



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 5.4.2005
SEC(2005) 467

COMMISSION STAFF WORKING PAPER

New Sources of Financing for Development: A Review of Options

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1. INTRODUCTION

Over the years a consensus has emerged in development policy that, while further improving the conditions for economic growth, an increasing focus should be put on poverty reduction. This consensus culminated in the UN Millennium Declaration, signed in September 2000 by 189 governments, committing themselves to reduce extreme poverty in all its key dimensions by 2015. The eight Millennium Development Goals (MDGs) that derive from this Declaration provide an agenda for global action¹. Their achievement has also become a key objective for the European Union as confirmed by the April 2004 General Affairs Council.

In March 2002, the international community agreed on a comprehensive agenda for action by adopting the so-called Monterrey Consensus at the International Conference on Financing for Development (FfD). The EU contributed significantly to the overall positive outcome of the Conference by acting collectively at Monterrey, on the basis of explicit commitments concerning both the volume and the quality of aid, endorsed by the European Council in Barcelona on 14 March 2002 (see Box 1 below).

The most visible outcome of the FfD Conference was in terms of increased donor commitments in Official Development Assistance (ODA²), estimated at about an extra US\$15 billion a year as of 2006. These efforts however still fell short of the financing gap deemed necessary to meet the MDGs, estimated at the time at some additional US\$50 billion a year. Latest cost estimates by the UN Millennium Project³, led by Jeffrey Sachs, give a somewhat higher financing gap.

Box 1: The Barcelona Commitments

- Increase EU ODA to 0.39% of GNI, by 2006 and to examine the means and timeframe for each EU Member State to reach the UN 0.7% ODA goal. The intermediate ODA target consists of an individual and a collective angle: Member States commit to individually reach a baseline target of at least 0.33% ODA/GNI so that the EU collectively can achieve the collective 0.39% goal.
- Improve aid effectiveness through closer coordination of policies and harmonisation of procedures, and take concrete steps to this effect before 2004.
- Take measures with regard to untying of aid to Least Developed Countries.
- Increase Trade-Related Assistance.
- Support the identification of relevant Global Public Goods.
- Explore innovative sources of financing.
- Support the reforms of the International Financial Systems and strengthen the voice of developing countries in international economic decision-making.

¹ The eight MDGs are: eradicate extreme poverty and hunger; achieve universal primary education; promote gender equality and empower women; reduce child mortality; improve maternal health; combat HIV/AIDS, malaria and other diseases; ensure environmental sustainability; develop a Global Partnership for Development.

² ODA is the formal term for aid, defined by the OECD/DAC as the sum of grants and concessional loans (i.e. with a grant element of at least 25%) undertaken by the official sector.

³ See <http://www.unmillenniumproject.org/>

- Pursue the efforts to restore debt sustainability in the context of the enhanced HIPC initiative.

Following a Council mandate, the Commission prepares annual monitoring reports on the implementation of the “Barcelona commitments”⁴

In September 2005, the UN General Assembly will take stock of the progress made by UN Members in the implementation of this global agenda at the MDG High Level Event. The General Assembly will prepare this High Level Event through the High Level Dialogue on Financing for Development (27-28 June 2005). In preparation for these events, various initiatives have been developed with the aim of estimating the financing resources needed to reach the MDGs, as well as identifying the modalities through which such resources could be mobilised.

A number of reports have also been issued in the recent months to analyse the various proposals on ways to increase financing for development, such as: the joint IMF/World Bank paper “Aid effectiveness and financing modalities” prepared for the 2004 Annual Meetings; the Quadripartite Report (sponsored by the Presidents of Brazil, Chile, France and Spain) and presented in New York by President Lula in September 2004; the Landau Report, commissioned by President Chirac and also submitted in September 2004. Finally, in March 2005 the UK-sponsored Commission for Africa issued its report, specifying a comprehensive package of actions needed for the continent.

This Staff Working Paper takes up the invitation of the ECOFIN Council⁵, while also attempting to provide input to follow-up to the GAERC Conclusions⁶. By bringing together work carried out in the different Commission Services concerned, this paper aims to inform the debate among EU ministers with a view to a possible EU position for the 2005 UN High Level Event on innovative ways of financing. In this context, in order to contribute to the international debate, the Commission services are preparing a Communication on financing for development and aid effectiveness.

The paper builds upon the Commission 2002 Globalisation Report⁷, which already contained an assessment of various options for innovative sources of financing, and updates the debate with the most recent ones. The various proposals made on the voluntary mechanisms which range from an international lottery to opt-out levies are beyond the scope of this paper. A number of criteria could be considered when assessing the options: revenue-raising capacity; stability and predictability of resources raised; degree of additionality achieved; economic impact (both at micro-economic and macro-economic level); practical feasibility, e.g. legal and institutional constraints, taking into account timing and whether global participation is a necessary condition.

⁴ SEC (2003) 569, 15.05.2003; COM (2004) 150 final of 05.03.2004.

⁵ As reported in document SI(2005)29 “Le Président JUNKER a conclu que le Conseil ECOFIN du mois d’avril examinera les questions de relatif court terme (allègement de la dette, [...]) sur la base de contributions du Comité économique et financier et de la Commission; les questions et actions à plus long terme (notamment la possibilité de financement innovants) [...] feront l’objet d’une discussion lors de la réunion informelle des Ministres des finances au cours du mois de mai”

⁶ The November 2004 GAERC concluded that “The EU will also explore innovative ways of financing based upon proposals submitted by the Commission with a view to the 2005 High Level Event.”

⁷ CEC “Responses to the Challenges of Globalisation” SEC(2002)185.

Clearly, no single proposal would meet all criteria simultaneously. The paper therefore takes the stance to omit some of them and select those that: (i) have a revenue-raising potential appropriate to the needs linked to the MDGs; (ii) do not need global consensus and hence can be implemented at the regional (EU) level, bearing in mind the need to ensure a proper burden-sharing at the global scale; (iii) offer reasonable prospects for rapid implementation; (iv) yield predictable and stable resources; and (v) avoid major economic distortions.

The paper first reviews the option of increasing ODA by increasing the share of national budgets devoted to development (section 2). It then examines the UK Government's proposal for an International Finance Facility (section 3), and a range of proposals for taxation to yield additional resources (section 4). Section 5 considers the recent proposals for further debt relief. Given that discussion of innovative sources of finance would be incomplete without considering the ways in which such resources might be most effectively deployed, section 6 reviews ways to increase aid effectiveness. Section 7 provides concluding remarks.

2. ACTING ON AID BUDGETS

Global ODA flows⁸ from OECD/DAC members to developing countries reached in 2003 US\$ 69 billion; of these, nearly 54% were provided by the EU (of which 19% managed by the European Commission). This represents an increase in real terms from 2002 levels of nearly 5%. In terms of GNI, the EU-15 countries together provided in 2003 an effort of 0.35% of ODA, against a DAC average of 0.25%. Large differences are visible though among DAC members (see Chart 1).

Recent years have seen a reversal in the negative ODA trend recorded in the 1990s, when ODA as a percentage of GNI decreased from 0.33% in 1990 to 0.22% in 2000. The FfD Conference of 2002 has certainly helped revitalise ODA flows, but these are still far away from the recommended aid target of 0.7%. Moreover, the recent surge in ODA mostly derived from debt relief operations, as well as from Iraq and Afghanistan reconstruction. Therefore there are still reasons to expect donors to act on aid budgets.

A direct, simple and efficient way to increase the flow of development aid is to increase the resources allocated to aid in national budgets⁹. Aid budgets are devoted to activities that support countries to reach the MDGs, and they are subject to the normal processes of democratic debate and scrutiny that ensure transparency and accountability. Additionality can thus be monitored.

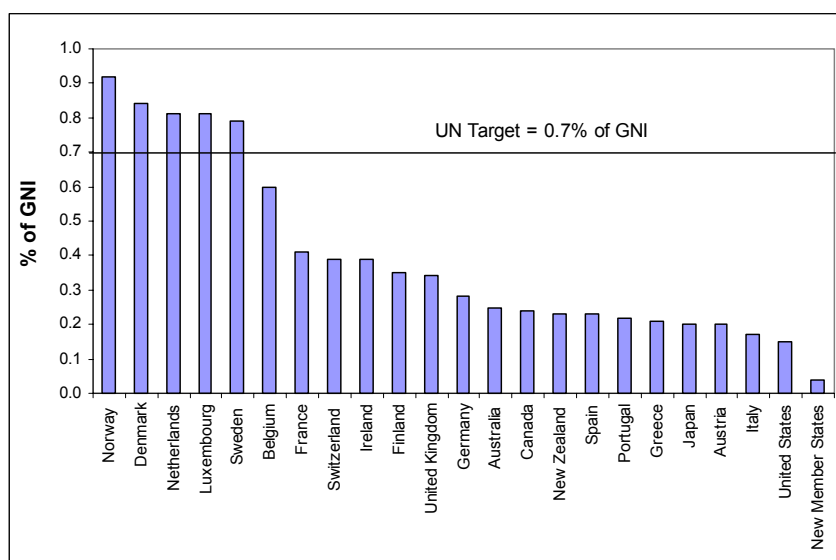
While increasing national aid budgets may be simple in terms of technical implementation, this is less so in terms of political decision-making. Like any other form of additional public spending on development aid, this involves a shift in relative budgetary priorities from domestic to external ones. Since a considerable number of EU Member States are in a phase of fiscal consolidation to reduce excessive deficits, this can be a politically difficult process. The report by the ECOFIN Council of 20 March 2005 on improving the implementation of the Stability and Growth Pact has agreed on a way

⁸ Source: OECD DDC/DAC "2004 Development co-operation Report", January 2005.

