

G20 MONITOR

TAX, INFRASTRUCTURE, ANTI-CORRUPTION, ENERGY AND THE G20

MIKE CALLAGHAN

STEPHEN GRENVILLE

MARIA MONICA WIHARDJA

DANIELA STRUBE

MARTY HARRIS

PHILIP ANDERSON

HUGH JORGENSEN

The Lowy Institute for International Policy is an independent policy think tank. Its mandate ranges across all the dimensions of international policy debate in Australia – economic, political and strategic – and it is not limited to a particular geographic region. Its two core tasks are to:

- produce distinctive research and fresh policy options for Australia’s international policy and to contribute to the wider international debate.
- promote discussion of Australia’s role in the world by providing an accessible and high quality forum for discussion of Australian international relations through debates, seminars, lectures, dialogues and conferences.

Funding to establish the G20 Studies Centre at the Lowy Institute for International Policy has been provided by the Australian Government.

The views expressed in the contributions to this Monitor are entirely the authors’ own and not those of the Lowy Institute for International Policy or of the G20 Studies Centre.

Table of Contents

Overview: the G20 and long-term financing for investment, reforming international taxation, global energy governance, and fighting corruption.....	1
Mike Callaghan	
Financing for infrastructure – what contribution can the G20 make?	6
Stephen Grenville	
Looking at G20 initiatives on infrastructure investment from a developing country’s perspective: Indonesia	17
Maria Monica Wihardja	
A 7-point plan for the G20 infrastructure financing agenda	25
Daniela Strube	
Reforming international taxation: the role of the G20	31
Mike Callaghan and Marty Harris	
Multilateral response to base erosion and profit shifting	40
Philip Anderson	
Hard graft: the G20 and anti-corruption	46
Hugh Jorgensen	
G20 and global energy governance	57
Mike Callaghan and Marty Harris	
Contributor biographies.....	65

Overview: the G20 and long-term financing for investment, reforming international taxation, global energy governance, and fighting corruption

Mike Callaghan¹

This issue of the Monitor deals with four topics: long-term financing for investment, combating tax evasion and avoidance, fighting corruption and global energy governance. Consistent with the approach taken in previous issues of the Monitor, the question explored within each topic is ‘how can the G20 add value?’

Long-term financing for investment and the G20

There are three papers on this topic: from Stephen Grenville, Maria Monica Wihardja and Daniela Strube. All three concentrate on the issue of financing for infrastructure investment.

Grenville and Wihardja’s papers were written prior to the St Petersburg summit on 5-6 September 2013 and the associated release of the workplan prepared by the G20 Study Group on Financing for Investment.² However, Grenville has written an addendum to his paper that provides a brief summary and comment on the outcomes from the St Petersburg summit.

Importantly for Australia, leaders have outlined an agenda of issues to be pursued during Australia’s charring of the G20 in 2014, including the implementation of various measures by the time of the Brisbane summit. For example, in St Petersburg, leaders agreed to:

- identify and start to implement, by the Brisbane summit, a set of collective and country-specific actions that tangibly improve ‘our investment environment’;
- identify, by the next summit, approaches to implementing the OECD’s High-level Principles of Long-term Investment Financing by Institutional Investors;
- identify measures that will facilitate the development of domestic capital markets and improve the intermediation of global savings for productive long-term investments; and
- give particular attention to ways of improving public-private partnership (PPP) arrangements.

The key issue addressed by both Grenville and Strube is ‘how can the G20 add value in facilitating increased financing for infrastructure investment?’ Both authors observe that infrastructure investment is not a global public good, and that most of the steps required to improve the environment for infrastructure investment involve measures that lie within national decision making processes. In this context, as Strube notes, one role that the G20 can play is in advocating for appropriate domestic policy settings. This is consistent with the leaders’ commitment made in St Petersburg that G20 members develop country-specific measures for improving their respective investment climates by the time of the Brisbane summit.

¹ Director, G20 Studies Centre, Lowy Institute for International Policy.

² G20. *G20 workplan on financing for investment: study group's findings and ways forward*. G20 Study Group on Financing for Investment, July 2013: <http://en.g20russia.ru/news/20130906/782776427.html>.

