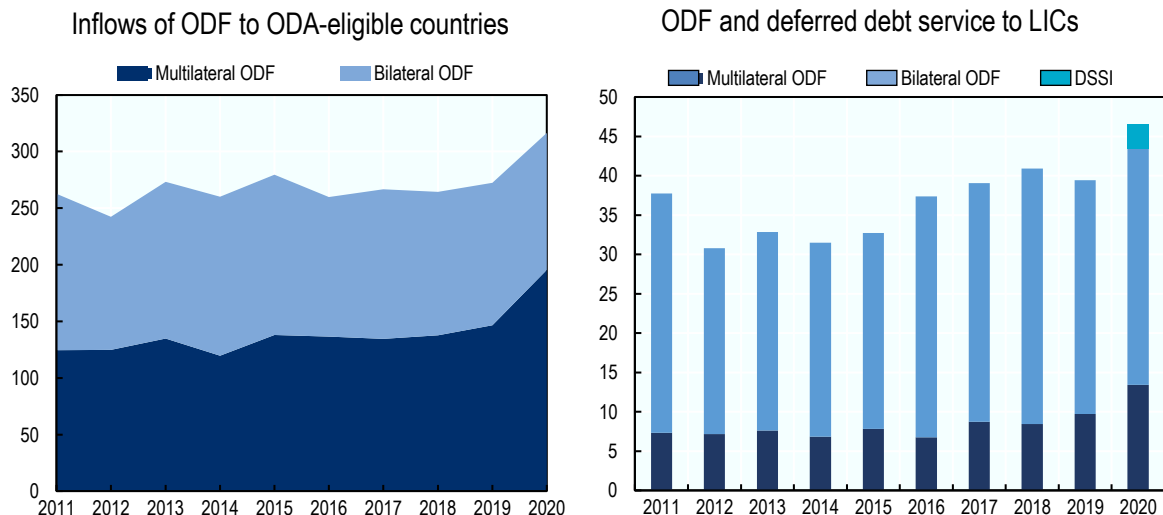
Source: For left side, remittances are based on KNOMAD (2022<sup>[19]</sup>), *Remittance inflows* (database), <https://www.knomad.org/data/remittances>. For right side, remittances costs are based on World Bank (2022<sup>[95]</sup>); remittance prices worldwide on (World Economic Forum, 2022<sup>[95]</sup>), *Remittance Prices Worldwide* (database), <http://remittanceprices.worldbank.org/>.

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### **2.2.3 Official development finance reached record levels in 2020 yet did not fully compensate for the loss of other resources during the pandemic**

Despite predictions to the contrary, total ODF reached record levels in 2020. ODA from DAC countries amounted to USD 162.2 billion in 2020, its highest level ever recorded and a 7% increase over 2019 (Figure 2.7, left side). Total ODF to developing countries, the combination of bilateral and multilateral ODA and other official flows (OOF), amounted to USD 307.7 billion in 2020, up by 8% from 2019. The increase of total ODA during a global crisis demonstrates the significant effort of ODA providers and reasserted the countercyclical role of ODA as a reliable form of international solidarity. Most donors had adopted their ODA budgets for 2020 by the time the pandemic hit and were able to maintain their planned ODA commitments. In addition, some donors were able to rapidly mobilise additional funding to support developing countries facing exceptional circumstances. However, recent analysis shows that COVID-19 spending was responsible for most of the increase in bilateral ODA, meaning that bilateral ODA to all but UMICs actually fell in 2020 once COVID-19 spending is stripped out (OECD, 2022<sup>[128]</sup>).

**Figure 2.7. Bilateral and multilateral providers' combined efforts ensured continued financial support to developing countries at the height of the crisis**



Source: DSSI = Debt Service Suspension Initiative. ODF flows are measured as a sum of ODA and OOF and accessed from OECD DAC Table 2a (OECD, 2022<sup>[22]</sup>), *Aid (ODA) disbursements to countries and regions [DAC2a]*, *OOF and export credits - disbursements [DAC2b]*, <https://stats.oecd.org/Index.aspx?DataSetCode=Table2A> and Table 2b (OECD, 2022<sup>[23]</sup>), *OOF and export credits - disbursements [DAC2b]*, <https://stats.oecd.org/Index.aspx?DataSetCode=TABLE2B#>. DSSI deferred debt service is calculated based on World Bank estimates as of 8 February, 2022: World Bank (2022<sup>[24]</sup>), *Debt Service Suspension Initiative* (webpage), <https://www.worldbank.org/en/topic/debt/brief/covid-19-debt-service-suspension-initiative>.

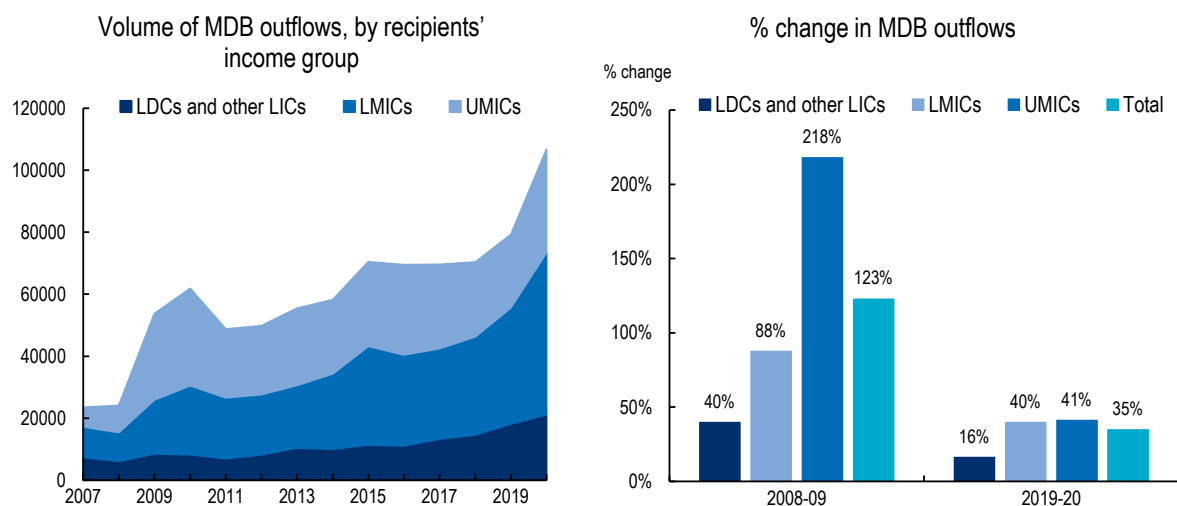
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**Bilateral development partners took historic action as creditors through the Debt Service Suspension Initiative (DSSI).** In April 2020, the Group of Twenty (G20) finance ministers agreed to a debt standstill for LICs as part of the DSSI. Between May 2020 and December 2021, debt service totalling USD 12.9 billion was suspended through the initiative to provide some breathing space to the 48 participating countries (of the 73 eligible) (Figure 2.7, right side). The effort came predominantly from bilateral development partners. Multilateral creditors did not take part in the initiative to safeguard their credit ratings, and despite repeated calls by the G20, only one private creditor consented to participate. In November 2020, the G20 reached an agreement to establish a Common Framework for Debt Treatment with the aim of helping DSSI-eligible countries facing insolvency and protracted liquidity problems.

**Multilateral development finance was instrumental in providing liquidity and financial support to help developing countries cope with the devastating impact of the COVID-19 pandemic.** Multilateral ODF reached USD 195.4 billion in 2020, up from USD 146.7 billion the previous year. This 33% increase in multilateral disbursements was mainly driven by the rapid reaction of the international financial institutions and was accompanied by a similar increase of multilateral commitments. The World Bank and the regional development banks were able to significantly increase their lending by repurposing parts of their existing programmes and fast-tracking financial support to developing countries. Despite this significant effort, the increase in lending from multilateral development banks (MDBs) did not match the increase observed during the 2008-09 financial crisis (Figure 2.8), leading to renewed calls for reassessing the lending capacity of these institutions (Humphrey and Prizzon, 2021<sup>[129]</sup>). It should be noted, however, that the baseline for the 2020 increase in multilateral ODF was higher, owing to the rising trend of multilateral ODF in the decade preceding the COVID-19 crisis. The IMF was also highly active in 2020 in helping developing countries weather the storm of the COVID-19 crisis, most notably through emergency


financing, liquidity support, grants for debt relief and a general Special Drawing Rights (SDR) allocation of USD 650 billion, although only a fraction of the SDR allocation went directly to developing countries.