⁹ The World Bank staff paper for the 2004 Development Committee said that "the simplest approach to ensuring that more aid is available where it is needed would be for donor countries to increase their aid budgets".

to deal with the possible tension between the requirements of the Pact and ODA. It provides that - when taking into account “all other relevant factors” in the Commission’s report under Article 104(3) - “special consideration will be given to budgetary efforts towards increasing or maintaining at a high level financial contributions to fostering international solidarity and to achieving European policy goals, ...”. While ODA is likely to be considered as a contribution to international solidarity, this rule will only apply to a deficit which is temporarily above, but close to the reference value.

Chart 1: Net ODA in EU Member States and other OECD countries in % of Gross National Income (GNI) in 2003



Source: OECD/DAC Annual Report 2004 and replies of EU Member States to the Monterrey questionnaire

In terms of the ODA/GNI ratio the Barcelona commitment foresees an individual baseline target of 0.33% for each Member State that contributes to achieve the collective EU target of 0.39% by 2006. If commitments by Member States are confirmed over time, the EU-25 would collectively reach an ODA level of 0.42% of GNI in 2006 - representing a potential allocation of €46.5 billion p.a.. Eight Member States have either achieved or pledged to achieve the UN goal of 0.7 % ODA/ GNI.

The European Council of December 2004 confirmed the EU’s commitment to the MDGs and mandated the Commission to present to the Council “*concrete proposals on setting new and adequate ODA targets for the period 2009-2010, while taking into account the position of the new Member States*”. In this context, draft proposals are currently under preparation for a new intermediate target for 2010, with a view to meeting the target of 0.7% in 2015; the proposals will be submitted for possible adoption by the Commission in April.

3. FRONTLOADING THE MONTERREY COMMITMENTS

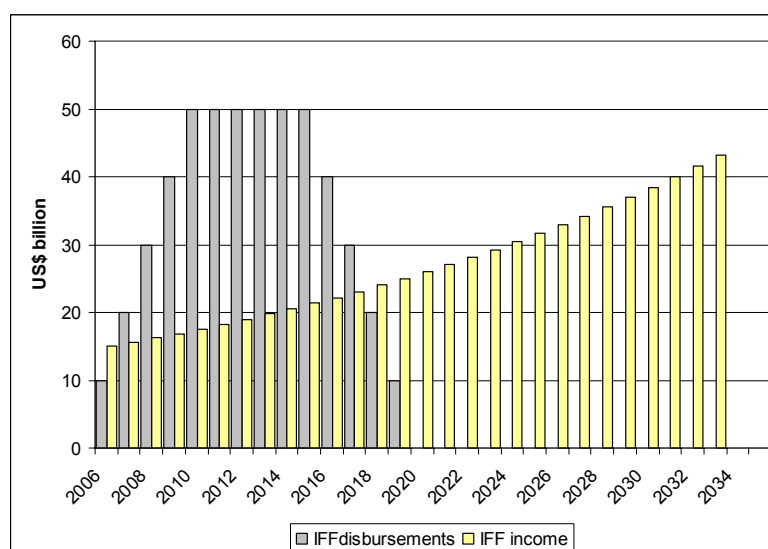
Commitments made at the Monterrey FfD Conference of additional aid per year may amount to around US\$ 15 billion as of 2006 (some of which are already materialising or even being surpassed), which can be expected to grow over time. However, the rate at

which these extra commitments are made available may be too slow in comparison with the pressing needs in order to attain the MDGs in due time.

The International Financial Facility (IFF), a proposal put forward by the UK Government in January 2003, has to be seen in this context. It is designed as a temporary facility to *frontload* the commitments made in Monterrey by issuing bonds in international capital markets, backed by binding commitments of donors to provide regular payments to the facility. It is not designed to provide additional resources on top of those already committed in 2002. Hence it would only temporarily contribute to filling the financing gap identified in section 1.

So far, the working hypothesis is that the lifespan of the IFF would be of 30 years, 15 devoted to disbursing to developing countries, and the last 15 years only for repaying bondholders¹⁰. As a result, the frontloading implies an increase of aid flows up to 2015, and a subsequent nominal decrease as donors' payments to the facility are used to reimburse IFF bondholders (see Chart 2).

Chart 2: International Finance Facility income and disbursements – scenario of a 30-year life-time



Source: UK HM Treasury

It is worth noting that in the recent months a pilot IFF scheme for immunisation has been developed in more detail for supporting GAVI (Global Alliance for Vaccines and Immunization). Its launch, when it occurs, should help clarify some of the open questions about the IFF.

Several issues are at stake to assess the desirability and feasibility of the IFF proposal, which can be treated in four categories: (i) the rationale of frontloading; (ii) the recording in the national accounts of donors; (iii) institutional and governance issues; (iv) the financial structure.

¹⁰ See HM UK Treasury 'International Finance Facility- technical issues note' issued in March 2003. The possibility of other scenarios would of course not be precluded in further discussions.

(i) *The rationale of frontloading*

From the recipient countries' perspective, the main justification for frontloading aid stems from the urgency of providing stable and predictable resources *now* rather than *later*, in order to accelerate progress towards the MDGs which seems unattainable under current trends of financing. From the donor countries' perspective, and in analogy to a private investment project with a positive net present value, the intertemporal shift of ODA through the capital market would be an efficient solution if frontloaded public investment triggered a self-sustaining development process. This would both generate faster poverty reduction and allow ODA savings in the future. In technical terms, a rate of return on development programmes which is higher than both the borrowing cost (estimated around 5-6% for the IFF bonds, assuming an AAA rating) and the social "time preference rate" (estimated at 5-8% for low-income countries) would ensure efficiency. However, this potential benefit could in principle also be achieved if each donor borrowed directly on the capital market. The advantages of the 'common pool approach' of the IFF therefore have to be found elsewhere, according to the UK proposal in terms of greater co-ordination and harmonisation, hence greater aid effectiveness; in terms of better market conditions for refinancing due to pooled risks; or in terms of locking in donor pledges for a longer term. This would require a certain critical mass of donors participating in the IFF to fully reap these benefits.

However, there are a number of issues for further consideration, in particular related to the absorption capacity of developing countries and intergenerational distribution. The World Bank's conservative estimates show that in the short-term US\$ 30 billion could easily be absorbed by those developing countries with sound institutions and policies.¹¹ Over time, as more countries improve their policies, an extra US\$ 50 billion could be absorbed. This would fit with the temporal profile of IFF disbursements as depicted in Chart 2. However, regarding aid effectiveness there are also arguments against frontloading and in favour of a more gradual phasing-in of aid over time, for example because of improvements in the harmonisation and co-ordination among donors, improved management of aid flows at the recipient's end allowing a higher absorption capacity, or to avoid economic shocks arising from sudden large aid flows which could negatively impact on macroeconomic stability.

Frontloading could also imply that the generation of 'poor' of today would be favoured compared to the one of tomorrow (i.e. post-2015), since more efforts would be made *now* to reduce poverty¹². Although it seems plausible to assume that the marginal utility of aid declines as people become less poor over time, the difference is probably too small to be significant, in the context of *absolute* poverty. There might therefore be no strong argument for discriminating between generations. Moreover, the relative geographic composition of poor people might change over time. While today the largest number of poor people is in Asia, tomorrow it will mostly be in Africa. Frontloading could hence raise the issue of an intertemporal discrimination of treatment between the poor.

Furthermore, after the disbursement period, donors' contributions to the IFF will be used only to reimburse IFF bondholders rather than to provide funds to developing countries. In case the self-sustaining process of development did not happen in many of the

¹¹ World Bank, "Supporting sound policies with adequate and appropriate financing", paper prepared for the Development Committee of 22 September 2003.

¹² See also the Landau report.

recipient countries and development needs did thus not diminish substantially, the next generation of poor could be faced, *ceteris paribus*, with a decrease in aid. Whether that implies a decline in absolute amounts of aid would then depend on the general evolution of ODA. The best way to avoid these intergenerational distortions would therefore be to concentrate IFF disbursements into projects with a high social rate of return and hence a large overall impact on present and future generations.

Frontloading also raises the issue of intergenerational fairness within donor countries. The IFF would allow an increase in ODA at the expense of an increase in future public liabilities, thereby transferring costs to future generations. This future fiscal burden would occur precisely at a time when many countries, in particular EU Member States, will need to make higher expenditure linked to ageing.

(ii) Recording in the national accounts of donors

An important question relates to the treatment in national accounts of the IFF operations. This matters in particular for the EU Member States and their obligations to avoid excessive government deficits. The way Eurostat would treat the IFF under ESA 95 depends critically on the final and precise features of the IFF, in particular its institutional structure when it is effectively launched, and therefore no final decision may yet be expected from Eurostat. As a general rule, the ESA 95 system records flows on an accrual basis, that is, when economic value is created, transformed or extinguished, or when claims and obligations arise, are transformed or are cancelled.

The treatment of the IFF in national accounts depends critically on whether it is considered an institutional unit or not, depending primarily on its degree of autonomy in decision-making. If it is not considered to be an institutional unit, it would act on behalf of participating countries whose government deficit and debt positions would be proportionally affected by the IFF's operations. Therefore, there would be an effect on participating countries' deficit at the moment in which funds are disbursed by the IFF to recipient countries, and on participating countries' debt when bonds are issued by the IFF. If, on the contrary, it is considered to be an institutional unit, the IFF might be classified as an 'international organisation' in the 'rest of the world' sector. In this case, the key issue is at which moment the donors' contributions should be recorded as government expenditure. Given that the accrual-based ESA95 system requires the recording of expenditure when an obligation arises, there are mainly two possibilities depending on the exact contractual relationship between participating countries and IFF:

1. Donors' pledges to the IFF could be regarded as the obligation which requires the recording as expenditure in the budget plans according to the time schedule of the commitments to the IFF. These pledges would have a multi-annual profile, and the UK proposal foresees a number of subsequent pledging rounds, each of which should be reflected as expenditure in the respective budgets of a donor country (i.e. the 30-year payments profile in Chart 2). In practice, actual payments of a donor country to the IFF could be lower due to the non-compliance of some of the recipient countries with the financing conditions.
2. The obligation could also be considered to be the IFF issuing the bond which creates the donors' commitment to repay. It would then be appropriate to record the amount of the issued bond – i.e. the share representing the country's

participation in the IFF - as government expenditure (i.e. over the initial 15-year horizon in Chart 2).¹³ Depending on the type of bond, due interest payments would have to be added to that amount. With the exception of interest payments, administrative costs and a potential risk reserve, this is equivalent to recording expenditure at the moment the IFF disburses to recipient countries, if we assume no time lag between the two operations.