While the constraints and challenges of infrastructure financing are not principally global matters, sharing ‘best practice’ is something that the G20 can do, and in this regard the paper by Wihardja, which focuses on the infrastructure needs of Indonesia, provides a useful benchmark in terms of the needs of emerging markets and where the G20 may assist. As Wihardja notes, Indonesia is in dire need of infrastructure and needs help from its regional and global partners in furthering the debate on infrastructure development, in learning lessons from other successful countries and in receiving assistance so it can build up domestic capacity. Wihardja says that Indonesia needs external pressure that will galvanise reform.

Strube make a similar point in her paper that the G20 can advocate for the adoption of infrastructure-friendly domestic policies. In terms of taking forward the commitments made by leaders in St Petersburg, and in recognising that domestic policy settings are the main factor that influence a country’s investment environment, Strube suggests that infrastructure should be viewed as a ‘cross-cutting’ issue on the G20’s agenda, rather than as a separate work stream. As such, work on other policy issues, such as macroeconomic policy settings, financial regulation, climate change and reducing corruption, should explicitly consider the relevant implications of improving the environment for infrastructure investment.

Grenville identifies a number of areas where international cooperation can assist infrastructure financing, such as building up greater cross-country uniformity to help reduce research and decision making costs, supporting the development of local bond markets, and by providing technical support, particularly through the multilateral development banks (MDBs).

A particularly challenging task that leaders have set for themselves in 2014 is to improve the intermediation of global savings towards productive long-term investments. As Grenville and Strube point out, instead of capital flowing ‘up-hill’ from emerging markets to developed economies, there are benefits from connecting the surplus savings of developed countries with the high social-return infrastructure investment opportunities in emerging markets. While Grenville feels that reversing the ‘up-hill’ flow of capital from emerging to mature economies may be beyond the G20’s reach, it is nevertheless a challenge that the forum will have to confront in 2014.

Reforming international taxation and the G20

There are two papers on this topic: one by Marty Harris and myself and another by Philip Anderson.

The progress made in combating tax evasion and tax avoidance was a major outcome of the St Petersburg summit. The G20’s focus has been on reducing tax evasion through greater tax transparency and the promotion of the automatic exchange of tax information, as well as on dealing with tax avoidance by responding to ‘base erosion and profit shifting’ (BEPS).

The reform of international taxation is a complex and contentious issue. As both papers note, in many respects St Petersburg dealt with the easy parts – the endorsement of ‘High-level Principles’ to combat BEPS and an agreement that G20 members would aim to automatically exchange tax information by end-2015. However, Australia has the difficult task of ensuring that concrete progress is made on these commitments throughout 2014, if the deadline is to be met. And it is essential for the credibility of the G20 that this is the case. It would be extremely unfortunate if what is considered to be a major outcome from one summit is seen

to languish under the next G20 chair, thereby confirming concerns that the G20 fails to deliver and that as the chair rotates, the G20 embarks on a new set of priorities. Moreover, apart from the concern that governments have about revenue leakage, there are also equity considerations embedded within the failure of corporates to pay their fair share of tax, a matter that resonates with the public in all G20 countries.

Harris and I propose that Australia, as G20 chair, advance the BEPS project in 2014 by focusing on the three areas:

- First, focus on greater transparency, in particular, getting taxpayers in all G20 countries to disclose more targeted information about their tax planning strategies. The drive for greater transparency should include disclosure of taxpayers' beneficial ownerships, and a renewed effort should be made by all G20 members to commit to the Extractive Industry Transparency Initiative. Improved transparency is an area that can be advanced relatively quickly and does not require the negotiation of an international agreement.
- Second, the work on BEPS should be placed in the broader context of the need for G20 members to adjust to a changing global business landscape. The core problem has been the failure of international tax laws to maintain pace with global and technological changes, particularly in the digital economy. The same changes are also impacting on trade policy, which has not adjusted to the rise of global value chains and the fact that goods are increasingly being made 'in the world' and not in any one country. Technological change will continue to occur. In 2014 the G20 should introduce a forward looking component to the process, where ministers and leaders reflect on the implications of likely future corporate and technological developments and what they mean for economic management and the importance of international cooperation. For example, Anderson's paper notes the increasing challenge of imposing VAT/GST on cross border transactions that involve the digital supply of goods and services.
- Third, it is important that the G20's work on tax is seen as a global initiative and is particularly responsive to the needs of developing countries. Improving the domestic revenue raising capacity of low-income countries will have enormous implications in improving their development prospects. In 2014 there should be closer engagement between the G20 members and non-G20 members, particularly developing countries, on the BEPS project.