**Figure 2.8. The increase in official development finance from multilateral development banks is larger than ever, though less than the increase in response to the global financial crisis**



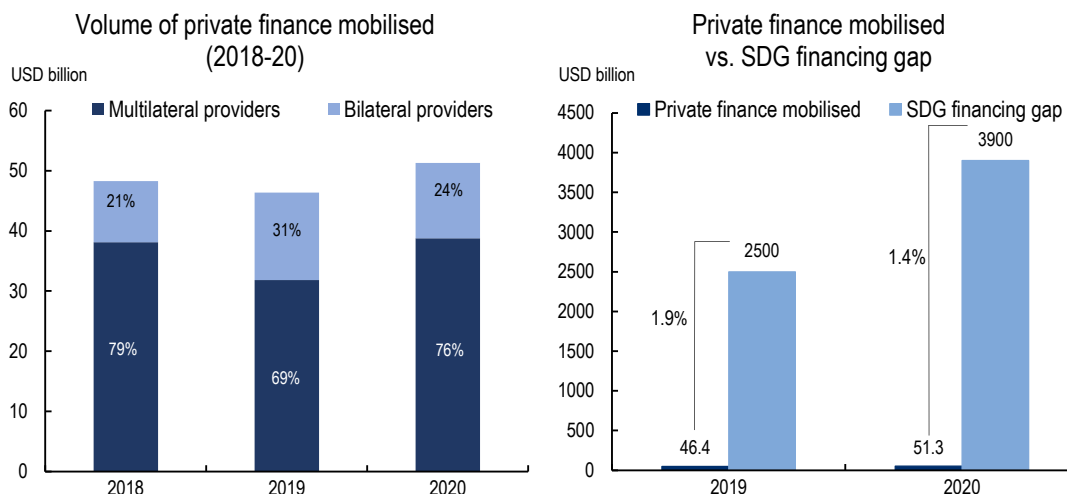
Note: LDCs = least developed countries. MDBs include the World Bank Group and all regional development banks for which data are available. ODF flows are measured as the sum of ODA and OOF. The numbers in the figure on the right correspond to the total year-on-year percentage change.

Source: OECD (2022<sup>[130]</sup>), *Creditor Reporting System*, <https://stats.oecd.org/Index.aspx?DataSetCode=crs1>.


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**Despite some progress, the mobilisation of private finance for sustainable development remains below the ambition of the 2030 Agenda.** The need to mobilise private resources is at the heart of the 2030 Agenda and has been clearly established as a priority in the Addis Ababa Action Agenda. Official providers have made significant efforts to increase the measurement of private finance through official interventions since the first survey on mobilisation carried out in 2013 by the OECD. Today, the OECD DAC measures private finance mobilised through six financial instruments: credit lines, guarantees, simple co-financing, direct investment in companies and special-purpose vehicles, shares in collective investment vehicles, and syndicated loans. Unlike the broader concept of blended finance, the DAC measure of mobilisation uses a restrictive definition, in that it only considers the amounts of private finance that would not have been mobilised without the use of ODF. According to the latest OECD (2022<sup>[131]</sup>) data collected, private finance mobilised by official providers grew by 11% in 2020 from USD 46.4 billion to USD 51.3 billion, following a 4% drop in 2019. Multilateral organisations continued to be the largest contributors to the mobilisation of private finance, accounting for 76% of the total, up by 7% from 2019 (Figure 2.9, left side). While this increase is positive news, the amounts involved remain far from the order of magnitude established by the Addis Ababa Action Agenda for private finance and can only contribute marginally to fill the SDG financing gap (Figure 2.9, right side).

**Figure 2.9. The amounts of private finance mobilised through official interventions remain largely insufficient to meet the needs despite a slight increase in 2020**



Source: For amounts mobilised from the private sector for development: OECD (2022<sup>[131]</sup>), *Amounts Mobilised from the Private Sector for Development* (webpage), <https://www.oecd.org/dac/financing-sustainable-development/development-finance-standards/mobilisation.htm>; OECD (2022<sup>[18]</sup>), *TOSSD Total Official Support for Sustainable Development/Data Visualisation Tool*, [www.tossd.org](http://www.tossd.org).

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**The increase in total ODF in 2020, however, does not compensate for the drop in other sources of FSD.** It is noteworthy that the increase in ODA flows observed in 2020 follows a trend of slow but steady decline. ODA decreased by 3% between 2017 and 2019, from USD 170.9 billion to USD 166.2 billion. Initial estimates suggest that DAC countries spent USD 12 billion (or 7% of total ODA) on COVID-19-related activities in 2020 (OECD, 2021<sup>[132]</sup>). However, the USD 63 billion rise in ODF observed in 2020 makes up for less than half the USD 148 billion decline in total external private finance flows in the same year.

## 2.3 Domestic public and private resources in developing countries are increasingly stretched

### 2.3.1. Government revenue registered a steep decline in 2020, leading to a significant fiscal crunch

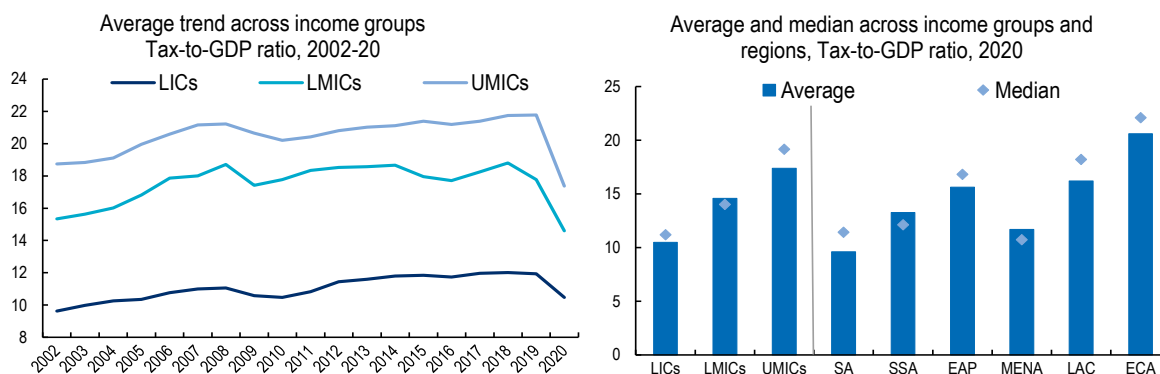
**Before the COVID-19 crisis, the growth in developing countries' tax revenue was levelling off.** Following a big spike in the early 2000s and a slight contraction in the aftermath of the 2008-09 global financial crisis, developing countries' tax revenue started to increase again in 2010, growing by 6% annually until 2015. However, from 2015 and 2019, even before the pandemic, tax revenue in developing countries excluding China grew by less than 1% annually.

**During the pandemic, developing countries' tax revenues fell further than gross domestic product (GDP) and registered a steeper decline than during the global financial crisis.** As noted in Chapter 1, developing countries' GDP fell as a consequence of COVID-19 lockdowns. While tax revenues also fell, the decline in the 2020 tax-to-GDP ratios indicates that tax revenues fell further than GDP in most developing countries. As shown in Figure 2.10 (left side), the decline in their tax-to-GDP ratios following

the outbreak of the pandemic was of historic magnitude and the opposite of what happened in high-income countries. The decline over 2019-20 also was more significant than it was during the 2008-09 global financial crisis: three times greater in LICs, two times greater in LMICs and four times greater in UMICs. The tax-to-GDP ratio of seven of 47 developing countries fell below the 15% threshold for economic growth and poverty reduction, or an increase of 17.5% in 2020.


**The huge drop in government revenue experienced by developing countries is in large part attributable to the massive decline in economic activity and existing constraints on domestic resource mobilisation (DRM).** The shutdown of global economic activity during the COVID-19 crisis resulted in significant revenue decline for developing countries due to the combined effects of a shrinkage of their tax base, proactive fiscal policy measures put in place by governments to provide relief to households and companies, and reduced tax compliance. As discussed in detail in Chapter 1, developing countries' macroeconomic vulnerabilities left them with insufficient space for the fiscal support packages that could have indirectly helped soften the blow to revenues (especially taxes on goods and services) by keeping household consumption and corporate activity afloat. Moreover, measures to prevent workers moving to the informal sector or dropping below the tax return threshold as a consequence of the pandemic could also have helped mitigate the shrinkage of the tax base. Another key explanation for the divergence of developing countries and high-income countries is the former's relatively low reliance on direct taxes due to tax collection issues. To a lesser extent, the drop in revenue in developing countries is also due to their comparatively greater reliance on temporary tax and payment relief measures in response to the crisis. Temporary tax and payment relief measures accounted for 15% of developing countries' COVID-19 fiscal packages, compared to just a 1% share of the packages of high-income countries (Oxford University Economic Recovery Project, 2021<sup>[133]</sup>).

**Figure 2.10. Developing countries experienced a historic drop in tax-to-GDP ratios due to the COVID-19 crisis**



Note: Unweighted averages are calculated for a sample of 105 developing countries. Regional groupings are South Asia (SA), sub-Saharan Africa (SSA), East Asia and Pacific (EAP), Middle East and North Africa (MENA), Latin America and the Caribbean (LAC), and Europe and Central Asia (ECA). Tax revenue includes social contributions.

Source: Authors based on OECD (2022<sup>[134]</sup>), *Global Revenue Statistics Database*, [https://stats.oecd.org/Index.aspx?DataSetCode=RS\\_GBL](https://stats.oecd.org/Index.aspx?DataSetCode=RS_GBL); IMF (2022<sup>[135]</sup>), *World Revenue Longitudinal Data (WoRLD)* (database), <https://data.imf.org/?sk=77413f1d-1525-450a-a23a-47aeed40fe78&sid=1390030341854>; UNU-WIDER (2021<sup>[136]</sup>), *GRD - Government Revenue Dataset*, <https://www.wider.unu.edu/project/grd-%E2%80%93-government-revenue-dataset>.