If no equivalent reduction in expenditure or increase in revenue is made in a participating country's budget, this would imply an equivalent change in the budget balance. The second possibility would give a higher degree of fiscal transparency in that it more adequately reflects the future liabilities of a country, but would have a frontloaded effect on budget balances.

The UK proposal argues that because of the existence of financing conditions (i.e. the donor country only paying to the IFF if recipient countries fulfil specified conditions) donors' contributions are 'contingent liabilities' and hence should be recorded only when effectively paid to the IFF. Contingent liabilities are expenditures that are recorded only when a certain event takes place, such as the calling of guarantees when a default occurs. Indeed, the scheme foresees that, if one or more recipient countries do not fulfil the financing conditions, donors would have to contribute less to the IFF than initially pledged. However, this boils down to the question of the probability of recipient countries not fulfilling the financing conditions. The UK proposal is to use prolonged arrears to the IMF as the only condition which would trigger a reduction of payments to the IFF. Statistics prepared for the UK Treasury mention that out of 100 countries funded by the IDA during the last 25 years, 21 countries went into prolonged arrears to the IMF. Given that this is rather the exception than the rule, it would seem inappropriate with a view to fiscal transparency to record nothing in government expenditure plans because of a small possibility of all recipient countries not fulfilling the financing conditions.

Apart from these accounting issues, it remains to be confirmed that national budgetary procedures allow donors to make full contractual or legal commitments to the IFF for a period of up to 30 years – or to credibly renew shorter-term commitments on a multi-year basis.¹⁴ Moreover, it remains to be clarified whether current OECD Development Assistance Committee (DAC) calculation rules, which are based on donors' outflows, would classify IFF-related expenditure as ODA on the basis of issued bonds, disbursements to recipient countries or actual payments to the IFF.

(iii) Institutional and governance issues

The UK proposal states that the IFF would have two components: a treasury platform to raise the funds, and a central trust to determine overall policy (e.g. fund allocation to disbursement channels, monitoring compliance with aid allocation and aid effectiveness principles). It would disburse its assistance through existing multilateral and bilateral channels to reduce the risk that the facility rapidly develops its own institutional life with related high administrative costs. A new international development institution would increase the coordination burden with the existing ones.

¹³ This view is also supported by the Statistics Department of the IMF as mentioned in "Aid effectiveness and financing modalities", background paper prepared by the IMF and WB for the 2004 Annual meetings, September 2004, p.54, fn. 47.

¹⁴ This could also make a participation of the European Community in the IFF difficult given its annual budget procedures and the limited time horizon of the financial perspectives.

For the first component, recent discussions point in particular to the possibility of using the existing treasury platforms of Multilateral Development Banks (MDBs), and establishing the IFF as a subsidiary or affiliate that is legally and financially separate. This option would bring advantages in terms of costs and management skills. No details are available on the second component, as these would presumably be determined by the donors subscribing to the IFF.

Apart from the decision mechanism itself, an important aspect of governance of the IFF is to ensure that aid resources are delivered in the most effective way. The current proposal defines some ‘overarching principles’ for aid allocation. In particular funds should be used for poverty reduction, they should be untied, provided in multi-annual programmes, mainly in grant form, and disbursed to a wide range of recipients, while targeted at low-income countries. These principles are generally sound and in line with state of the art principles of aid effectiveness. However, the relation and consistency between the IFF’s principles and those applied by existing instruments through which the funds are channelled is still unclear. It could be that some existing channels apply less effective (or simply different) principles on aid, hence rendering the overarching principles not applicable or void of content. In other terms, channelling the funds through existing instruments may not be a guarantee for enhanced aid effectiveness.

(iv) Financial structure

The UK proposal assumes a scenario which sets donors’ annual payments at US\$ 15 billion in 2006, rising by around 4% a year, in line with conservative long-term projections of nominal growth. The IFF’s stock of debt would peak at US\$ 300 billion. This scenario would allow the IFF to disburse in total US\$ 500 billion (in grants) over a 14-year period starting in 2006. The bulk of disbursements would take place in the years up to 2015 and require total payments from donors of US\$ 750 billion over a 28-year period starting in 2006.

One of the main advantages of the IFF proposal is that it relies on pledges rather than initial injections of cash, capital or other collateral to back the bonds. However, from a financial point of view, only if a low risk to bondholders is ensured which translates such pledges into a good credit rating, the facility could be a superior alternative to the issuing of bonds by sovereign governments with a lower rating.

In order to receive the expected AAA rating, the bonds issued by the IFF would have to fulfil strict conditions set by financial markets. The main conditions would be linked to donor countries’ ability and willingness to pay. For this purpose, donor countries are required not to opt out from their commitments, and hence donors should be legally bound to make the annual payments to the IFF, subject to fulfilment of the financing conditions by recipient countries.¹⁵

The decision on the legal act of the IFF is therefore relevant for its rating and the related risk premium. An international treaty among participating donors would facilitate the

¹⁵ Goldman Sachs calculations for Standard and Poor’s indicate that three main factors will have an effect on the leverage limit and the objective of achieving an AAA rating:

- The credit quality of donors that would contribute with annual payment commitments to the IFF;
- The nature of the contractual obligation which binds donors to make annual payments to the IFF: the more binding, the highest the possible rating, and related to this
- The nature of the financing condition, e.g. recipients being in protracted arrears with the IMF.

legally binding character of the donors' commitments. A major issue to clarify is who is to carry the risk if a donor country, whatever the reason, revokes its earlier commitments under the treaty. This is particularly critical in the phase after all disbursements have been made, since no downward adjustments can be made any more on the issuing of bonds, and when IFF debt still needs to be serviced. If this risk falls on the bondholders this might have a negative effect on the credit rating and the risk premium; if it is shared among the remaining donor countries it might be more difficult to get the initial political support for the ratification of the treaty.

A further issue is the potential effect of IFF debt on the cost of borrowing on international capital markets. In case interest rates increased, this could have a negative effect on global investment and growth, which would also mitigate some of the expected positive effects in recipient countries. The UK proposal expects no effects on borrowing costs since "the international market for bonds similar to those the IFF would issue is very deep". This expectation is made under the assumption of an AAA rating and would require further detailed analysis, also with a view to the possibility of a lower rating than assumed.

4. TAX INSTRUMENTS

Over the last decades there have been a number of proposals to introduce taxes at international level in order to increase the financing of development aid. Although these proposals are fairly diverse, they tend to be based on the same rationale compared to simply raising taxes at national level to increase the national aid budget:

1. Coordinated action at EU or international level allows for less distortion with a view to the loss of a mobile tax base or the loss of competitiveness for an immobile tax base.
2. Compared to other taxes they are expected to be less unpopular for taxpayers because the generated revenues are foreseen for a good cause, i.e. development aid.
3. As a "double dividend" some of the proposals do not only raise revenues, but also internalise negative cross-border externalities.

The geographical coverage for this paper, unlike many studies, would at this stage be the EU only. The application of the proposed measures should not hinge on a hypothetical international agreement. The taxes proposed to finance ODA can be summarised in the following "families"¹⁶:

- Environmental/energy/transport-related taxes, like taxes on maritime transport, aviation, or a CO₂ tax/charge;
- Taxes on currency or financial transactions, like the Tobin tax;
- Health-related food taxes, like a tax on the sugar content of food;
- Taxes on the trade of arms;

¹⁶ This list builds on the Commission Globalisation Report, the 'Landau' report, and the 'Lula' Report.

- Taxes on the profits of large multinational companies.

Some of these taxes will not be further discussed in this paper. Taxation of maritime transport would probably require a globally coordinated effort to address possibilities of tax avoidance and competitiveness effects, which are likely to be more significant than for air transport because maritime transport consists essentially of freight. Since health-related food taxes do not exist in the Member States, technical implementation difficulties would be significant, for instance in the definition of the tax base. A specific tax on the profits of multinational companies does not appear as a viable long-term option, also because of the volatility of profits. Broadening the tax to cover all companies in the EU could have negative effects on their global competitiveness. Finally, the arms industry is both very competitive and highly concentrated, with a handful of countries representing a major part of the trade. Global participation would therefore be a condition for the efficiency of a tax on the arms trade, also to not endanger efforts to control illegal arms trade.

Therefore, this section only looks at the kerosene tax, the flight departure tax, as well as the currency or financial transaction tax. A much broader analysis of several of these proposed taxes was already presented in the Commission's Globalisation Report in 2002. In order to provide further background information for the discussion of these proposals, increased rates of existing taxes, like VAT and excise duties on motor fuels, are also discussed. A more detailed description of the specific characteristics of each of the tax proposals on the basis of the criteria of revenue-raising capacity, economic and competitiveness aspects, implementation, legal aspects and equity can be found in the Annex. The main text will focus on the revenue-raising capacity, on economic and competitiveness effects, and on some implementation and legal aspects, while a synthesis table on the strengths and weaknesses of the different taxes is presented at the end of the section.