Continuing with the theme that the G20 needs to respond to the changing international business landscape, Anderson notes in his paper the increasing challenge of imposing VAT/GST on cross border transactions that involve the digital supply of goods and services. Anderson also notes that the combined OECD and G20 membership represents only twenty per cent of countries in the world, quite small countries can play a major role when it comes to tax planning. Hence the interest of all countries needs to be taken into account if the proposed changes are to be effective.

The G20 and the fight against corruption

Hugh Jorgensen's paper offers a critical review of the G20's work on anti-corruption. The context of the paper is that the mandate of the G20's Anti-Corruption Working Group and the most recent G20 Anti-Corruption Action Plan are set to expire in 2014, meaning that leaders at the Brisbane summit will have to decide whether to extend the current approach to combating corruption, or try something different.

Many of the issues that Jorgensen discusses go to the heart of the operation of the G20 and where it can add value. As noted in the papers on long-term investment financing, one of the great advantages of the G20 is that participating leaders can give a political push to get things done. This has occurred in the work on anti-corruption, notably in encouraging countries to ratify the United Nations Convention against Corruption (UNCAC) and the OECD's Anti-Bribery Convention. But Jorgensen notes that while corralling G20 members into ratifying an international convention is a valuable first step, the real test is getting countries to fulfil their obligations under that convention. To date, the weak point of the G20's activities has been in closing the gap between commitments and implementation. In discussing which issues should be dealt with by leaders, Jorgensen points out that the detailed aspects of anti-corruption work should not be on the leaders' agenda. However, the question that arises is that if a country is to take any given commitment seriously, might it be necessary for it to be directly considered by leaders?

Another very relevant point that Jorgensen makes about the Anti-Corruption Working Group, which is applicable to all G20 working groups, is that there should not be an expectation that they are meant to last in perpetuity – their role and ongoing relevance should regularly be considered. Jorgensen concludes that while the G20 has brought value to the anti-corruption agenda, its ability to do so in the future will require leaders to push for a more specific and outcome-oriented set of objectives.

Global energy governance and the G20

Marty Harris and I also have a second paper that considers the role of the G20 in dealing with changes in the global energy market and the lack of institutional arrangements to deal with these changes. As we note, the problem is that international energy governance has not sufficiently adapted to the major changes that have been taking place in world energy markets, particularly: the emergence of major developing countries; changing relations between oil producers and consumers; and, climate change as a key energy policy issue. For example, the International Energy Agency (IEA) is the most prominent international energy body, but its membership is limited to OECD countries and is largely a consumer-oriented agency. Any reform of global energy governance will have to include the major energy exporting countries.

Given that its membership includes both major energy producer and consumer countries, it has been argued that the G20 could play a direct role in coordinating the work of the various energy agencies and other international bodies working on related issues, such as the UNFCCC, IEA, World Bank, IAEA, Energy Charter Secretariat, WTO, OPEC, International Energy Forum, IPCC and others. However, as an informal political grouping without a secretariat, this would involve a level of engagement that goes beyond the G20's existing structure. Nevertheless, we do conclude that the G20 is the only forum that has the political power or weight that could improve global energy governance. Moreover, consistent with

efforts to reform the governance arrangements in the international financial institutions, a central objective of the G20 should be to ensure that all global international economic institutions are adapting to a rapidly changing global economy.

Conclusion

The issues covered in this Monitor are wide ranging, but they do raise similar issues in terms of where the G20 can add value. It is evident that one of the main roles that the G20 can play is to bring to bear the political weight of leaders in advancing an issue. But this is a power that has to be used in a targeted and selective way. For as we have seen, the fastest way for the G20 to lose credibility is for leaders to make a commitment that they then fail to implement.

Financing for infrastructure – what contribution can the G20 make?

Stephen Grenville¹

Addendum

The main text of this paper was drafted before the St Petersburg Leaders' meeting. This addendum provides a brief summary of the outcomes of the St Petersburg meeting that relate to infrastructure.