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**In developing countries, non-tax revenue remained more stable on average than tax revenue.** According to data from the United Nations University World Institute for Development Economics Research for a sample of 48 developing countries, non-tax revenue dropped by 3.3% between 2019 and 2020, while

total government revenue dropped 8.4% and GDP dropped 1.8% (UNU-WIDER, 2021<sup>[136]</sup>). These figures mask wide differences across income groups, with non-tax revenue down by 13.7% in UMICs, for example, and by 1% in LICs but up by 0.6% in LMICs. However, the values of non-tax revenue in 2020 remained close to or higher than 2018 levels across all income groups. Non-tax revenues are easier to collect and not affected by high levels of informality, as is often the case for tax revenues, and thus represent a sizeable source for developing countries. However, as non-tax revenues are often linked to economic activity, they also are subject to greater volatility. The greater volatility would explain the particularly significant drop in non-tax revenue in UMICs, since their exposure to global markets is higher, as explored in Chapter 1.

**The pandemic has strengthened the need for digitalisation of tax administration to enable resilience in tax collection and ensure that e-commerce is effectively taxed.** The pandemic has increased the urgency for tax administrations to digitalise. While some developing countries have digitalised their tax systems, further support is needed to reap the full benefits of implementation of the digital transformation of their tax administrations. Digitalisation of tax administration not only offers greater ease of use to taxpayers. It also reduces opportunities for corruption, increases the ease of data analysis to identify avoidance and evasion, and can improve the efficiency of tax administrations. The process of digitalisation presents a number of challenges related to the technology itself as well as to the change management process and the education of taxpayers on the new systems. [Supporting the Digitalisation of Developing Country Tax Administrations](#) (OECD, 2021<sup>[137]</sup>) examines the common elements of successful digitalisation. In addition, the OECD [Digital Transformation Maturity Model](#) (OECD, 2020<sup>[138]</sup>) provides a tool for countries to self-assess their current level of maturity and facilitate future strategy development. There is also largely untapped revenue potential from the rapid growth of e-commerce. For example, the African e-commerce market is already worth USD 27 billion and expected to grow by around 13% a year to reach USD 46 billion by 2025 (OECD, 2021<sup>[139]</sup>). As most African countries have not yet updated their value-added tax (VAT) rules to account for digital trade, they are missing out on significant tax revenues. International standards for VAT on e-commerce provide a proven tool to effectively levy VAT on the sector. A series of regional toolkits – for LAC (OECD et al., 2021<sup>[37]</sup>); Asia-Pacific (OECD/WBG/ADB, 2022<sup>[140]</sup>); and Africa (OECD/WBG, forthcoming<sup>[117]</sup>) – are being produced to help countries in the process of implementing these standards as part of VAT reform. There are broader challenges with how to effectively levy corporation tax in a digitalised global economy. The historic developments in this area are discussed in subsection 2.4.1.

### ***2.3.2. Domestic private investment can play an essential role in countries' resilience to external shocks, but it remains scarce in many developing countries***

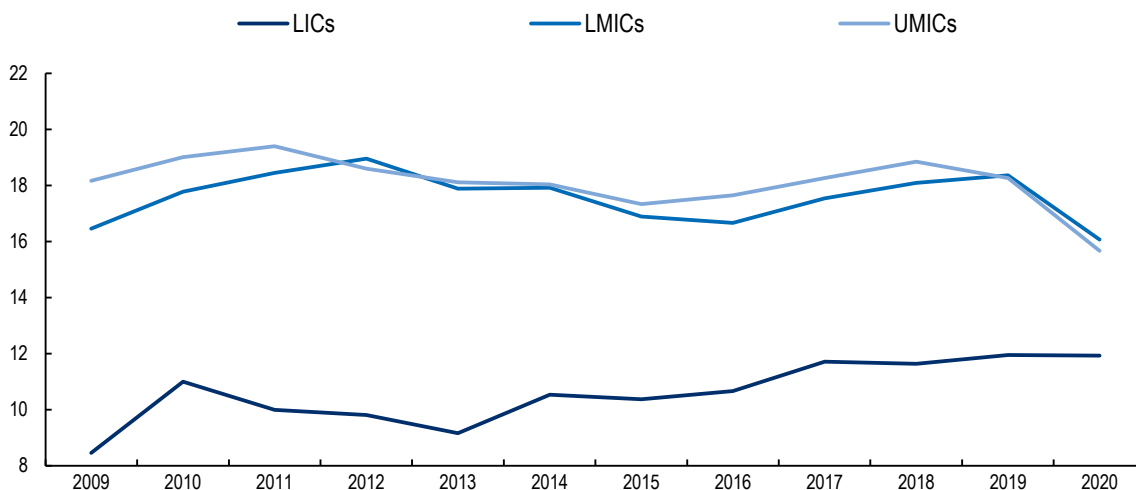
**Domestic savings are a key determinant of economic growth and long-term sustainable development.** Research suggests that domestic savings by households, corporates and governments are positively correlated with investment levels (Tagem and Kunal, 2021<sup>[141]</sup>). As a source of finance for investment, domestic savings can also reduce countries' vulnerability to sudden drop-offs in international capital flows and effectively insulate countries against certain external shocks.

**The pandemic led to a decrease of gross domestic savings in middle-income countries (MICs) after several years of increases across all income groups.** Between 2015 and 2017, domestic savings increased across all income groups, growing by 13% in LICs, 4% in LMICs and 5% in UMICs (Figure 2.11). Their performance was mixed over the next two years, with domestic savings reaching a plateau in LICs and, after three consecutive years of growth, decreasing in UMICs between 2018 and 2019. In 2020, the pandemic led to a sharp drop of domestic savings in MICs in large part due to increased government spending, which offsets potential increases in household and corporate savings. In LICs, where the fiscal response of governments was limited, domestic savings remained stable in 2020, although their low levels (at around 12% of GDP) remain largely insufficient to reduce these countries' dependence on external financing sources.



**Figure 2.11. Gross domestic savings declined significantly in middle-income countries and plateaued at low levels in low-income countries**

Average gross domestic savings as % of GDP (2009-20), by income group



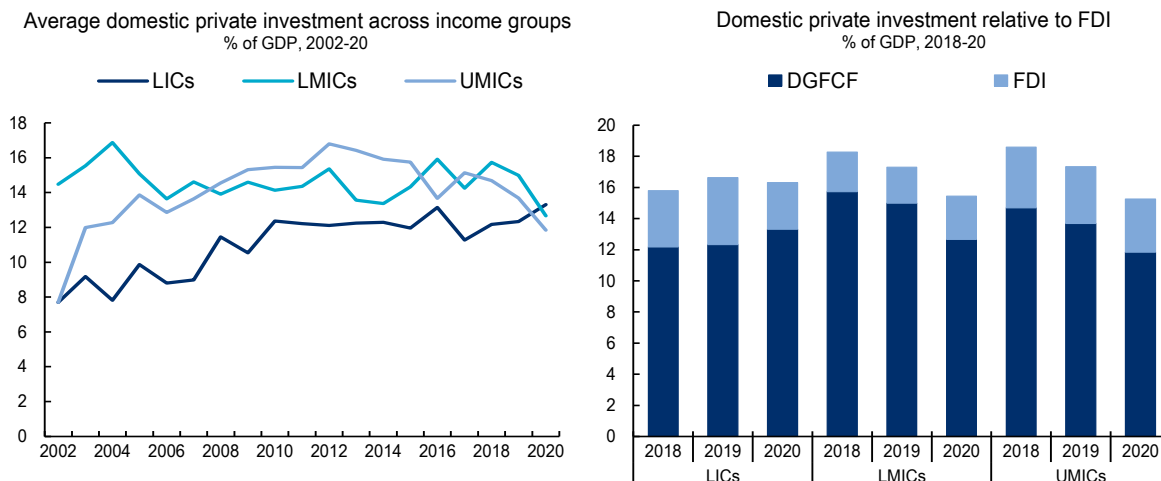
Note: Unweighted averages are calculated for a sample of 106 developing countries.

Source: Authors based on World Bank (2022<sub>[19]</sub>), *World Development Indicators* (database), <https://datacatalog.worldbank.org/dataset/world-development-indicators>.

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**MICs experienced a shock to levels of domestic private investment.** Domestic private investment is a critical financing source for all developing countries. In 2020, the volume of domestic gross fixed capital formation (DGFCF), used in Figure 2.12 as a proxy for domestic private investment in developing countries, was more than four times the volume of FDI. Between 2019 and 2020, domestic private investment decreased by 15.5% and 13.5%, respectively, in LMICs and UMICs (Figure 2.12, left side), accelerating a pre-existing downward trend. The implementation of containment measures to limit the spread of the coronavirus had a severe impact on economic activity in MICs, resulting in a drop in investment in fixed assets. In LICs, however, domestic private investment continued its long-term upward trend, reaching a 20-year peak in 2020.

**Figure 2.12. Domestic private investment, a key financing source for developing countries, has declined, especially in middle-income countries**



Note: Unweighted averages calculated for a sample of 46 developing countries. Domestic private investment (shown as DGFCF on the right side) is proxied by private gross fixed capital formation minus FDI. It should be noted that FDI may not accurately represent the foreign component of gross fixed capital formation.

Source: Authors based on World Bank (2022<sup>[119]</sup>), *World Development Indicators* (database), <https://datacatalog.worldbank.org/dataset/world-development-indicators>; IMF (2022<sup>[20]</sup>), *Balance of payments* (database), <http://data.imf.org/bop>.