(i) The revenue-raising options

The general effect of most of the taxes is to increase the relative price of specific goods or services. This usually leads to a reduction in demand and thereby to a gradual erosion of a part of the tax base in the medium to long run depending on the demand elasticities.¹⁷ Taxes on negative externalities are even explicitly designed to lead to a decrease in the tax base in that the activity producing external costs should be reduced. For the currency transaction tax, the high mobility of the tax base may additionally have the effect to relocate currency transactions to countries where the tax is not levied and would therefore require a rather high number of countries introducing the tax. In the case of the VAT, which does not change relative prices, but rather the price level, the possibilities of avoiding the tax are more limited, but there are risks of fraud or a shift of activities into the grey economy. Thus, there is a potential long-term conflict between the objectives of revenue generation and of the internalisation of negative externalities which might however be mitigated by economic growth.

On aviation, one possibility is a tax on kerosene used for intra-Community and domestic flights. Several countries are currently already taxing aviation fuel used for domestic flights, like for instance the Netherlands (€200 / 1000 litres), Japan (€239 / 1000 l), the US (€6 / 1000 l at federal level, plus taxes at State level of up to €24 / 1000 l). A tax level

¹⁷ Econometric studies show that demand elasticities tend to be low in the short term, but much higher in the long term. Cf. OECD (2001), Environmentally-related taxes in OECD countries.

of €330 per 1000 litres, which corresponds to the Community minimum rate for diesel and kerosene in 2010 according to the Energy Tax Directive¹⁸, would raise around €6 to 7 billion per year depending on the assumed price elasticity of demand for air travel.

A further possibility on aviation is a flight departure tax levied on all flights leaving a Community airport. Such taxes are levied as a lump sum per chargeable passenger. If a tax rate of €10 on intra-Community flights and of €30 on international flights were applied, in addition to the taxes which already exist in Member States¹⁹, expected revenues are about €6 billion per year.

Currency or financial transaction taxes are generally presented as addressing undesirable externalities such as short-term capital movements or excessive exchange rate volatility. Since most proposals do not provide a clear-cut indication of how to implement, collect and enforce the tax, tax proceeds are difficult to estimate. Assuming a single rate of 0.01% applied on all currency transactions made by all operators in the EU-15, and based on data from the Bank for International Settlements on foreign exchange market turnover, the French Treasury estimates revenues in a range of €7 to 11 billion.²⁰ However, there is a high degree of uncertainty in the estimates since the price elasticity of transaction volumes is rather difficult to predict.

As a benchmark for the above proposals, increasing the rates of existing taxes is also considered. VAT is an important source of revenue representing on average 7% of GDP in Member States. A surcharge of 0.5 percentage point to the existing VAT base would bring revenues of about €14 billion, taking into account feedback effects on the economy, which would reduce other tax revenues and increase some expenditure. An increase in excise duties on motor fuels could also be envisaged. With 338 billion litres (180 of diesel and 158 of petrol in EU 25) consumed annually, a surcharge of 3 cent on motor fuel duties would raise €11 to 12 billion of revenue, including additional VAT revenues and assuming basically no effect on fuel demand.

(ii) Economic and competitiveness effects

The relative price and demand reactions on the tax increases can have effects on the specific sectors in the EU, depending on the possibilities to pass the tax increase on to consumers and assuming that other non-EU countries would not introduce a similar tax. In the aviation sector, there could indeed be some distortion for EU carriers with regard to non-EU competitors when they operate on intra-EU routes and bilateral Air Service Agreements (ASA) would not allow taxing them in the same way as EU carriers. Furthermore, since the taxes would represent a higher share of the operating costs of low-cost airlines and these companies are expected to have customers with a higher price elasticity, they could be more affected than traditional airlines. The tourism industry could also be affected by a kerosene tax. However, as flight is only one component of the tourist package, an increase in the flight price of up to 40 euros for return tickets is not expected to have a significant impact, also with a view to the overall positive outlook for the development of this sector. The impact of destination-switching within the EU and

¹⁸ Directive 2003/96/EC (OJ L283 of 31.10.2003, p. 51, as last amended by Directive 2004/75/EC (OJ L 157 of 30.04.2004, p. 100).

¹⁹ An Air Passenger Transport is for instance to be paid in the UK, up to 40 GBP.

²⁰ There are also proposals for a two-tier structure of the Tobin tax to differentiate between normal and turbulent periods on foreign exchange markets. See Spahn, Paul Bernd (1996), The Tobin Tax and Exchange Rate Stability, in *Finance and Development*, IMF, June 1996, pp. 24-27.

with outside destinations is likely to be small, as most alternative destinations are geographically much more distant. Regarding the departure tax, the rate differentiation between intra-Community and international flights would help to maintain the attractiveness of European tourist destinations. Finally, since the departure tax would apply to all carriers, it would not necessarily distort competition. Departure tax and kerosene tax could also complement each other.

Regarding the potential effects of the currency transaction tax on the financial sector in the EU, there is a high degree of uncertainty about the relocation of transactions to countries where such a tax is not levied. Furthermore, there is a risk of substitution of bank transactions by non-bank transactions. These changes could reduce the liquidity of some financial markets, which might even exacerbate their volatility. On motor fuel, the price elasticity is generally considered to be rather low, at least in the short run, so that no major immediate effects on transport volumes are to be expected. VAT is broadly neutral across sectors and has more effects at macroeconomic level. In all cases the potential negative effects could be mitigated by a phasing-in over several years which would give the sectors concerned more time for adjustment.

The macroeconomic effects of tax increases are rather complex and can best be captured with a model-based simulation. Therefore, the potential impact of an increase in VAT rates in EU countries to finance an increase in development aid was simulated with the help of the Commission's QUEST model.²¹ While VAT is different in some respect from other indirect taxes, in particular regarding the more limited possibilities of substituting demand to avoid the tax, most of the results should also hold – in proportion to their revenues - for other tax proposals in that all of them have an effect on the prices of consumption, while the net increase in tax revenues is transferred abroad.

The simulation assumes that VAT rates are raised by 0.5 percentage points in all Member States included in the model (EU-15).²² This leads to higher consumer prices and a fall in consumption by roughly 1%. Workers are partly compensated for the increase in prices and the resulting increase in wages has a negative impact on employment. Unemployment increases by 0.2 percentage points. The overall effect on GDP is a decline of 0.13% in the long run. As it is assumed that the exercise must be budgetary neutral, and may not lead to deterioration in government budget balances, only the net revenues are used to finance additional spending on development aid (net transfers abroad in the table below).²³ These include the revenue from the VAT rate increase taking into account that the tax base is smaller as consumption is reduced, as well as lower income tax revenues and more expenditure on unemployment benefits since higher wage costs lead to lower employment. Therefore, the additional funds available for more development aid (about 0.14% of GDP) are roughly half what would *ex ante* be expected to be raised by the rate increase (about 0.25% of GDP). The higher transfers to the rest of

²¹ For a description of the main features of the QUEST model see Roeger, Werner; Veld, Jan in 't (1997), QUEST II - A Multi-Country Business Cycle and Growth Model; Brussels (= DG II Economic Paper No.123)

²² VAT rates in the model baseline are effective rates (the average effective VAT rate in the model is around 15%). It is assumed that the 0.5 percentage point increase is applied across the board (to standard and reduced rates). The presence of some zero-rated goods is not taken into account. As this only applies to a small share of goods in two member states (UK, IRL) this is not likely to have a significant impact on the overall results.

²³ These transfers are allocated in the model to Africa, Latin America and Asian countries (excluding OPEC or ASEAN countries).

the world partially flow back to the EU as recipient countries would raise their imports, softening the negative impact on consumption and output in the EU by roughly 15 to 20%.

Table 1: QUEST simulation on the macroeconomic effects of a 0.5 percentage point increase in VAT rates and higher transfers abroad (in EU-15, difference from baseline in % unless otherwise indicated)

Year	1	5	10	15
GDP	-0.24	-0.16	-0.14	-0.13
Consumption	-0.94	-1.09	-1.00	-0.91
Unemployment rate (%-p)	0.12	0.21	0.21	0.21
VAT revenue (% of GDP)	0.27	0.25	0.25	0.26
Transfers abroad (% of GDP)	0.07	0.14	0.14	0.14

Source: DG ECFIN

Apart from these macroeconomic effects of tax increases, the general efficiency of taxes as an instrument for the internalisation of negative externalities should also be analysed. In the set of instruments of environmental policy, taxes are one possible instrument among others, such as quantitative restrictions or tradable emission certificates. In this perspective, the Commission services are currently preparing a Communication for later this year on aviation and climate change, setting out possible approaches for a contribution of the aviation sector to the reduction of the climate change impact of its activities. Whilst kerosene taxation is one of the economic instruments relevant for reducing greenhouse gas emissions to be considered, a decision to use kerosene taxation as a source for generating revenue for ODA may have an impact on initiatives on the use of economic instruments for the purpose of managing the environmental dimension of the aviation sector.

Similarly, the efficiency of a financial or currency transaction tax in stabilising foreign exchange or financial markets needs to be compared with that of other options, such as for example the international coordination of economic policies. These alternative instruments usually do not raise tax revenues, but it could be a preferable strategy to apply the more efficient instrument to internalise negative externalities, while more traditional channels are used to raise tax revenues.

(iii) Other aspects

There are a number of issues related to the implementation and legal aspects of the different tax instruments. Regarding implementation, excise duties, VAT and departure taxes would not create particular problems. As for other mineral oil products, aviation kerosene would be taxed when delivered for consumption. In order to reduce implementation problems of a tax on currency transactions taxing net positions at the level of a centralised settlement system could be an option to be further assessed. Such a

mechanism might avoid some of the implementation difficulties inherent to the application of a tax to all currency transactions.

A legal issue remaining to be clarified is the compatibility of a currency transaction tax with the EC Treaty as regards the free movement of capital and payments (Article 56 TEC). The main concern is the discrimination of transactions between countries with different currencies – including intra-EU transactions – compared to those within a country and within the euro area. To avoid this problem it could be envisaged to have a tax on all financial transactions, which may, however, have adverse effects on EU financial markets. Furthermore, it needs to be clarified whether such a tax would be compatible with GATS rules and other international obligations.