The St Petersburg G20 summit² covered infrastructure-related issues under the agenda topic *Financing for Investment*, with leaders committing 'to identify and start to implement by the Brisbane summit a set of collective and country-specific actions that tangibly improve our domestic investment environments such that they are more favorable to long-term investment financing and can lead to an effective increase of implemented projects, particularly in infrastructure and for SMEs.' The leaders also:

- endorsed the Work Plan prepared by the G20 Study Group on Financing for Investment;
- endorsed the G20/OECD High-level Principles of Long-term Investment Financing by Institutional Investors;
- noted the work underway by the World Bank Group and regional development banks to mobilise and catalyse additional financing for infrastructure investment, particularly in emerging markets and developing countries; and,
- called for particular attention to be given to ways to improve public-private partnership (PPP) arrangements.

The Work Plan of the G20 Study Group on Financing for Investment has set in train a number of studies relevant to infrastructure investment. These cover capital markets and local-currency bond markets (including enhanced coordination of technical assistance from international organisations), as well as a comparative analysis of financial market deepening in emerging and advanced economies. Other studies will cover securitisation and equity markets, and the role of sovereign wealth funds (SWFs) in long-term investment, especially in infrastructure.

The OECD, having led the development of the High-level Principles for Long-term Investment Financing (see below) will shift its focus to a more practical and detailed examination of insurance and pension funds as long-term investors in infrastructure. This will include both old models (listed funds, private equity and monoline guaranteed project bonds) and new forms (direct/co-investment or club format investment, such as the pooling of pension funds, open-ended models, EU/UK project bonds initiatives, and debt funds and institutional investors' direct lending).

Several of the study projects will directly address a request from G20 leaders' to provide analysis that will 'drive well-founded, evidence-based policy initiatives'. An example is the

¹ Visiting Fellow, Lowy Institute for International Policy.

² G20. *G20 leaders' declaration*. 6 September 2013: <http://www.g20.utoronto.ca/2013/2013-0906-declaration.html>.

OECD's project to examine the risk/return characteristics of private infrastructure investments, drawing on a large data sample of specific investments (which the OECD can access because it can offer anonymity and independent objectivity). This should be of interest to both investors (benchmarking their own portfolios) and regulators in investment countries. The World Bank will lead a study on *Practical Solutions and Models for Addressing Obstacles to Institutional Investment in Infrastructure in Developing Countries*, focusing on providing examples of infrastructure investments (successes and failures) in developing economies by institutional investors. Based on the findings of these case studies, a set of 'models' will be suggested for how institutional investors might operate.

Also relevant to infrastructure are the High-level Principles of Long-term Investment Financing by Institutional Investors, endorsed at St Petersburg. These principles have largely been developed by the OECD, but with very extensive consultation and input from a wide range of international agencies, including the multilateral development banks. The principles are designed to assist the OECD, the G20 and any other interested countries to facilitate and promote long-term investment by institutional investors, particularly among those institutions, such as pension funds, insurers and sovereign wealth funds, that typically have long duration liabilities and consequently can consider long-term investments in infrastructure. Such institutions hold global assets of \$US85 trillion. The principles also cover the development and governance of these latter institutions with regards to: regulation and tax treatment; suitable financial instruments; information sharing and disclosure; financial education; and consumer protection.

The wide participation in the development of the principles has resulted in an omnibus document, with many issues covered at a high level of generality. There is something for everyone, without much attempt to discuss the merits of alternative approaches, or to identify the operational challenges. With these principles now at a highly refined stage, it seems time for the G20 to 'declare victory' on this project and steer the very considerable resources that have been devoted to this broad topic, towards narrower and more specific aspects of the subject, as set out in the Work Plan of the Study Group.

The remainder of this paper was written prior to the St Petersburg summit.

Introduction

The G20's interest in long-term investment financing was identified at Seoul in 2010. As G20 chair, Russia has nominated to include this topic within the forum's agenda for 2013. A diagnostic report assessing factors affecting long-term financing was prepared by the international organisations and presented to G20 finance ministers at their meeting on 15-16 February 2013. A taskforce has subsequently been established to examine the report.³

³ High-Level Panel on Infrastructure. *Recommendations to G20 - final report*. October 2011: http://www.boell.org/downloads/HPL_Report_on_Infrastructure_10-26-2011.pdf; MDB Working Group on Infrastructure. *Infrastructure action plan: submission to the G20 by the MDB working group on infrastructure*. October 2011: http://www.boell.org/downloads/MDBs_Infrastructure_Action_Plan.pdf.