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**There is still little evidence available on the role played by public development banks (PDBs) to support long-term investment in developing countries during the COVID-19 crisis.** PDBs of developing countries are important actors in these countries' FSD landscape. PDBs and development finance institutions from developing countries excluding China held total assets amounting to USD 1.4 trillion in 2020. Although significant, these assets represent only 6.2% of the total assets held by PDBs worldwide (including multinational PDBs and development finance institutions) (Xu, Marodon and Ru, 2021<sup>[69]</sup>). Moreover, while early research suggests that the PDBs of several developing countries played an important countercyclical role in the first year of the COVID-19 pandemic (McDonald, Marois and Barrowclough, 2020<sup>[142]</sup>), a thorough assessment of their contribution to the crisis response is not yet complete.

## 2.4. The risk of growing imbalances in the financing for sustainable development landscape has increased over the medium to long term

### 2.4.1. The financing outlook remains grim for developing countries

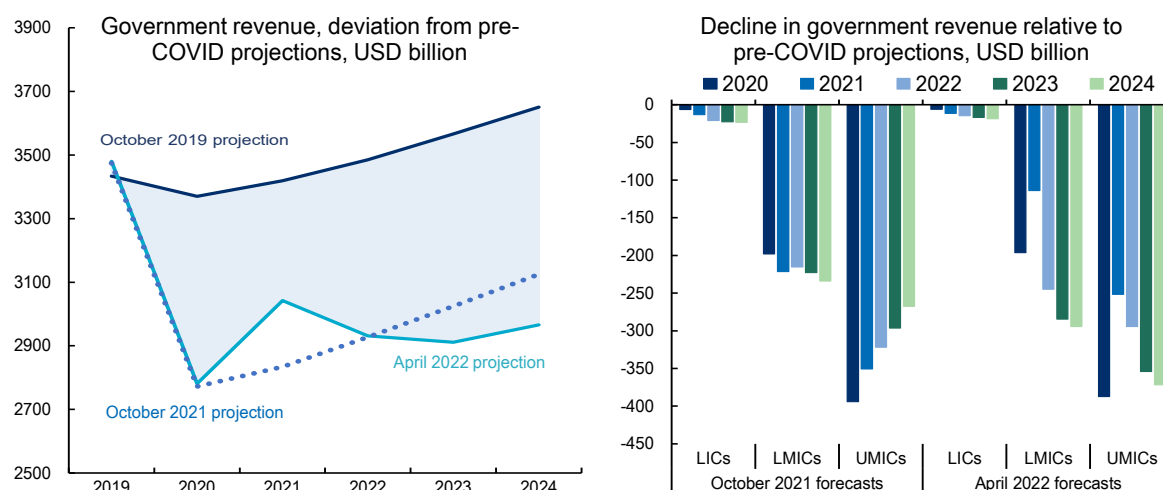
**The recovery of the FSD landscape from the COVID-19 crisis could be short-lived due to a tightening of global financing conditions and the impact of the war in Ukraine.** While developing countries' financing sources experienced a nascent recovery in 2021, the gradual withdrawal of policy support measures and heightened global uncertainty generated by Russia's full-scale invasion of Ukraine weigh on developing countries' financing prospects. This deteriorated global context is exerting downward pressures on private financing flows to developing countries and translating into new risks and growing imbalances in the FSD landscape. At the same time, successive crises are putting external public finance

under pressure. As a result of Russia's aggression against Ukraine, additional financing is needed to address the humanitarian emergency and cover in-donor refugee costs. However, increasing the allocation of aid to crisis response poses a risk that resources may be diverted from longer-term development priorities, including investments necessary for a just and sustainable recovery. Taking into consideration the expected tightening of global financing conditions, projections by the UN Conference on Trade and Development and the IMF suggest that the SDG financing gap could reach USD 4.3 trillion per year from 2020 to 2025, an increase of USD 400 billion over OECD estimates in 2019-20 (UNCTAD, 2022<sup>[25]</sup>). This section examines the outlook for the FSD landscape.

*Successive crises, including Russia's war in Ukraine, could stifle the government revenue of developing countries for years to come*

**The stifled recovery is lowering government revenues and increasing debt servicing costs, which impede financing for the SDGs over the long term.** Developing countries' government revenue is expected to remain almost 20% below pre-pandemic projections into the foreseeable future (Figure 2.13, left side). Russia's full-scale invasion of Ukraine upended pre-war projections of a slow but steady recovery of developing countries' government revenue. At the current pace of recovery, government revenue may not reach pre-pandemic levels before 2030. Government revenue now is expected to decrease in 2022 and 2023, with MICs particularly affected (Figure 2.13, right side). Projections for 2022-24 for MICs suggest government revenue decline will amount to about USD 95 billion annually in the current geopolitical and economic context. Box 2.2 looks at the potentially severe repercussions for developing countries with limited government revenue of rising external debt service costs to self-finance long-term SDG strategies.

**Figure 2.13. The war in Ukraine stopped the recovery in government revenue in developing countries and will result in a durable shortfall in government revenue**



Note: The grey area in the chart on the left represents the drop in the projected volume of government revenue due to the successive crises. The chart on the left also shows the deviation of government revenue from pre-pandemic projections for all developing countries excluding China.

Source: Government revenue projections are drawn from the IMF World Economic Outlook databases: (IMF, 2019<sup>[26]</sup>), *World Economic Outlook - October 2021 edition* (database), <https://www.imf.org/en/Publications/WEO/weo-database/2019/October>; (IMF, 2021<sup>[27]</sup>), *World Economic Outlook - October 2021 edition* (database), <https://www.imf.org/en/Publications/WEO/weo-database/2021/October>; (IMF, 2022<sup>[28]</sup>), *World Economic Outlook - April 2022 edition* (database), <https://www.imf.org/en/Publications/WEO/weo-database/2022/April>.

### Box 2.2. Rising external debt service costs relative to total government revenue jeopardise countries' ability to invest in long-term development goals

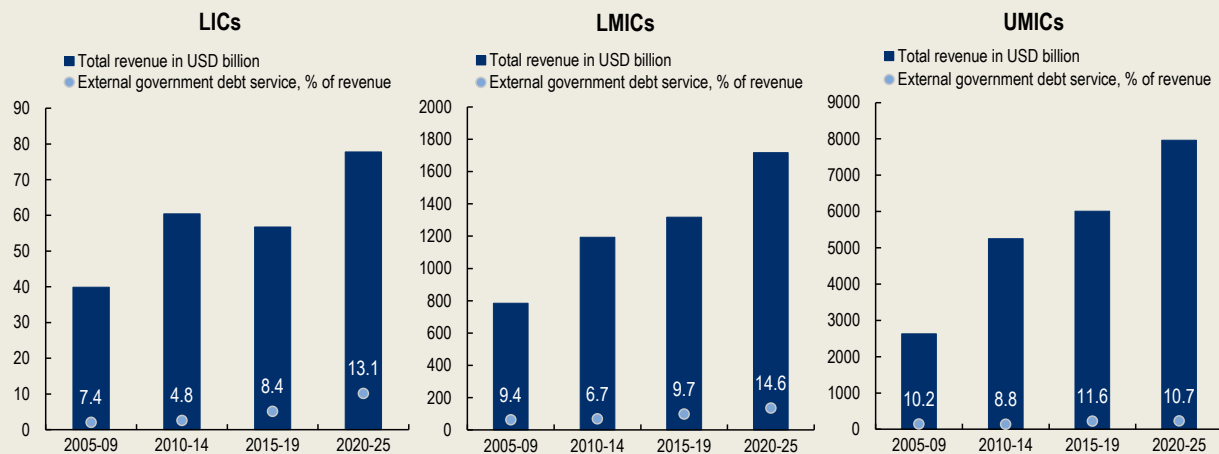
**Developing countries face a “wall of debt service repayment” that could have enormous impacts on their debt sustainability and fiscal space** (UNCTAD, 2020<sup>[29]</sup>). The average public and publicly guaranteed (PPG) external debt service ratio to total government revenue is expected to reach its highest level in 2020-25 across all income groups. PPG external debt service could represent 13.1% of government revenue in LICs, 15% in LMICs and 11% in UMICs (Figure 2.14). This sudden increase resulted from the simultaneous drop in government revenue and increase in external debt service. While the DSSI offered the 73 eligible LICs a welcome but temporary respite in 2020, it did not provide a long-term solution for developing countries' debt solvency issues. Developing countries also accumulated large amounts of short-term debt during the pandemic that require repayment or refinancing by 2024.

**A considerable share of domestic resources in developing countries could be diverted from public spending to service external debt.** The accumulation of short-term debt during the COVID-19 crisis and the worsening global economic outlook foreshadow an increase in the cost of debt service. External debt service for developing countries could amount to USD 387 billion in 2022. Between 2020 and 2025, it is projected to reach USD 375 billion on average, already a jump from the USD 330 billion on average between 2015 and 2019. Besides the risk of debt distress mentioned in Chapter 1, the rise in debt service costs also affects the available revenue that countries can invest in their long-term development goals. This implies that future improvements in DRM may yield lower returns in terms of development impact since a substantial share of the new revenue may have to be used to service debt rather than carry out productive investments.