A kerosene tax would also involve some legal issues related to third country carriers. The 1944 Chicago Convention, which was established when aviation was an infant industry, requires that fuel on board of an aircraft of a State, upon arrival in another State and retained on board when leaving that State, must be exempt from taxes. Until 2003, kerosene for international aviation was exempted under the former EC Mineral Oils Directive²⁴. From 2004 onwards, the Energy Tax Directive allows for taxation of kerosene used for domestic and intra-EU flights under certain conditions. However, most bilateral Air Services Agreements (ASAs) between States still oblige the Parties to exempt kerosene supplied to Parties' aircrafts. In this context, the ASAs would have to be modified with a view to the so called fifth freedom of third country carriers, taking into account the wide spread use of code-sharing²⁵ on intra Community routes, in order to allow for the taxation of kerosene on all intra-Community flights. However, in practice, a kerosene tax on intra-Community and domestic flights could be implemented by making it mandatory while allowing for the possibility to exempt all carriers on specific routes where non-EU carriers operate and benefit from exemptions under unchanged ASAs. Ongoing renegotiation of ASAs would then gradually allow for the taxation of third country carriers on intra-EU flights.

²⁴ Council Directive 92/81/EEC of 19 October 1992 on the harmonisation of the structures of excise duties on mineral oils (OJ L 316, 31.10.1992, p. 12. Directive amended by Directive 94/74/EC (OJ L 365, 31.12.1994, p. 46)).

²⁵ Code sharing relates to an intra-Community flight of a Community carrier, using in addition to its own flight number the flight number of a another (here third country) carrier.

Table: Comparison of strengths, weaknesses, opportunities and threats of the tax proposals

	Strengths	Weaknesses	Opportunities	Threats
Kerosene tax (€330 / 1000 l; revenues of € 6-7 billion)	Reduction in distortion of competition between transport modes. The "Polluter pays principle" is applied in a sector where CO2 emissions have significantly increased in recent years.	Distortion of competition between EU and third country carriers on routes which benefit from an exemption. Low cost carriers and charters more affected than traditional ones.	Phasing in of the tax over several years would mainly reduce the growth in EU air traffic which is expected to remain high for the next decade. Renegotiations of international ASA for international kerosene taxation are ongoing. The combination with a departure tax affecting all flights could partly compensate the non-taxation of kerosene used for international flights.	Amendments of hundreds of bilateral ASAs with third countries necessary to permit the taxation of all carriers on intra-EU routes.
Flight departure tax (€10 for intra-EU; €30 for international flights; revenues of €6 billion)	Affects all operators, including extra-Community ones. Reduction in distortion of competition between transport modes. Indirect positive environmental effects.	Less efficient than the kerosene tax for internalising the externalities of aviation.	Phasing in of the tax over years would mainly reduce sectoral growth rates. Differentiation of the tax rate for equity reasons. Combination with kerosene taxation possible. Broadening of the measure to maritime transport (cruises...).	
Currency transaction tax (0.01% tax rate; revenues of € 7-11 billion-)	Substantial revenues are possible.	Significant risk of tax avoidance. Compatibility with EC Treaty uncertain because of unequal treatment among currencies in the EU..		May affect negatively financial/currency markets. Uncertainty regarding the level of the revenues, the implementing mechanisms, the compatibility with EC Treaty and GATS rules.
VAT (0.5% surcharge; revenues of €14 billion)	Substantial revenues are possible. No direct competitiveness effects. Easy to implement technically.	Regressivity of VAT on income distribution.	Could lead to new discussions on VAT base harmonisation.	Member States applying zero VAT rate contribute less than the others.

Motor fuel excise tax (3 cents surcharge/ l; revenues of €11-12 billion)	Stability of revenues in the short to medium term. Easy to implement. Positive environmental effects.	Risk of increase in tax tourism at the EU border.	Progressive phasing in.	In some Member States, the measure would come in addition to the increases which must be done, even within transitional arrangements, to reach the Community minimum rates.
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5. ADDITIONAL DEBT RELIEF PROPOSALS

The experience with the HIPC Initiative²⁶ has shown that debt relief can be an effective way of channelling aid: it provides untied, stable and predictable flows of aid, at rather low transaction costs. Inscribing the Initiative within the Poverty Reduction Strategy process has also ensured a right balance between country ownership and incentive mechanisms for reforms.

So far²⁷, out of the 42 eligible countries, 27 have actually entered the initiative and are receiving debt relief. As a result, their debt stock has been reduced by two thirds, and debt service as a percentage of exports has declined substantially (from 16% in 1998 to around 10% in 2004). Moreover, the savings from debt repayments have been increasingly channelled towards poverty reduction expenditure (mostly for health or education), which increased from 6.4% of GDP in 1999 to 8% of GDP in 2004 in the 27 countries.

The Initiative however still faces a number of challenges. Its financing is not yet secured; both commercial and non-Paris Club official creditors have not yet fully participated; moreover, the current resources of the HIPC Trust Fund, managed by the World Bank, will soon be exhausted. The Bank foresees a financial gap of US\$1.9 billion between 2006 and 2008. Furthermore, there are a number of HIPC eligible post-conflict countries, such as Sudan or Somalia, which have not yet entered the HIPC initiative, and which may not be able to do it before the final deadline, end-2006. The international community should probably seek solutions to address the specific needs of these countries and help them return to normal economic relations with the rest of the world. Finally, there is some evidence that several countries that graduate from HIPC are falling back into high indebtedness, with debt-to-exports ratios higher by between 19% and 40% than originally foreseen. This occurs despite the fact that most Paris Club creditors are committed to 100% debt relief. These considerations have probably motivated the recent proposals – in their various versions (see Box 2) - for a deeper debt relief of up to 100% multilateral debt cancellation, covering IMF, IDA and African Development Fund (AfDF) debt²⁸.

Box 2: Proposals for additional debt relief

The *US proposal* simply calls for 100% multilateral debt relief to HIPC countries. For the IMF part, financing would come from existing reserves (PRGF Trust Fund and the Special Disbursement Account). According to IMF staff figures, the cost would be US\$ 6 billion. For the IDA and AfDF part, the claims would be simply written off, without any donor replenishment. Debt relief would therefore be financed by reducing the IDA and AfDF allocations of beneficiary

²⁶ The Initiative for Heavily Indebted Poor Countries (HIPC) was launched in 1996 by the IMF and the WB, and enhanced in 1999, with the aim of reducing their debt burden to sustainable levels, including debt to multilateral institutions. The overall cost of the Initiative for the current eligible countries is estimated at \$54.5 billion (in 2003 NPV terms). HIPC has been recently extended to end-2006, to allow remaining countries to enter.

²⁷ See “HIPC Initiative: Status of Implementation” joint World Bank-IMF paper for the Annual Meetings, August 2004.

²⁸ In fact the HIPC Initiative cancelled on average only 50% of multilateral debt. Proposals do not address the small-sized claims of the Inter-American Development Bank and the Asian Development Bank since they can finance debt cancellation by themselves. The credits of IFAD and other smaller multilateral institutions however could raise concerns in terms of fair burden-sharing.

countries, hence leaving net transfers unchanged. The action would not provide additional resources to developing countries.

The *UK proposal* calls for 100% relief of multilateral debt service (interest and principal) of poor countries for the period 2005-2015. In a first stage, this additional debt relief will be available to all post-completion point HIPC (currently 15, but some more will qualify in the coming months), and IDA-only low income countries with well performing public finance management, being in practice the Poverty Reduction Support Credit eligible countries (such as Armenia, Mongolia, Nepal, Sri Lanka and Vietnam). In contrast to the US proposal, this action is to be funded through additional donor resources for the part of the debt owed to the World Bank and the African Development Bank (estimated at US\$ 0.5 billion in 2005 and between US\$ 1.5 billion and US\$ 2.3 billion in 2015), and a mobilisation of IMF gold reserves for the IMF part.

The *French proposal* calls for a debt service relief to be provided in case an exogenous shock hits eligible countries (post-completion point HIPC and non-HIPC IDA-only countries) and debt service to export ratios reach certain thresholds. Specific grant windows would be created within IDA and AfDF, funded both by additional donor resources and internal resources. Costs cannot be assessed at present, as the debt thresholds have yet to be defined.

The proposal by the *Commission for Africa* calls for a transparent debt compact to include all Sub-Saharan African low-income countries, including those excluded from current schemes, which should cancel debt stock and debt service by up to 100% and cover multilateral and bilateral debt. No further details have been made public, nor has it been costed.

While the ultimate goal of these proposals seems legitimate, namely freeing resources in developing countries for the attainment of the MDGs, the merit of each proposal should be assessed against its capacity to minimise the risk of moral hazard and distortion in aid allocation. Moral hazard arises because 100% multilateral debt relief would sideline those poor countries that have managed their debts carefully, and weaken the credit and financial discipline culture in recipient countries. As underlined by a Commission funded study²⁹, debt relief can distort the allocation of aid across poor countries since it appears that (i) there is little correlation between the level of poverty and the amount of debt relief and (ii) within the group of HIPCs, those benefiting most are not the best performers in terms of policy and institutions. Unless they are properly designed, further debt relief actions could therefore exacerbate this distortion.

The study also points out the weak evidence of additionality of debt relief relative to the Monterrey ODA commitments, whereby it appears that HIPC relief may indeed have been used as a means to reach the Monterrey targets. In addition, there may be a risk of overstating DAC/ODA figures, namely because of a mismatch between the HIPC debt relief recorded and the one effectively received, the lack of analysis of the amounts effectively “liberated” in recipient countries, or the reporting of the nominal values of credits cancelled.