There are already substantial reports that have been written in response.⁴ At the same time, independently, there has been growing interest in this broad topic from the G30,⁵ McKinsey⁶ and others. The Australian deputy prime minister announced in January 2013 that regional infrastructure development would be a priority for the G20 in 2014. However, long-term funding is a crowded field, and if Australia is to make a contribution, it will have to identify how the G20 can add value. The focus of this paper is confined to one important aspect of long-term financing: facilitating infrastructure financing.

This paper looks at what needs to be done for, and where the G20 might contribute to, infrastructure financing. The following dot points contain a summary of the argument made in this paper.

- No one disputes the potential of very substantial beneficial infrastructure expenditure with high social returns, especially in developing countries.
- The potential funding for this expenditure exists at a global macro level, with the world experiencing a prolonged saving/investment imbalance with excess *ex ante* savings, reflected in low long-term official interest rates.
- The nature of infrastructure presents special difficulties for a financier. Such public-good projects are large-scale, long-term, illiquid, and present challenging revenue problems. To turn opportunities for macro-level funding into specific project funding involves detailed governance, competent project appraisals and effective intermediary links between funders and spenders. Putting these preconditions in place has proved to be a challenge, even in advanced countries, and even before the 2008 financial crisis severely disrupted funding channels. The 2008 crisis has altered global funding opportunities. Bond issues are the key to replacing some of the funding lost from the deleveraging of advanced-country banks.
- Heightened concerns about budget deficits and official debt provide an additional constraint on funding in advanced countries. This is especially important as conventional budget funding has been the predominant source of infrastructure financing in the past and austerity efforts inevitably fall heaviest on capital spending. This constraint seems less pressing for the emerging economies, but the psychological message of austerity seems to have gained wide currency.
- Given this budget austerity, attention turns to PPPs, often seen as a residual source of capital that can fill the funding gap. PPPs are a significant source of infrastructure funding, but the preconditions for successful PPP contracts are very demanding. Potentially, rather than providing a substantially larger source of funding, PPPs might find an expanded role in encouraging full privatisation of infrastructure services

⁴ Specifically, finance ministers and central bank governors noted in the February 2013 communiqué: ‘We look forward to the OECD report on the “High-level Principles of Long-term Investment Financing by Institutional Investors” by the Leaders’ summit in St Petersburg. The FSB will continue to monitor the possible effects of regulatory reforms on the supply of long-term financing. We have asked the MDBs to consider modalities to optimize their lending capacity and to enhance the catalytic role they play in mobilizing long-term financing from other sources, including through PPPs. We encourage the World Bank and other relevant IOs to intensify their efforts in addressing weaknesses in infrastructure project preparation and design and, drawing on existing G-20 work, where relevant, come up with the recommendations on how to address this challenge. We also ask the MDBs to analyse the existing modalities of interaction with the National Development Banks (NDBs).’ For the full text of the communiqué, see: G20. *Communique of G20 finance ministers and central bank governors, Moscow*. February 16 2013: <http://www.fin.gc.ca/n13/13-025-eng.asp>.

⁵ G30 Working Group. *Long-term finance and economic growth*. Washington, DC, 2013.

⁶ McKinsey Global Institute. *Infrastructure productivity: how to save \$1 trillion a year*. January 2013: http://www.mckinsey.com/insights/engineering_construction/infrastructure_productivity.

where appropriate, and in providing the incentives for better project appraisal and administration, as a filter to exclude low-return ‘white elephant’ projects.

- Because PPPs tend to have neither the capacity to fund the major part of an investment, nor the likelihood of ensuring widespread satisfactory governance and project appraisal, official debt issue will remain the main source of new funding. Hence, more attention should be given to expanding and improving conventional bond funding.
- The existing links between infrastructure projects and sources of long-term capital are not well developed and the intermediaries linking them (including credit rating agencies) may not be appropriately aligned with the key task of presenting attractive investment opportunities to the ultimate sources of long-term capital, such as pension funds and insurance companies.
- The constraints and challenges explored here are not principally global. Although common to many countries, they are largely under the control of national authorities. However, while resolutions to the main problems that are listed above might not lie in international rule-making or coordination, there remain opportunities to learn from others who have established successful infrastructure governance procedures and whose bond markets are growing quickly. The multilateral development banks (MDBs) could usefully expand their role in improving governance and project appraisals, although their funding capability will remain modest.
- An expansion of infrastructure spending in emerging countries would be helpful for the global economy, both lifting demand and shifting imbalances in the right direction. However, while it is easy enough to propose grand plans for a coordinated expansion based on infrastructure spending, the necessary preconditions might not exist yet.