**In many developing countries, debt service already surpasses government expenditure in key SDG sectors.** Even before the COVID-19 pandemic, one in eight developing countries spent more on debt service than on health, education and social protection combined (UNICEF, 2021<sup>[143]</sup>). The higher borrowing costs faced by developing countries may also prevent them from effectively investing in a fair and sustainable recovery. A recent study, noting the importance of low financing costs to accelerate the energy transition in developing countries, found that nominal financing costs are currently up to seven times higher in developing countries than in the United States and Europe (IEA, 2021<sup>[74]</sup>).


**Figure 2.14 Debt service takes up a sizeable share of government revenue in low-income and lower middle-income countries and will not return to pre-pandemic levels by 2022**

Aggregate external debt service as a proportion of total government revenue, by income group



Note: Averages are calculated for a sample of 134 developing countries. Debt service is measured on PPG external debt. Total revenue includes social contributions and grants. Aggregate values for 2020 to 2025 are based on IMF country estimates.

Source: Authors based on IMF (2021<sup>[27]</sup>), *World Economic Outlook – October 2021 edition* (database), <https://www.imf.org/en/Publications/WEO/weo-database/2021/October>; World Bank (2022<sup>[53]</sup>), *International Debt Statistics* (database), <https://databank.worldbank.org/source/international-debt-statistics>; and IMF (2022<sup>[144]</sup>), *IMF Article IV Staff Reports*, <https://www.imf.org/en/Publications/SPROLLs/Article-iv-staff-reports#sort=%40imfdate%20descending>.

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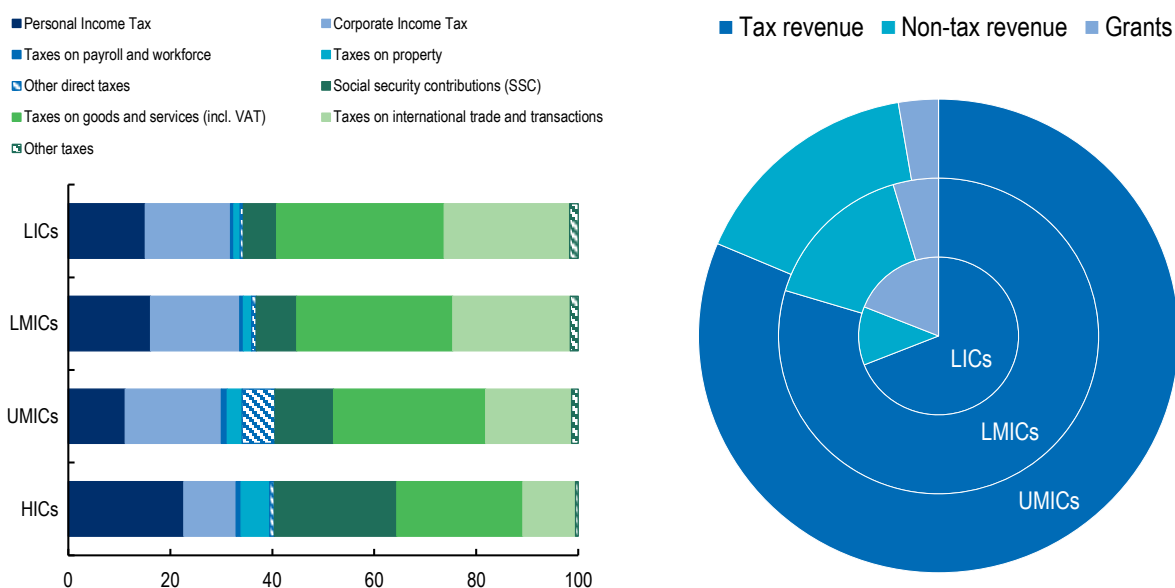
**Dwindling government revenues could limit developing countries' redistributive capacities, further fuelling inequalities.** Government revenue is a key enabler of the provision of social protection and public services. Reliable levels of tax revenue are also crucial for long-term policy planning. Therefore, developing countries faced with adverse shocks that ultimately translate to steep declines in tax revenues may struggle to maintain the quantity and the quality of their public services. The fraction of the population at the bottom of the income distribution could be the most affected as they are most dependent on the provision of social protection and public services, such as access to health or education.

**The characteristics of developing countries' tax structures could hinder the implementation of more equitable taxation policies.** The capacity of tax systems to reduce inequality is partly design-dependent, with tax progressivity and limited use of tax expenditures being relevant features. For instance, an over-reliance on indirect taxes (without compensatory transfers) can increase income inequality because these require low-income households to pay more as a share of their income than high-income households for the same taxed good or service. Indirect taxes, such as tax on goods and services and tax on international trade and transactions, play a prominent role in developing countries, with taxes on goods and services constituting on average 30% of total government revenue in UMICs, 31% in LMICs and 33% in LICs (Figure 2.15). By comparison, these taxes make up on average 25% of total government revenue in OECD countries. Income taxes, especially personal income tax, also offer much scope to increase government revenue in developing countries, as they now make up a smaller share (by 6 to 11 percentage points) of total tax revenue than in high-income countries. Such taxes would also improve distributional outcomes so long as progressive schedules are implemented. With regard to social security contributions, the gap is even wider and translates into weaker social protection systems in developing countries, a


vulnerability that is especially relevant in light of the impact of recent successive crises. Low personal income tax capture and low social security contributions are in part a reflection of low tax collection capacity and high informality in developing countries and demonstrate how the reform of tax structures can be a challenging process. Alternatively, insofar as indirect taxes remain an effective and prominent source of revenue, stronger ex post redistribution policies can be designed to address equity concerns.

**Figure 2.15. Government revenue structure differs across income groups, with potentially large implications for income redistribution**

Revenue components as % of total tax and government revenue, respectively, 2019, by income group



Source: Authors based on (for left side) OECD (2022<sup>[134]</sup>), *Global Revenue Statistics Database*, [https://stats.oecd.org/Index.aspx?DataSetCode=RS\\_GBL](https://stats.oecd.org/Index.aspx?DataSetCode=RS_GBL) and on (for right side) UNU-WIDER (2021<sup>[136]</sup>), *GRD - Government Revenue Dataset*, <https://www.wider.unu.edu/project/grd-%E2%80%93-government-revenue-dataset>.

StatLink  <https://stat.link/yolcq3>

**In addition to government revenue mobilisation, developing countries will continue to rely on fiscal policies to shield vulnerable populations from the impacts of crises.** The COVID-19 pandemic showed the importance of government revenue as a key financing source to both sustain the economy during adverse shocks and offer a social safety net to the population in times of crises. Some developing countries that are directly affected by the war in Ukraine due to their geographical proximity may require additional spending to deal with refugee inflows and disrupted trade and supply chains. Even countries not directly affected by the war are very likely to suffer from negative spillovers such as increased energy and food prices, supply shortages, and a slowdown of global economic activity that may lower government revenue.

**In the context of rising food and energy prices, fiscal measures should aim to protect the population and ensure affordable access to low and zero carbon options.** Several developing countries – among them, India, Nigeria and South Africa – have increased or implemented fuel tax cuts or subsidies to shield the population from price increases in an attempt to alleviate poverty and ensure access to basic goods and services. Unless targeted at the most vulnerable households, these measures may

increase inequality as they disproportionately benefit the households that spend more on fuel and food. Furthermore, the sizeable increase in foregone revenue may constrain long-term planning to sustain the quantity and quality of public services offered to the population. On top of the equity concerns, the context of high fuel prices is challenging recent progress in environmental taxation, which contributes to DRM while fighting climate change and air pollution (OECD, 2021<sup>[88]</sup>). In addition, non-tax revenue exceeds tax revenue for some commodity exporters, especially oil-rich countries (Ivanhoe, 2000<sup>[145]</sup>). Without effective policies to phase out fuel and other environmentally harmful subsidies in the medium term while also generating sufficient public revenues, governments could be forced to choose between reducing inequalities and a green transition.

**International tax reforms may yield additional revenues as well as encourage much-needed reform of tax incentives.** In October 2021, members of the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting, or BEPS, among them more than 60 developing countries, reached a landmark agreement on the two-pillar solution to the tax challenges of the digitalising economy. This agreement on a new approach to ensure that the profits of the largest and most profitable companies are reallocated to the jurisdictions where their consumers are located (Pillar One), together with the establishment of a global minimum corporate income tax of 15% (Pillar Two), mark the biggest change in international corporate income tax in a century. Pillar One is expected to lead to the reallocation of more than USD 125 billion of profit to market jurisdictions each year. Pillar Two is expected to generate about USD 150 billion in additional annual tax revenues globally. Developing countries have been integral to the negotiations, and though developing countries did not achieve everything they had hoped for in the negotiations, the deal contains a number of features that respond to the concerns expressed by developing countries (OECD, 2021<sup>[87]</sup>). The final rules are still being determined and developing countries will need substantial assistance in the coming years to support their implementation. The global minimum tax of 15% may encourage countries to review their tax incentive regimes, as incentives that reduce taxes below the new global minimum will result in effectively gifting revenues to the countries where the multinational enterprises are headquartered. While the priority will be to reform incentives offered to these enterprises in scope for the global minimum tax, countries may take the opportunity to look at more fundamental reforms of tax incentives regimes, which have become a major challenge in many developing countries (Box 2.3).