The recently approved Debt Sustainability Framework of the IMF and the World Bank, when operationalised, should provide *ex-ante* guidance on the best combination of grants and loans to be provided to recipient countries, based on the quality of their policies and institutions. Over time, this should therefore help avoiding situations of over-indebtedness, and hence limit moral hazard attached to debt cancellation operations.

²⁹

“Beyond the HIPC Initiative”, March 2004, available on http://www.europa.eu.int/comm/development/body/theme/hipc/docs/Beyond_HIPC_en.pdf#zoom=100

On aid allocation, it is clear that concentrating 100% cancellation on *post-completion point* HIPC countries rather than on all HIPC countries would not yield the same result. Post-completion countries should have improved their policies and institutions, hence additional debt relief should have a less distortive effect. A tentative analysis carried out on the 20 post-completion point HIPC countries and IDA-only countries indicates that while debt relief would be allocated to the poorest, there would still not be a strong link to their performance, as measured by their CPIAs³⁰.

In terms of financing, the proposals have differing merits. While the US proposal requires no additional funding from donors, it reduces the financial capacity, hence the role, of the financial institutions in low-income countries; it also puts a heavier burden on European countries, which have gained a stronger weight in the latest IDA-14 replenishment, hence raising an equity issue among donors.

In the UK proposal, the call for additional donor resources for the World Bank part could be at the expense of the need to fill the existing financing gap in the HIPC Trust Fund. There are also potential downsides to the use of a substantial share of IMF gold holdings to finance debt relief. As an undervalued asset, gold provides a fundamental strength to the IMF's balance sheet³¹. Any mobilization of IMF gold should therefore avoid weakening its overall financial position. Whenever feasible, profits from any gold sales could be used to create an investment fund, of which only the income should be used. Moreover, as the world's third largest holder of gold, the IMF has a systemic responsibility to avoid causing disruptions to the functioning of the gold market. Since the gold market is rather shallow, gold sales by the Fund could negatively affect not only the value of the holdings of all other official gold holders, but also the profitability of the gold mining industry, including in many gold-producing developing countries. Finally, any decision on IMF gold sales requires an 85% majority of total voting power, with the US (17.1% of the votes) holding an effective veto over the issue.³²

6. INCREASING EFFECTIVENESS IN THE USE OF FUNDS

As reflected in the main body of this paper, the debate has so far focussed on innovative sources of financing. There is, however, an urgent need to complement these considerations with a discussion on innovative mechanisms for aid delivery, to ensure the greatest possible effectiveness for the use of additional resources – whatever their origin – hence allowing concrete progress in reaching the MDGs.

One aspect of this is the risk of fragmentation of aid if particular sources of finance are linked to specific activities. This risks neglecting the lessons on aid effectiveness and the centrality of country ownership, and reducing the gains from more predictable flows of funds by introducing rigidities in developing countries' budgets.

Actions to improve aid effectiveness would translate into gains for recipient countries: enhancing co-ordination of policies and harmonisation of procedures would bring

³⁰ CPIAs are Country Policy and Institutional Assessments, which are based on indicators used by the World Bank to assess the 'quality' of a country's policy and institutional framework.

³¹ The IMF holds 103.4 million ounces of gold with a book value of SDR 5.9 billion (about \$9 billion) and a current market value of some \$44 billion, an undervaluation of some \$35 billion.

³² In this context, it should be recalled that any decisions on IMF gold sales have to be approved by the US Congress, whose opinion binds the US Executive Director when a Board vote is taken.

reduction in transaction costs; further untying aid ensures better value for money in goods and services; greater aid predictability allows longer-term commitments. Nevertheless, development gains depend primarily on improved policies and institutions in developing countries themselves.

The ongoing international process on aid effectiveness provides a positive impetus. The results of the work at EU level as well as the political commitments made by the international community as a whole, and by the EU, at the recent “High Level Forum on Aid Effectiveness” in Paris, provide a comprehensive agenda for immediate implementation. The EU is committed to further improving the effectiveness of its aid based on the comprehensive agenda agreed at EU and global level. The Communication on financing for development and aid effectiveness prepared by the Commission services intends to present policy initiatives in that regard.

Aid effectiveness is also maximised by ensuring the right balance among the available aid modalities. Project aid is not designed for supporting the financing of the increased recurrent costs implied by any policy aimed at achieving the MDGs. The results however are more easily monitored or evaluated (both ex-ante and ex-post). By requiring no separate accounting or reporting, budget support is an effective form of aid to support harmonisation of procedures. By providing resources to the national budget, it also guarantees alignment of aid with national priorities, as well as providing the flexibility to finance the most urgent needs for the country to make progress towards the MDGs. At the same time, it requires a sound framework in recipient countries for public expenditure management, to ensure accountability and transparency in the use of funds. Debt relief is both predictable and flexible and therefore represents a highly effective aid modality. However, it can only complement other sources of financing for the MDGs since it allocates resources according to a country’s debt stock rather than its needs and capacity to use funds effectively to reduce poverty.

Apart from the inherent characteristics of each of the existing aid modalities, the stability and predictability of ODA flows is also constrained by the unpredictability of the existing sources of development finances, which are to a considerable extent always vulnerable to changes in donors’ budgetary priorities. Limiting such vulnerability through dedicated sources of revenues, as in the tax proposals, or by locking in future pledges, as in the IFF, could support the financing of more predictable aid modalities. New options for flexible, stable and predictable aid modalities, to be deployed in high-performance countries, are being explored by the Commission services.

7. CONCLUDING REMARKS

The aim of this paper was to inform the debate in the EU on the proposals for increasing the financing of development aid with a view to achieving the Millennium Development Goals. Based on a number of criteria, the advantages and disadvantages of each of the different options were briefly discussed. While certainly none of the options would be a single perfect solution, most of them are not mutually exclusive and a combination of different options could be envisaged. This could be all the more interesting since they are likely to require a different timing to take account of preparations needed for their implementation, phasing-in possibilities or the medium-term erosion of the tax base. A combination of options would also diversify the risks arising from the uncertainties on some of the more innovative proposals.

Criteria for the assessment of the tax instruments

The criterion "*Revenue raising capacity*" relates to the amount of Government revenues which could be generated and to its stability over time. Considering the global target, a threshold has been set at 5 billion euros as a minimum level of the annual revenue raising capacity. An efficiency aspect has also to be considered here. This concept relates to the extent to which the tax will contribute to its objective and at which cost. As a general principle, it depends on the price elasticity of the tax base and the possibilities of relocation or substitution, which might reduce the tax base if a tax is introduced. It should be highlighted that very little is known or can be measured in the cases of taxes which have not been applied in practice, such as a tax on financial transactions.

The assessment of the *economic effects* concentrates on competitiveness issues. When relevant, other aspects are examined, like the impact on growth, inflation, and employment. The environmental dimension is included here as appropriate.

Implementation refers mainly to compliance and administrative costs. Risks of fraud/avoidance linked to the specific instrument will also be assessed, when relevant.

Legal aspects are analyzed, to pinpoint the legal requirements/conditions for the setting up of the measure.

Finally, *equity* has to be considered when assessing the impact of a tax. Horizontal equity refers to the principle that "equals should receive an equal treatment", while vertical equity refers to the progressivity of the tax among taxpayers. In the framework of an international debate, equity is connected to the impact of the tax on the distribution of income between countries.

Kerosene taxation used for intra-Community and national flights by EU carriers (330 € / 1000 l) ³³												
Criteria		Comments										
Revenue raising capacity		Based on current air transport volumes, estimates vary from € 6 to 7 billion annually, taking into account a decrease in demand due to higher prices. Fuel efficiency improvements are not included in the higher figure as they will have an impact on revenues mainly in the medium term. However, this effect will be at least partially offset by the strong growth of air transport demand in the longer term. The difficulties related to code-sharing practices with non-EU carriers need to be further assessed.										
Economic aspects / Competitiveness		<p>Estimates show that the tax would double fuel costs, which currently represent on average about 15% of the operational costs for intra-EU flights. Using the assumption that 100% of the costs are transferred to customers, the tax would translate into fare increases of 10 to 20 euro for one-way tickets. Estimates for average price elasticities in aviation for the whole market typically range between -0.6 and -1.1³⁴. The impact on air travel demand would be the following:</p> <table><tr><td>Elasticity</td><td>high (-1.1)</td><td>medium (-0.8)</td><td>low (-0.6)</td></tr><tr><td>Impact on demand</td><td>-15%</td><td>-11%</td><td>-8%</td></tr></table> <p>In the longer term, the reduction in demand would be more than offset by factors that increase the demand for air travel (higher income level etc.), and airlines would also respond to the increased fuel costs by reducing fuel consumption through changes in operations and the use of more energy-efficient aircrafts.</p> <p>The impact of the tax on airlines profits depends in the short term on their ability to pass the fuel cost increase on to customers. If the increase is entirely passed on to customers, then the impact on airlines' operating results, stemming from reduced demand, would remain limited. Extrapolating from former modelling exercises, the operating result of EU carriers as a share of revenues is expected to decrease only moderately. However, recent large fluctuations in the price of kerosene require that the above arguments are taken with some caution.</p> <p>Low-cost airlines would be more affected than traditional airlines, both because of a higher share of fuel in their costs and a higher price elasticity of demand. Although the definition of a common tax rate at EU level would limit the risk of distortion of competition, fuel taxation on EU carriers only would create distortions of competition with non-EU carriers operating on intra-EU flights. However, non EU carriers currently operate physically less than 5% of this market, mainly for freight, in connection to constraints imposed by bilateral agreements. To limit the tax-related distortions of competition, renegotiation of international Air Services Agreements (ASAs) should aim at levelling the playing field between EU and non EU carriers (see below). Finally, conditions of competition would be fairer towards other transport modes (road), which are currently taxed.</p> <p>A gradual introduction of the kerosene tax, over several years, would not lead to a net reduction in air transport demand but rather reduce its rate of growth.</p>			Elasticity	high (-1.1)	medium (-0.8)	low (-0.6)	Impact on demand	-15%	-11%	-8%
Elasticity	high (-1.1)	medium (-0.8)	low (-0.6)									
Impact on demand	-15%	-11%	-8%									
Environmental		The tax on aircraft fuel would decrease CO2 emissions by decreasing the demand for air travel, and by giving airline companies more incentives to improve aircraft fuel-efficiency.										