The scale of the infrastructure challenge

To put the task of financing infrastructure into a broad global ‘order-of-magnitude’ context, infrastructure investment accounted for around 3-4 per cent of GDP between 1980-2005, although it has been substantially higher in the fast-growing emerging economies.⁷ The OECD estimates current global infrastructure requirements stand at around \$2 trillion per year, with a further \$1 trillion needed for climate change mitigation.⁸ For developing countries (currently spending perhaps \$800-900 billion per year), their infrastructure spending should rise to 6-8 per cent of GDP. Of the estimated \$0.8-0.9 trillion per year that is currently invested by developing countries, the majority (\$500-600 billion) is financed by domestic government budgets (including retained profits of state-owned infrastructure companies), 20-30 per cent by the private sector, and an estimated 5-8 per cent through developed country ODA and MDB financing.⁹ Other sources put the MDB share even lower, at around 2½-3 per cent of infrastructure financing.¹⁰

⁷ OECD. *The role of banks, equity markets and institutional investors in long-term financing for growth and development: report for G20 leaders*. 15-16 February 2013.

⁸ Ibid.

⁹ See p17 of Amar Bhattacharya, Mattia Romani and Nicholas Stern. *Infrastructure for development: meeting the challenge*. Centre for Climate Change Economics and Policy, Grantham Research Institute on Climate Change and the Environment, June 2012.

¹⁰ Sustainable Development Network Infrastructure Policy Unit. *Long-term financing of infrastructure: a look at non-financial constraints. Issues note (no. 6) for consideration by G20*. World Bank, 2013.

Looking ahead, it is estimated that both the plans and needs for infrastructure will significantly increase in scale. The ADB estimates that Asia alone will need around \$750 billion per year for the next ten years to meet its infrastructure needs.¹¹

If these numbers seem overwhelming, it is worth noting that global savings amount to \$17 trillion annually. On its own, Asia's annual savings are worth around \$4 trillion per year. Moreover, the world has been experiencing a persistent savings/investment imbalance, with substantial excess *ex ante* savings. Greater expenditure has the potential to shift output to a higher level, as well as provide the real resources required for meeting infrastructure needs.

Inherent problems in the characteristics of infrastructure

Setting out the characteristics of infrastructure helps identify the challenges in funding such projects.

Infrastructure projects generally have a long-gestation, are long-lived, and require long-term funding. This long effective life makes accurate cost/benefit calculations uncertain, with room for substantially different opinions about discount rates and levels of demand for the service (traffic on freeways, for example). Achieving appropriate scale for a project requires accurate long-term forecasts and mistakes will be costly. These projects are often large-scale: perhaps too big for a single investor, especially if an investor seeks diversification in a portfolio. Thus, collective funding is required, which is more complex to arrange. The legal framework (affecting land tenure and bankruptcy) is often important. Large infrastructure is often politically contentious;¹² frequently some measure of *eminent domain* is required to obtain access and land, and community angst often accompanies this. Infrastructure assets are illiquid and provide a small return if the project fails. There is also need for high equity backing during the construction phase to handle risk.

Perhaps the most vexed issues relate to the level of income and return on infrastructure projects. Often these are public goods with substantial externalities: benefits accrue to those who cannot easily be required to pay for these benefits. A traffic tunnel may benefit those in surrounding areas as much as it benefits those actually using the tunnel. Infrastructure often boosts land and property asset values (e.g. rail links). Even when the beneficiaries can be asked to pay, there is often a history of supplying the service for free, on the basis that it is 'essential', with large social benefits: water supply, for example. In other cases, services are still supplied at well below cost (sometime the case with electricity). In these cases, there is usually strong community resistance to charging a full economic price.

Similarly, projects are often linked to other government-owned infrastructure and the benefits derived by a single project may not be easily allocated between projects. Because of the scale or nature of these projects (it is not efficient to lay more than one supply pipe or cable), they often give rise to a monopoly, making efficient and equitable pricing controversial. This monopoly aspect means that competition or market discipline is rarely available to enhance

¹¹ Asian Development Bank and Asian Development Bank Institute. *Infrastructure for a seamless Asia*. Manila, 2009.