### Box 2.3. Building an Investment Tax Incentives database

**Tax incentives for investment are frequently used across the world.** Tax incentives are targeted tax provisions that provide favourable deviations from the standard tax treatment in a country. They have the potential to promote investment, with positive effects on output, employment and productivity and on other objectives related to the SDGs. If poorly designed, though, tax incentives may be of limited effectiveness and could result in windfall gains for projects that would have taken place in the absence of the incentive. Tax incentives can also reduce revenue-raising capacity, create economic distortions, increase administrative and compliance costs, and potentially increase tax competition. Striking the right balance between an efficient and attractive tax regime for domestic and foreign investment, on one hand, and securing the necessary revenues for public spending and development, on the other, is a particular concern in developing countries.

**The wide use of tax incentives globally, along with concerns about their net impact, are also an important policy concern for national governments and the international policy community.** Recent OECD work improves insights into tax incentive policies and increases the policy relevance of tax incentive analysis, with the objective of helping policy makers make smarter use of tax incentives and reform inefficient ones.

**The OECD Investment Tax Incentives database systematically compiles quantitative and qualitative information on the design and targeting of corporate income tax (CIT) incentives across developing and emerging economies using a consistent data collection methodology.** As illustrated in Figure 2.16, the database includes information along three dimensions for each tax incentive: instrument-specific design features, eligibility conditions and legal basis. As of July 2021, the database covered 36 developing countries in Eurasia, MENA, Southeast Asia and sub-Saharan Africa.

Figure 2.16. Key dimensions of the OECD Investment Tax Incentives database

A. Design features	B. Eligibility conditions	C. Legal basis
How does the tax incentive reduce taxation?	Which investors and projects qualify for the tax incentive?	How is the tax incentive governed?
e.g. tax incentive instrument, if temporary tax exemption then length in years, reduced CIT rate, sunset clause	e.g. sector conditions, location conditions, outcome conditions, investment size conditions	e.g. legal provision introducing the tax incentive, granting authority

The first descriptive statistics based on information from the 36 countries show that tax incentive designs are multidimensional, complex, and often specific to a certain sector, region or investor within a country. Complex features may be a sign that countries are adjusting tax incentive designs to specific contexts. This may improve policy making, for example by improving the effectiveness of incentives or limiting foregone revenue. However, complexity also reduces transparency and can create unintended effects.

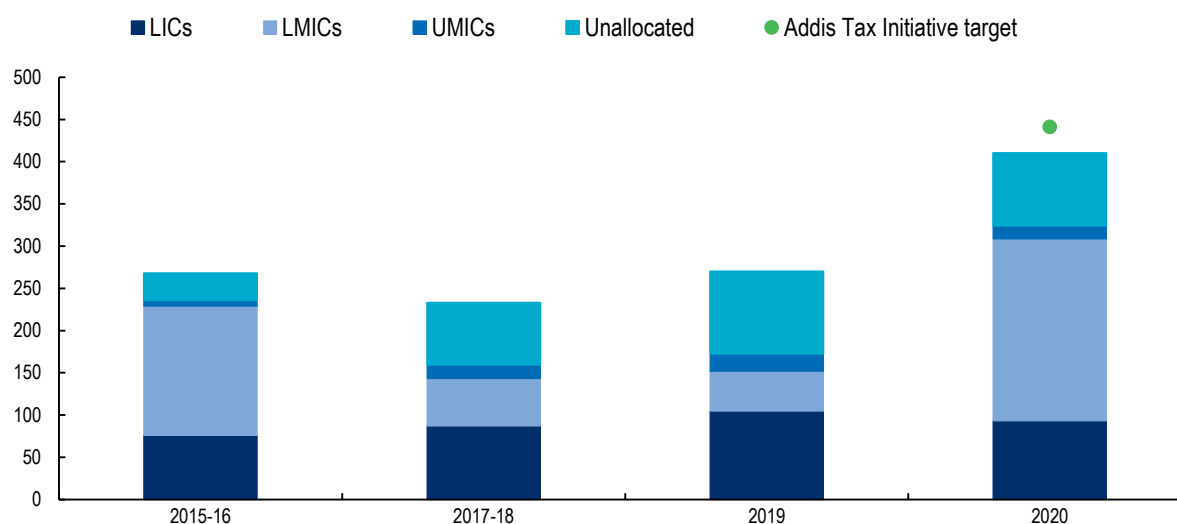
Source: Celani, Dressler and Wermelinger (2022<sup>[146]</sup>), "Building an Investment Tax Incentives database: Methodology and initial findings for 36 developing countries", <https://doi.org/10.1787/62e075a9-en>.



**Donor support to DRM has increased, yet it falls short of commitments to assist developing countries to strengthen their tax base and increase tax compliance.** Between 2015 and 2020, DAC members invested approximately USD 1.9 billion in ODA for DRM, which corresponds to an average of USD 310 million per year (Figure 2.17). In 2020, DAC members' ODA in support of DRM nearly doubled compared to 2019, reaching a record high of USD 410 million. This rise, however, was mainly driven by disbursements in a few countries. When a single large disbursement by the EU for a DRM project in Indonesia is removed from the analysis, gross disbursements in 2020 are seen to have decreased across all income groups. Despite the progress made and according to the data reported in the Creditor Reporting System, this is still far from the target set by the Addis Tax Initiative to double ODA to DRM in the period 2015-2020 to USD 441.1million (2020<sub>[64]</sub>).

**Figure 2.17. Official development assistance in support of domestic resource mobilisation rose considerably in 2020**

Gross ODA disbursements from DAC countries for DRM, 2020, USD million



Note: ODA for DRM is based on amounts reported under the purpose code 15114 (domestic resource mobilisation) of the OECD Creditor Reporting System. The Addis Tax Initiative set a global target (horizontal line in the graph) for 2020 of USD 441.1 million of DRM co-operation for country-owned tax reforms. The increases in 2016 and 2020 are largely driven by the disbursements to Indonesia totalling USD 123 million in 2016, or an increase of 3.61%, and USD 176 million in 2020, or up 3.43%. The values for 2015-16 and for 2017-18 are simple averages of the annual values. Considering all bilateral and multilateral official donors, total ODA for DRM reached a record high in 2020, doubling, and crossing the USD 1 billion mark, the 2019 ODA for DRM total of USD 519 million.

Source: OECD (2022<sub>[130]</sub>), *Creditor Reporting System* (database), <https://stats.oecd.org/Index.aspx?DataSetCode=crs1>.

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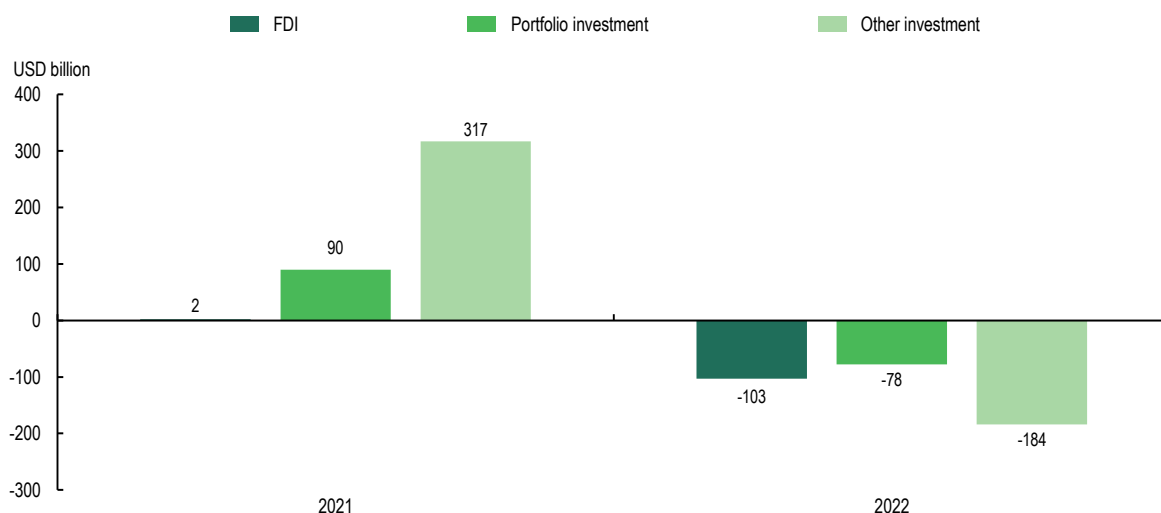
*Fragile investor sentiment and deteriorated credit conditions will continue to weigh on private finance in the medium to long term*

**Following a rebound of cross-border capital flows to developing countries in 2021, a new drop is projected for 2022.** Non-resident capital flows to developing countries excluding China rebounded to reach USD 1.011 billion in 2021, a 67% increase relative to 2020 (Institute of International Finance, 2022<sub>[31]</sub>). This increase was driven by a recovery in portfolio flows and by the issuance of IMF SDRs, which account for about half of the volume of investments other than FDI and portfolio investment in developing countries excluding China in 2021. However, estimates for 2022 suggest that the recovery of cross-border

capital flows will be short-lived. Portfolio investment and other investment are expected to decline by 50% and 45%, respectively, in 2022 while FDI is projected to drop by 23% (Figure 2.18).

**Expectations of monetary tightening and emergent headwinds in the global economy contribute to the bleak outlook for capital flows in 2022.** Even before the start of Russia's war against Ukraine, projections of capital flows to developing countries for 2022 pointed to a fall stemming from slower growth and incipient inflationary pressures. The recovery of FSD flows could be further constrained by recent geopolitical turmoil generated by the Russian invasion, which adds to the uncertainty and volatility in financial markets. Ultimately, these could erode investor confidence and spur another wave of capital flight from developing countries.