³³

Community minimum rate applicable to kerosene and diesel as of 2010.

³⁴

Cf. notably Gillen, Morrison, Stewart (2003), Élasticités de la demande de transport aérien de passagers: Concepts, problèmes et mesures; DETR (2000), Valuing the external cost of aviation, 2000, and DETR, Air traffic forecasts for the United Kingdom; Resource Analysis et al. (2000), Aviation Emissions and Evaluation of Reduction Options (AERO); ICAO (1995), Outlook for air transport to the year 2003. Elasticities differ between different types of flights, being higher for short-haul and for leisure flights than for long-haul and for business flights.

effects	Aviation is the source of other emissions (NO _x , PMs, HC, SO ₂), which have an impact on climate and local air quality. The impact on climate is estimated to be 2-4 times that of CO ₂ emissions mainly because NO _x emissions and condensation trails in high altitudes (Environmental assessment report no 10, EEA 2003).
Implementation	Aviation kerosene would be taxed when delivered to consumption, as other mineral oils are. For the acceptability of the tax, administrative and compliance costs are expected to remain limited. However, it should be taken into account that some aircraft are operated for extra-EU flights following intra-EU flights. With only a small number of operators, the risk of fraud would also be low. An extensive geographical coverage may be relevant to secure the effectiveness of a tax on aviation fuel. It would appear useful to negotiate with Switzerland, the EEA and Croatia, to take part in the measure, in order to limit re-routing or tankering.
Legal aspects	The current tax exemption for kerosene for international aviation is included in Directive 2003/96/EC ₂ , which allows Member States to tax kerosene on domestic flights or via bilateral agreements between MS. In addition, Art. 24 of the Chicago Convention provides that the kerosene which is contained on board of an aircraft of a contracting State on arrival in the territory of another State and retained onboard on leaving the territory of that State shall be exempt from tax in the country of arrival. When a third country carrier has access to intra-Community routes by using the so called 5th freedom rights under its bilateral ASA with Member States, the fuel used for these services is exempted from taxation as long as the bilateral agreements are not amended. Code-sharing on intra-Community flights makes it difficult for Member States to distinguish taxation between Community operators and third country operators. The amendment of bilateral ASAs between Member States and third countries allowing for the taxation of kerosene would therefore be necessary for the taxation of kerosene on all intra-Community flights. Or, conversely, distortion effects could be eliminated by exempting all carriers on specific routes where non-EU carriers operate in direct competition with EU carriers and where remaining legal obligations in ASAs continue to prevent them from being taxed. Negotiations to modify ASAs are currently ongoing at different levels and could provide an opportunity to insert the necessary tax provisions. In this legal framework, in order to tax kerosene on intra-Community and domestic flights, two possibilities exist: i) amending the Energy Tax Directive to make such taxation mandatory, or ii) Member States decide to tax their national flights, and amend their bilateral agreements foreseen under Art. 14 (2) of Directive 2003/96/EC in order to include the taxation of intra-Community flights.
Equity	The tourism industry and countries/regions that are dependent on long distance transport for tourism would be more affected. However, the flight is only one component of the tourist package (including accommodation, catering, leisure); an increase in the flight price of € 20 to € 40 for return tickets is not expected to have a significant impact on tourism. Moreover, the demand for tourism-related travel is likely to increase in the future due to other factors (increasing income level, number of pensioners) and these factors are likely to counter-act the demand impact of higher travel prices in the long-run. Modelling shows that the impact of destination-switching within the EU and with outside destinations is likely to be small, as most alternative destinations are geographically much more distant. As regards the impact on consumers, low-budget air consumers would be more affected by the measure. As air travel represents a much higher share of spending of high-income than of low-income households, the overall impact of the tax would be progressive.

Departure tax: € 10 on intra-Community flights and € 30 on international flights																
Criteria	Comments															
Revenue raising capacity	Around € 6 billion annually, taking into account the demand reaction due to the price increase. The revenues are similar to the ones stemming from the kerosene tax option because, while the tax base is wider if all flights leaving the EU are included, the average rate is lower.															
Economic aspects / Competitiveness	<p>The impact of a departure tax of € 10 on demand for intra-European flights would be somewhat lower than the impact of kerosene taxation since it corresponds to a lower average ticket price increase (10 compared with € 10 to € 20). Moreover, a departure tax of 30 euros would also apply to international flights departing from the EU, which increases the overall impact on demand.</p> <p>For a range of price elasticities between -0.6 and -1.1, and assuming that 100% of the tax would be borne by customers (which means that airlines would not adjust pre-tax prices to partially offset its impact on demand), the impact on demand would be the following, based on preliminary estimates:</p> <table border="1"> <thead> <tr> <th rowspan="2">Elasticity</th><th colspan="2">Impact on demand</th></tr> <tr> <th>Intra-EU flights</th><th>Flights from EU</th></tr> </thead> <tbody> <tr> <td>high (1,1)</td><td>-10%</td><td>-15%</td></tr> <tr> <td>medium (0,8)</td><td>-7%</td><td>-11%</td></tr> <tr> <td>low (0,6)</td><td>-5%</td><td>-8%</td></tr> </tbody> </table> <p>The negative impact of the departure tax on airlines profits would remain limited if the cost of the tax is entirely borne by customers (i.e. assuming no pre-tax adjustment of fares), as it would only result from reduced demand. The decrease in airlines revenues from intra-EU flights would be smaller than in the kerosene tax option, as the tax is lower, but revenues from flights to extra-EU destinations would also be reduced. Extrapolating from former modelling exercises, the operating result of EU carriers as a share of revenues is expected to decrease only moderately.</p> <p>Low cost airlines would be more affected than traditional ones, both because the tax would represent a higher share of the average ticket price, and because of a higher price elasticity of demand, unless there is a tax rate differentiation.</p> <p>As regards the impacts on other economic sectors which rely on air transport, in particular the tourism industry, as in the case of the kerosene tax, they are the result of two effects: first, a net reduction in air travel demand, and second, destination switching. The main impact on tourism would come from reduced air travel demand, also taking into account substitution with land transport. The impact on tourism through destination switching would mainly concern non-EU travellers, as for travellers departing from the EU, international flights would be covered by the tax; in addition, the tax differentiation between intra-Community and international flights would help to maintain the attractiveness of European tourist destinations.</p> <p>As regards the competitiveness of airlines, the effects of any differentiated taxation between EU and non-EU carriers on international routes from the EU would potentially have a stronger impact than on intra-EU routes, since competition of non European airlines is higher. However, as the departure tax would apply to all carriers, it would not create direct distortions of competition. Indirect effects of the tax on EU carriers through reduced demand on their home market are likely to be very small according to previous studies³⁵.</p>		Elasticity	Impact on demand		Intra-EU flights	Flights from EU	high (1,1)	-10%	-15%	medium (0,8)	-7%	-11%	low (0,6)	-5%	-8%
Elasticity	Impact on demand															
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³⁵

Economic incentives to mitigate greenhouse gas emissions from air transport in Europe, study made for the European Commission, CE Delft, 2002.

Environmental effects	<p>A departure tax would not provide incentives for energy-efficiency improvements, but would reduce emissions through the impact on reduced demand for air travel. The impact on overall economic efficiency is less favourable than that of a fuel tax because it does not address directly externalities. However, the environmental impacts of the departure tax would be increased because of the larger tax base, as international flights departing from the EU, including long haul flights, would be covered. Taking also into account the lower rates, the environmental impacts are likely to be of the same order of magnitude as those of the fuel tax, at least in the short to medium term. In the longer term, the absence of incentives for improved fuel efficiency would make this option less favourable.</p>
Implementation	<p>Several Member States have already implemented taxes similar to departure taxes. The taxable event consists in the carriage from a Community airport of chargeable passengers on chargeable aircraft.</p> <p>Differentiated rates can be applied, one for domestic and intra-Community destinations, and one for other destinations. The class of travel (economy, business) could also be taken into consideration.</p> <p>The tax can be collected by operators of chargeable aircraft.</p> <p>Charge avoidance is likely to be smaller than in the case of a fuel tax, since fuel tankering would not be an option and the only way of avoiding the tax would be for passengers to change the origin of travel.</p>
Legal aspects	<p>A departure tax is compatible with the Community legislation when it does not distinguish between domestic and intra-Community flights. It needs to be clarified if a departure tax would be compatible with GATS rules and other international obligations.</p>
Equity	<p>Equity could be insured through differentiated tax rates.</p>