¹² In the words of U.S. House Transportation Committee Chair Bud Shuster: 'Angels in heaven don't decide where highways will be built. This is a political process.' Quoted in Timo Henckel and Warwick McKibbin. *The economics of infrastructure in a globalized world: issues, lessons and future challenges*. Washington, DC, Brookings, 4 June 2010.

the efficiency of the provision of the service (including the maintenance of the facility) or the pricing (although competition can often be brought to bear during the construction phase). Where pricing is set through a regulatory authority, this is also open to possibilities of misuse, particularly if regulators are susceptible to political pressure to keep the price low.

Funding solutions

At the macro level, the principal constraint does not appear to be a shortage of funding. More challenging is the linking together of infrastructure projects and their specific characteristics with the portfolio objectives of investors.

Some observers argue that there is an adequate supply of financing; it is just not flowing to the high-priority high-return investment opportunities. One example of this dynamic is the 'uphill' flow of capital from emerging to mature economies. Moreover, a substantial part of international capital flows is of a short-term market-driven nature, which is of little use for longer-term funding. Other potential funding sources are locked up in overly large foreign exchange reserves (Asia alone has well over \$4 trillion in foreign exchange reserves). On the investor side, some institutional investors (sovereign wealth funds, pensions, fund managers) have restricted mandates and conservative management strategies. There is a long list of reasons why emerging economies are not easy (or low-risk) places to carry out complex infrastructure projects.

The result is that investment portfolios are routinely significantly underweight on both emerging-economy assets and infrastructure. If infrastructure investment opportunities could be packaged with more attractive governance attributes, there is substantial long-term potential to bring about a reallocation of already-accumulated savings towards infrastructure assets.

Three channels of infrastructure funding are examined here: the traditional vehicle of the national budget and retained earnings of infrastructure enterprises; public/private partnerships; and multilateral development banks.

(a) Traditional funding channels

The 2008 financial crisis has substantially affected the way funding is sourced: it has made funding cheaper, but it has also narrowed the channels between lender and borrower, such that lenders have become more risk-sensitive. These changes are likely to be long lasting, if not permanent.

Policy interest rates have fallen substantially almost everywhere, allowing for cheaper financing costs. Further out along the yield curve, government bond rates have fallen dramatically, to zero or even negative in real (inflation-adjusted) terms. This has not, however, stimulated a burst of investment, largely because these low funding costs have coincided with bank deleveraging and widespread austerity as governments try to rein in excessive debt.

At the same time, risk margins for private borrowers have widened, offsetting the fall in policy rates for less-favoured borrowers. Portfolio investors are far more cautious in their investment choices, and give higher priority to investment-grade assets. The credit rating

agencies have been slow to recognise the improved bankability of many of the emerging economies, but over time are raising the rankings.¹³

The 2008 crisis also altered the nature of international capital flows, including flows to emerging countries. European banks, which had previously funded syndicate infrastructure loans, have pulled back and are deleveraging. Bank lending and securitisation have been adversely affected by the decline of the monoline insurers and derivative markets. Bond markets (particularly investment grade bonds) have become more important. Risk perceptions have sharpened, but the low rates of interest in advanced countries have created a ‘search for yield’ that will take some investors into new territory, especially in countries that are growing faster than the economically depressed advanced countries. FDI inflows to developing countries are projected to rebound by seventeen per cent in 2013 and reach close to US\$800 billion by 2014.¹⁴ The proportion of this amount that will flow into infrastructure is anticipated to remain at its historical level.

If bank syndicate lending is likely to be more limited in the future, where will the replacement funding come from? The segment of the financial sector that has expanded most since 2008 is bond issuance. This expansion has come not only in US-dollar-denominated issues, but in local currency issues as well. The prospects for enlarging the scale of such issues are good, even in less sophisticated markets, and especially if the issuer is a sovereign or has a sovereign guarantee.¹⁵

However, the task is not so much to develop a sophisticated financial market (which is many years away for some emerging economies), as it is to identify what specific types of bonds will be of most interest to investors, and that simultaneously complement the characteristics of infrastructure discussed earlier. By emphasising the development of a narrow range of simple standardised and well-regarded financial products with depth to their markets, strong ancillary markets in futures and derivatives would develop quickly without further official promotion.