**Figure 2.18. The threat of macroeconomic turbulence could hinder the recovery of cross-border capital flows to developing countries**



Note: Values for 2022 are forecasts.

Source: Institute of International Finance (2022<sup>[31]</sup>), *Capital Flows Report May 2022: Rising Global Recession Risk*, <https://www.iif.com/Research/Capital-Flows-and-Debt/Capital-Flows-to-Emerging-Markets-Report>.

StatLink  <https://stat.link/7c1uz9>

**Weaker credit conditions may also hamper developing countries' ability to access finance needed for their long-term recovery from the COVID-19 crisis.** Due to their weak macroeconomic fundamentals, downgraded credit ratings and shallow domestic debt markets, many developing countries may struggle to borrow from capital markets in coming years (OECD, 2022<sup>[11]</sup>). Tightening of global financing conditions and the impact of the war in Ukraine resulted in downward revisions to global growth forecasts and accelerated inflationary pressures. As a result, developing countries are facing higher borrowing costs, as demonstrated by the increase in sovereign bond yields observed in the first semester of 2022. The rise in global interest rates could add to the cost of borrowing as investors are likely to ask for higher interest on government bonds.

**Constrained access to credit and larger refinancing needs expose developing countries to rollover risks and could ultimately lead to sovereign defaults.** As a result of issuing a large volume of short-term debt in 2021 to respond to the COVID-19 emergency, developing countries face high amounts of debt that are due to be repaid or refinanced in the short term. With 45% of their outstanding debt maturing by 2024 (against 36% for all developing countries), LICs are particularly exposed to rollover risk (OECD,

2022<sup>[11]</sup>). These risks, compounded by higher borrowing costs, increase the likelihood of new debt crises in the medium to long term. Chapter 3 examines another aspect – the barriers to access the sustainable finance market due to spiralling debt and sovereign downgrade and/or defaults and climate-related vulnerabilities.

**The current limitations of the Common Framework for Debt Treatments beyond the DSSI add to the growing concerns about the sustainability of developing countries' sovereign debt.** The Common Framework for Debt Treatments announced by the G20 in November 2020 to deal with countries' insolvency and protracted liquidity problems has not produced the expected results (Ahmed and Brown, 2021<sup>[30]</sup>). Only three countries – Chad, Ethiopia and Zambia – have so far requested the treatment of their debt under the Common Framework, a reflection of the fear of other countries that participation in the initiative may impact market access. The participation of non-Paris Club members in the Common Framework is a welcome development due to the shift in the creditor base of developing countries observed in recent years, with emerging creditors such as China taking on increased weight. However, the slow pace of progress observed in the debt treatment of the three participating countries raises questions about the capacity of the initiative to confront a larger wave of debt treatments in the future. In addition, the Common Framework's restrictive focus on DSSI-eligible countries means that MICs facing debt distress still face the threat of disorderly defaults, as was the case with Sri Lanka, which defaulted in May 2022 (Parkin and Cornish, 2022<sup>[147]</sup>). Looking ahead, official providers and creditors, including international financial institutions and bilateral development partners, will need to make special efforts to strengthen the debt resilience of developing countries and avoid further credit rating downgrades and sovereign defaults.

#### **2.4.2. Financing for sustainable development leakages continue to deprive developing countries of considerable resources**

*The risk of increased leakages from illicit financial flows adds to the grim financing outlook*

**Even before the COVID-19 crisis, illicit financial flows (IFFs) were increasing the SDG financing gap.** Although IFFs are difficult to measure accurately because they are illicit and because there are so many different definitions of the concept, existing estimates indicate that these flows are of sufficient magnitude to contribute substantially to the SDG financing gap in developing countries. The IMF estimates that the annual cost of bribery alone is between USD 1.5 trillion and USD 2 trillion globally (IMF, 2016<sup>[32]</sup>). However, estimates of the amounts lost to bribery, corruption, theft and tax evasion in developing countries remain challenging to determine. Current efforts to develop and test a conceptual framework to define, measure and quantify IFFs may help bring some consistency and can help encourage improved data availability, an important asset in evaluating policy action to curb IFFs.

**COVID-19 may have widened pre-existing loopholes in the global financial system and reduced oversight due to emergency spending.** The timely response to the pandemic led to the temporary relaxation or suspension of administrative controls and accountability mechanisms in some countries. This increased the risk of corruption via three different channels: procurement for critical healthcare resources such as personal protective equipment, income support to individuals and fiscal support to the private sector (OECD, 2020<sup>[148]</sup>). An increase in IFFs could lead to further deterioration in the capacity of the health sector, which was already estimated to lose USD 455 billion per year to fraud and corruption worldwide prior to the pandemic (Mackey, Vian and Kohler, 2018<sup>[149]</sup>). By September 2020, 19 prominent cases of already been identified globally, with the lost funds reliably estimated to total USD 1.1 billion, or the equivalent of 50 000 ventilators (Transparency International, 2020<sup>[150]</sup>).

**IFFs not only deprive countries of resources for FSD but can also undermine trust in the government and public institutions.** While reduced revenues for governments and reduced domestic capital for investment are their most obvious impacts, IFFs can also have spillover effects. Corruption and lack of trust in public institutions that tolerate or appear unable to stop IFFs can negatively impact tax

morale (i.e. the intrinsic willingness to pay tax), thereby further eroding a country's tax base, and undermine trust in institutions more broadly (OECD/ILO, 2019<sup>[45]</sup>). The economic, equity and stability effects of IFFs are particularly pronounced in highly vulnerable countries – that is, developing countries already grappling with chronic poverty, fragility and episodic conflict. By corroding fiscal and regulatory capabilities and empowering those operating outside the law, IFFs also undermine the rule of law, with negative security and social impacts. In the Democratic Republic of the Congo, for example, approximately 98% of the net profits from illegal exploitation of natural resources, particularly gold, charcoal and timber, flow to transnational organised crime networks operating in and outside of the country. People smuggling, which has become the dominant illicit activity across the Sahel, has enormous human and social costs yet generates IFFs amounting to more than USD 100 million for criminal networks in the region year on year (OECD, 2018<sup>[151]</sup>).

**IFFs act as a reverse distribution mechanism, reinforcing economic and social inequalities and hindering progress towards the SDGs.** IFFs also contribute to within-country inequality as they constrain the resources available to provide high-quality public services, which households with lower incomes tend to benefit the most from. Additionally, IFFs may increase the price that citizens pay to obtain certain public goods and services or reduce the offer of such goods and services. Over the long term, IFFs may also undermine international investors' confidence in a country by fostering uncertainty in the business environment and reducing domestic agency to shape the country's future.

**While global estimates of the scale of IFFs help highlight the importance of tackling the problem, IFFs are country specific and require country-level analysis and targeted policy actions.** The economic, policy and institutional environment of a country will determine both its IFF risk and the actual IFF volume, and these may vary significantly across countries; for example, there appear to be increased risks of IFFs in commodity-exporting sectors (Porter and Anderson, 2021<sup>[152]</sup>). As such, more actionable insights on the policy responses needed are more likely to emerge from country-level analysis. A recent OECD (2022<sup>[153]</sup>) study of IFFs and tax compliance in South Africa uses foreign financial account data provided to South Africa under automatic exchange of information as well as data from voluntary disclosure programmes to quantify both the scale of non-compliant assets held offshore by South Africans – determined to be between USD 3.5 and USD 5 billion a year – and taxpayers' responses to global and domestic tax transparency initiatives.

**While countering IFFs requires country-specific actions, there are some common building blocks that can help countries identify and reduce their IFF risks.** Analytical capacity to identify IFF risks, as noted in the aforementioned OECD study of South Africa, is a key challenge in many countries. It is also vital to put in place frameworks for both international and domestic inter-agency co-operation. At the international level, exchange of information networks for tax purposes have grown dramatically since the global financial crisis, with new multilateral instruments for exchange on request as well as automatic exchange of information. Offshore tax investigations and voluntary disclosure programmes helped identify EUR 112 billion of additional revenue (EUR 30 billion for developing jurisdictions) since 2009 (OECD, 2021<sup>[154]</sup>). While progress has been strong on expanding international information exchange, this is limited to tax purposes. The multilateral treaties enabling exchange of information contain provisions to enable the information to be used for other purposes (e.g. for other financial crimes), but few countries have opted in to doing so. An initiative is under way in Latin America through the Punta Del Este Declaration to promote a wider use of information exchanged for other purposes than tax (OECD, 2018<sup>[155]</sup>).

**At the domestic inter-agency level, co-operation and exchange of information are also vital but often do not happen.** The OECD's Tax Crime Investigation Maturity Model is a useful tool to help jurisdictions understand where they stand in relation to implementing the Global Principles for Fighting Tax Crime, which set out essential legal, institutional, administrative and operational mechanisms necessary for fighting tax crimes and other financial crimes (OECD, 2020<sup>[156]</sup>). The OECD International Academy for Tax and Financial Crime Investigation also provides training for investigators, while the Tax Inspectors Without Borders criminal investigation programmes offer expertise to help countries build their investigative

capacity and provide support in real time on case resolution. Stepping up these global efforts to identify and tackle IFF risks could be instrumental to help developing countries significantly reduce their SDG financing gap.