Currency transaction taxes	
Criteria	Comments
Revenue raising capacity	<p>A number of studies suggest that a CTT could bring considerable revenues, sometimes estimated in the range of US\$ 30-300 billion globally³⁶. However, the underlying assumptions and parameters vary a lot, in particular with regard to the tax rate (sometimes of up to 1%) and the eventual impact of the CTT on transaction volumes.</p> <p>Figures calculated in the context of a unilateral application of the tax in the EU only and taking into account possible tax avoidance, and other changes of behaviour, lead to lower figures. According to estimates made by the French Treasury³⁷, tax proceeds of a unilateral tax in the EU-15 applied on all banking transactions involving currency exchange would be within a range of € 7 to 11 billion (assuming a rate of 0.01%). The Belgian High Council for Finance (2001) reaches estimates of € 9 billion for an equivalent rate³⁸.</p> <p>However, these figures need to be interpreted with caution. The simulations rely on assumptions, for instance, about the elasticity of transaction volumes to the tax rate that are not empirically verified. Both above-mentioned studies assume that transaction volumes would likely decrease significantly as tax rates increase.</p>
Economic aspects / Competitiveness	<p>The introduction of a currency transaction tax is likely to reduce the volume of transactions, which constitutes the base of the tax. According to the study conducted by the Belgian High Council for Finance the reduction effect is already significant at a 0.01% level and becomes critical at a 0.05% tax rate for some types of operations. In the lower range of the tax, the volume reduction effects would be far more important for inter bank transactions (the largest share of the market) than for other financial institutions and the non-financial sector.</p> <p>The reduction in transaction volumes would to a large extent result from the relocation of taxed activity outside the scope of the European jurisdiction. The risks of substitution between financial products would also play an important role as bank transactions could be replaced by non-bank transactions.</p> <p>A currency transaction tax could reduce rather than increase liquidity, because the tax would increase the bid-ask spreads. This effect could lead not only to an additional reduction of the tax base, but also trigger a price reaction from the banking sector in order to maintain profitability.</p> <p>Finally, a unilaterally applied tax would negatively affect the competitiveness of European investments, since international portfolio risk diversification would be penalised by the tax. The effects of a liquidity reduction on exchange rate volatility are ambiguous.</p>
Implementation	<p>In most Tobin-type proposals, there is no precise information available on how the tax should be implemented in practice. Taxing individual buying and selling transactions would in theory lead to larger revenues, i.e. due to a large tax base, but the practical implementation of such a broad-based CTT remains largely unknown.</p> <p>Taxing net positions at the level of a centralised settlement system could reduce the administrative burden at the expense of a narrower tax base, but many features of such an approach remain unclear.</p>

³⁶ See for instance, Nissanke, Machiko, "Revenue Potential of the Tobin Tax for Development Finance: A critical appraisal," Discussion paper 2003/81, World Institute for Development Economics Research, Helsinki. According to the UN Conference on Trade and Development, a rate of 0.1% would generate 72 billion dollars.

³⁷ Rapport sur la taxation des opérations de change – Ministère de l'Economie, des Finances et de l'Industrie (23 August 2000)

³⁸ Avis relatif à l'instauration éventuelle d'une taxe de type "Tobin"- Conseil Supérieur des Finances (June 2003).

Legal aspects	<p>The compatibility of the proposed tax with the EC Treaty is not established yet. A CTT could restrict the free movement of capital and payments (Art. 56 TEC). The tax could also discriminate transactions involving countries with different currencies – including intra-EU transactions – compared to those within one country and within the euro zone.</p> <p>The view of the European Central Bank, in an opinion relating to the Belgian tax model, was that the measure would not be compatible with the Treaty³⁹.</p> <p>Furthermore, it needs to be checked whether such tax would be compatible with the GATS rules and other international obligations.</p>
Equity	<p>Very few studies have investigated the issue of equity for the currency transactions tax. The ultimate impact of the CTT would depend on its concrete implementation and the reactions of financial operators.</p> <p>Currency markets are highly concentrated in a few major markets, in particular the City of London. The introduction of a currency transactions tax in the EU would affect mainly these markets.</p> <p>Given the fact that it is impossible to single out purely financial from real transactions, all currency transactions between euro and non-euro EU currencies would be subject to tax, while trade between euro members would remain unaffected.</p>

³⁹

European Central Bank (2004), "Opinion of the European Central Bank of 4 November 2004 at the request of the Belgian Ministry of Finance on a draft law introducing a tax on exchange operations involving foreign exchange, banknotes and currency", CON/2004/34.

VAT: Applying a surcharge of 0.5 point of percentage to the existing VAT rates ⁴⁰																																																																																								
Criteria		Comments																																																																																						
Revenue raising capacity		Around € 14 billion annually taking into account the economic impact of the measure and a budget neutrality constraint. Revenue fluctuates according to the business cycle.																																																																																						
Economic aspects / Competitiveness		<p>Using the results of the QUEST simulation (EU-15), a 0.5 percentage point increase in VAT would lead to a fall in the GDP growth of -0.24% the first year and -0.14% after 10 years.</p> <p>The higher consumer prices driven by this VAT rate increase shrinks the consumption by 1 percent. As workers are partially compensated for the increase in prices, the resulting increase in wages leads to a negative impact on employment. The unemployment rate increases by 0.2 percentage points.</p> <table><tr><th>Year</th><th>1</th><th>2</th><th>3</th><th>4</th><th>5</th><th>10</th><th>15</th></tr><tr><td>GDP</td><td>-0.24</td><td>-0.12</td><td>-0.15</td><td>-0.15</td><td>-0.16</td><td>-0.14</td><td>-0.13</td></tr><tr><td>Consumption</td><td>-0.94</td><td>-0.99</td><td>-1.07</td><td>-1.09</td><td>-1.09</td><td>-1.00</td><td>-0.91</td></tr><tr><td>Employment</td><td>-0.13</td><td>-0.18</td><td>-0.21</td><td>-0.22</td><td>-0.22</td><td>-0.23</td><td>-0.22</td></tr><tr><td>Real wage costs</td><td>0.10</td><td>0.10</td><td>0.05</td><td>0.03</td><td>0.02</td><td>0.03</td><td>0.04</td></tr><tr><td>GDP inflation (%-p)</td><td>-0.09</td><td>0.04</td><td>0.00</td><td>-0.01</td><td>-0.02</td><td>-0.02</td><td>-0.02</td></tr><tr><td>Cons. price inflation (%-p)</td><td>0.47</td><td>0.03</td><td>-0.01</td><td>-0.01</td><td>-0.02</td><td>-0.02</td><td>-0.02</td></tr><tr><td>Unemployment rate (%-p)</td><td>0.12</td><td>0.17</td><td>0.19</td><td>0.20</td><td>0.21</td><td>0.21</td><td>0.21</td></tr><tr><td>VAT revenue (% of GDP)</td><td>0.27</td><td>0.26</td><td>0.25</td><td>0.25</td><td>0.25</td><td>0.25</td><td>0.26</td></tr><tr><td>Transfers abroad (% of GDP)</td><td>0.07</td><td>0.14</td><td>0.14</td><td>0.14</td><td>0.14</td><td>0.14</td><td>0.14</td></tr></table> <p>No direct competitiveness effects are likely as all goods and services are taxed in the same way (exports are not concerned). However, as GDP growth is affected, a medium-term effect on EU competitiveness could appear.</p>							Year	1	2	3	4	5	10	15	GDP	-0.24	-0.12	-0.15	-0.15	-0.16	-0.14	-0.13	Consumption	-0.94	-0.99	-1.07	-1.09	-1.09	-1.00	-0.91	Employment	-0.13	-0.18	-0.21	-0.22	-0.22	-0.23	-0.22	Real wage costs	0.10	0.10	0.05	0.03	0.02	0.03	0.04	GDP inflation (%-p)	-0.09	0.04	0.00	-0.01	-0.02	-0.02	-0.02	Cons. price inflation (%-p)	0.47	0.03	-0.01	-0.01	-0.02	-0.02	-0.02	Unemployment rate (%-p)	0.12	0.17	0.19	0.20	0.21	0.21	0.21	VAT revenue (% of GDP)	0.27	0.26	0.25	0.25	0.25	0.25	0.26	Transfers abroad (% of GDP)	0.07	0.14	0.14	0.14	0.14	0.14	0.14
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Implementation		Neither administrative nor compliance costs would increase.																																																																																						
Legal aspects		No specific legal difficulty. No change would be required in the VAT Directive.																																																																																						
Equity		All final consumers bear the burden of the VAT. Therefore the burden is higher in proportion for low income households who consume a higher share of their income. Some Member States apply zero VAT rate and will therefore contribute less than others.																																																																																						

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The surcharge would not be applied to zero-rated goods.

3 cent surcharge on motor fuel excise duties	
Criteria	Comments
Revenue raising capacity	<p>€ 11-12 billion annually (including additional VAT revenues), taking into account the demand reaction due to the price increase.</p> <p>Data show that energy taxes revenues tend to be relatively stable, even in time of significant variations in oil prices.</p>
Economic aspects / Competitiveness	<p>The tax revenues raised would represent 0.1% of EU-25 GDP.</p> <p>The retail prices of transport fuels would increase 4% on average in EU- 25. This would lead to a 0.5% decrease in fuel consumption (TREMOVE model simulation). Since the increase in fuel prices is small, competitiveness impacts would be minor. For hauliers, as fuel prices only constitute a fraction of total transport costs (23%), the 4% increase in fuel prices would lead to a 0.9% increase in total transport costs. This would have only a limited impact on transport activities. However, if, for competitiveness reasons, it were envisaged to exclude professional diesel from the tax increase, revenue loss would amount to around one billion euros per annum.</p> <p>An incremental risk of fuel tourism may exist on the EU external border.</p> <p>In line with the decrease in fuel consumption, CO2 emission would fall by 0.5% and NOx and PM emissions approximately by 0.4% (TREMOVE model simulation).</p>
Implementation	<p>Present national rates on motor fuels would be increased by 3 cent per litre. Progressive increases (1 cent per year) could be contemplated.</p> <p>A harmonised energy tax structure is already in force in the EU (Directive 2003/96/EC). Administrative and compliance costs would remain at present level. No significant increase in fraud levels has to be feared.</p> <p>Fuel taxes and infrastructure charges could be compatible.</p>
Legal aspects	No specific legal difficulty. No change would be required in the Energy Tax Directive.
Equity	<p>The burden of motor fuel tax falls more heavily on the people using frequently private cars and living in the remote areas without public transport. The car ownership increases with a person's income level and hence the cost increase would be more important for higher than lower income households (although the cost increase would represent a smaller fraction of the household budget for higher than lower income households). As a whole, these effects are small.</p>