*Inefficiency and poor prioritisation of public spending result in lower returns on SDG-related investments*

**Public spending inefficiency represents an important but often overlooked dimension of the SDG financing gap.** Recently, policy makers have shifted their public spending and procurement objectives to focus more on seeking to benefit from the potential financial gains of increased public spending efficiency and to harness such gains to achieve the SDGs (The Economic Intelligence Unit, 2020<sup>[157]</sup>). Public spending efficiency is necessary to maximise the development impact of limited investments in developing countries. Inefficient public spending can contribute to widening the SDG financing gap by requiring greater levels of investment to reach development targets. While reforms to strengthen governance, public investment and public financial management can be costly, they contribute to reducing the cost of future investments and can have positive spillover effects on other sectors of the economy, for example by allowing for improved co-operation and greater trust between government institutions and the private sector.

**SDG-related infrastructure investments are more costly in LICs due to low public spending efficiency** (Rozenberg and Fay, 2019<sup>[16]</sup>). Losses due to inefficient public spending across the SDGs could amount to USD 102 billion in LICs, USD 2.7 trillion in LMICs and USD 6.5 trillion in UMICs per annum (Cristóbal et al., 2021<sup>[33]</sup>). Estimates vary widely across countries and within income groups, suggesting that public spending efficiency is closely linked to a combination of domestic institutional factors and can be the consequence of many other structural weaknesses. Inefficiencies may also arise at different points of the investment process, such as during selection and procurement or in the project planning and design stages and may also affect some investment sectors or targets more than others.

**Losses due to spending inefficiencies are expected to increase as a result of the use of fast disbursement processes and the relaxation of controls during the COVID-19 pandemic.** Evidence from supreme audit institutions in Liberia and Sierra Leone following the Ebola epidemic found, among other things, cases of overpayments, underpayments, and pre-delivery and duplicate emergency payments that led to significant financial losses. Similar conclusions and insights have emerged from emergency humanitarian aid and disaster management audits across developing countries (INTOSAI Development Initiative, 2020<sup>[158]</sup>), with the scale and speed of the COVID-19 pandemic posing an even greater challenge. The pressure to ensure a timely response not only increased the risk of corruption and fraud but may have undermined accountability and transparency in policy making. For instance, the COVID-19 rescue and recovery packages that governments deployed during the pandemic have failed to provide sufficient reporting on implementation and auditing and have been deployed with only limited consultation with legislatures and the general public, particularly the groups most affected by the crisis (International Trade Union Confederation, 2021<sup>[113]</sup>).

**Looking ahead, careful prioritisation, accountability and transparency of public spending can increase the potential of public investment to narrow the SDG financing gap.** Given the differences in efficiency across objectives, reallocating resources from sectors with high efficiency and lower investment needs to sectors with relatively high efficiency and higher investment needs may lead to further progress in achieving the SDGs, as could redirecting investment in low-efficiency sectors to improve public investment management. Clear identification of high-impact services and targeted investments may prevent countries from overspending resources in other policy areas and from developing an all-encompassing approach that results in lower quality overall of the public services delivered. Furthermore, consultation processes with stakeholders involved can guide policy action by identifying the issues and

population groups in greatest need, while confidence and trust in the government through the existence of reliable accountability mechanisms strengthen institutions and thus increase policy effectiveness.

### **2.4.3. Sustained efforts from official providers will be critical to enable a just and sustainable recovery in developing countries**

**The bleak outlook for the major sources of FSD means that ODA could come under increased pressure.** The lower government revenue and the increased volatility of private finance expected in the next few years represent an added pressure on the ODA budgets of official providers. Transition finance analyses show that, in normal circumstances, the share of ODA in countries' financing mix tends to decrease as they develop over time (Piemonte et al., 2019<sub>[159]</sub>). However, the huge decline in government revenue and private investment resulting from the successive crises could hamper this tendency in the next few years. Between 2021 and 2024, the decline in government revenue from the COVID-19 crisis and the war in Ukraine could amount to USD 572 billion per year on average. This is more than three times the total amount of ODA extended in 2021 (OECD, 2022<sub>[160]</sub>).

**Looking ahead, ODA resources risk being spread too thinly to effectively respond to the cascading crises facing developing countries.** ODA remains the most stable and countercyclical source of FSD, particularly during crises. Preliminary 2021 ODA figures show a 4.4% increase in real terms, bringing DAC countries' total ODA to USD 178.9 billion (OECD, 2022<sub>[160]</sub>). However, global inflation is degrading the purchasing power of ODA. Compensating for this may stretch ODA resources at the same time that they are being called upon to respond to growing humanitarian and development challenges. These include the lingering effects of the COVID-19 pandemic, the consequences of the humanitarian emergency generated by the war in Ukraine, the emerging debt crises in developing countries, and the global health and climate crises. Recent analysis points to a likely spike of ODA levels in 2022 alongside a shift in spending patterns (OECD, 2022<sub>[128]</sub>). In coming years, the need for humanitarian spending could also increase to address the growing number and intensity of climate disasters, with the potential risk of diverting resources from broader investments in development (OECD, 2021<sub>[161]</sub>).

**In the near term, the protracted COVID-19 recovery and the humanitarian, economic and social repercussions of Russia's war against Ukraine are creating additional financing needs.** Russia's invasion cast a new shadow on global development prospects. The war has already resulted in more than 6 million people seeking refuge in neighbouring countries, with three DAC countries hosting more than two-thirds of the refugees (UNHCR, 2022<sub>[162]</sub>). In addition to its humanitarian impact, the war in Ukraine is indirectly affecting the recovery in other developing countries by fuelling a global increase in food and energy prices, supply chain disruptions, and lower economic growth. One study estimates that the combined effect of the COVID-19 pandemic and the war in Ukraine could lead to 75 to 95 million people more living in extreme poverty in 2022 than anticipated in pre-pandemic projections (Gerszon Mahler et al., 2022<sub>[163]</sub>). Huge financing needs are also likely to arise from the post-war reconstruction.

**In the medium to long term, the new wave of spiralling sovereign debt in developing countries could also affect ODA trends.** The end of the DSSI in December 2021 and the tightening of global financial conditions observed in the past year have compounded the challenge of their enormous debt service obligations. While only three countries have so far requested the treatment of their debt under the Common Framework, a worsening of other countries' fiscal situation will likely lead to new requests for debt relief in coming years. In accordance with DAC reporting guidelines, the rescheduled or forgiven amounts could be reported as ODA under certain parameters<sup>1</sup> (OECD DAC, 2020<sub>[164]</sub>). New episodes of debt distress could also limit future lending to developing countries, resulting in additional downward pressures on ODA.

**Recent commitments by the DAC and other official providers in support of global public goods such as climate and health will exert upward pressure on ODA in the years leading up to 2030.** These include the commitment by DAC members in October 2021 to align their development co-operation

with the goals of the Paris Agreement on climate change (OECD, 2021<sup>[165]</sup>). Their declaration recognised the key role played by ODA and other official resources to achieve the Paris Agreement objectives and committed to scaling up finance for climate adaptation. Since the start of the pandemic, official providers have also made numerous commitments in global health, such as the G20 leaders' commitment to build and fund a Financial Intermediary Fund for pandemic preparedness and response and to support vaccination of the population in LICs and MICs through the COVID-19 Vaccines Global Access, or COVAX, and other initiatives.

**The decision to rechannel IMF SDRs will increase the resources available to vulnerable developing countries.** In October 2021, the G20 agreed to aim to rechannel USD 100 billion of SDRs to the benefit of LICs, small states and vulnerable MICs out of the total USD 650 billion allocated to IMF members in August 2021. This is a welcome innovation. While a large share of these SDRs will be made available to LICs through the IMF's existing Poverty Reduction and Growth Trust and a new Resilience and Sustainability Trust, other options are also being considered such as channelling the SDRs through MDBs. While there were questions initially regarding the ODA eligibility and additionality of the rechannelled SDRs, it appears unlikely that SDR on-lending will be ODA eligible except in some rare circumstances.

**With a heightened risk of a Great Divergence and a growing imbalance of financing needed to achieve the global goals, efforts to better align financing for sustainability and equity must be redoubled** While efforts to improve the sustainability of financing have increased (e.g. build back better recovery initiatives), the implementation of standards, policies and other accountability mechanisms could lead to countries at greatest risk of divergence being left behind. Chapter 3 examines the state of SDG alignment of the hundreds of trillions of dollars held by actors, mainly in developed countries. It provides a set of targeted actions for countries at the origin of financing, financial intermediaries and countries at risk of divergence to better mobilise and align the full array of public, private, domestic and international sources of financing needed to fill the growing gap.

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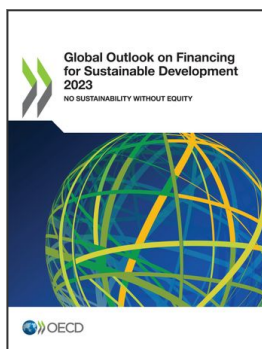
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## Notes

The reporting directives of the Creditor Reporting System require official providers to consider countries’ debt solvency in their lending decisions, for example by referring to the IMF and World Bank low -income Countries Debt Sustainability Framework (and non-concessional borrowing policies). See [https://one.oecd.org/document/DCD/DAC/STAT\(2020\)44/ADD2/FINAL/en/pdf](https://one.oecd.org/document/DCD/DAC/STAT(2020)44/ADD2/FINAL/en/pdf).





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