Part of the problem is the scanty knowledge and the tendency of portfolio managers to favour preferred investment habitats.¹⁶ Academic analysis of capital flows often exaggerates the degree of substitutability between assets: small differences in attributes can make an asset unfamiliar (and thus unattractive) for an investor or portfolio manager. It would be helpful if the ultimate investors (not the intermediaries) were able to engage in a dialogue with the bond issuers to ensure that bond attributes match their investors’ requirements and that the flow of monitoring information is adequate. While retaining the idea of pursuing a few simple instruments as a way of developing deeper markets, these instruments might be presented to investors in various formats. For example, region-wide currency funds (e.g. Asian Bond Fund No 2¹⁷) may be attractive to investors seeking currency and country

¹³ Sustainable Development Network Infrastructure Policy Unit, *Long-term financing of infrastructure: a look at non-financial constraints. Issues note (no. 6) for consideration by G20.*

¹⁴ Ibid.

¹⁵ For a discussion of bond fund prospects in Asia, see Mangal Goswami and Sunil Sharma. *The development of local debt markets in Asia.* IMF Working Paper 11/132 June 2011. See also, Ilhyock Shim. *Development of Asia-Pacific corporate bond and securitisation markets.* BIS Papers BIS, 2012.

¹⁶ One source of information is the ADB Bond Monitor, available online: <http://asianbondsonline.adb.org/regional/abm.php>

¹⁷ Guonan Ma and Eli M Remolona. Opening markets through a regional bond fund: lessons from ABF2. *BIS Quarterly Review* (June) 2005, pp 81-92; Eric Chan, Michael Chui, Frank Packer and Eli M Remolona. *Local currency bond markets and the Asian bond fund 2 initiative.* BIS, 14 July 2011.

diversification. Promoting bonds on a collective regional basis, rather than the bonds of individual countries, may also have some merit.¹⁸

There will be room, too, for specialised infrastructure funds such as the ASEAN Infrastructure Fund¹⁹ to issue bonds that can supplement equity funding made available by member countries.

(b) Public-private partnerships (PPPs)

The history of PPPs, in all of their various forms, goes back centuries. Railway construction in the US and the UK provide examples where the characteristics of infrastructure produced innovative risk- and profit-sharing solutions, particularly where the private party could be compensated for valuable externalities through land grants. This kept the governance simple and internalised many of the externalities.

Recent decades have seen an intense focus on promoting PPPs, largely driven by the types of funding constraints faced by governments.

Analysis of PPPs is complicated by the variety of projects that are described as ‘PPPs’. Given the origins of the concept as a funding measure, some countries include any infrastructure project not funded by the government as a PPP. Some include projects where there is some private-sector finance of the project (e.g. standard trade financing), while others include the sale of government-owned assets with full transfer of operations. It would seem more useful to confine the ‘PPP’ nomenclature to those projects where the private sector owns assets that are used to provide services directly under the management of the government. Even this approach leaves ambiguity in comparisons, as countries will differ on which services are provided by the government. This may change over time (e.g. telecommunications services were often provided through government-owned monopolies but technological change has made it feasible to shift the supply of this service to the private sector). It is possible to envisage a further shift in this direction, where the private sector provides the infrastructure service on a commercial basis without special regulation, price setting or involvement by the government. There are, too, examples of private-sector-owner infrastructure that only serves the owner (e.g. ports or railways for resource transport). Essentially, the figures on PPPs are likely to vary and lack comparability.

Acknowledging these definitional ambiguities, the data suggest that PPPs have so far played a quite modest role (at least less than the volume of discussion might imply). The OECD records \$900 billion worth of privatisations since 1990, of which \$550 billion was in infrastructure.²⁰ The ADB records private participation in infrastructure in East and South Asia as less than \$400 billion over the two decades prior to 2007.²¹

¹⁸ Barry Eichengreen, Eduardo Borensztein and Ugo Panizza. *A tale of two markets: bond market development in East Asia and Latin America*. Hong Kong Institute for Monetary Research, October 2006.

¹⁹ Masahiro Kawai. *Financing development cooperation in Northeast Asia*. ADBI Working Paper 407 ADBI, 2013.

²⁰ OECD. *The role of banks, equity markets and institutional investors in long-term financing for growth and development: report for G20 leaders*.

²¹ ADB. *Infrastructure for supporting inclusive growth and poverty reduction in Asia*. Manila, Asian Development Bank, 2012.

Comparing the characteristics of PPPs with the characteristics of infrastructure may explain why the bulk of infrastructure is still conventionally funded by governments and state-run institutions. PPPs have special and unique merits: they add useful incentives for efficiency and innovation at the construction and operation stage, and the increased focus on income flow serves as a counterweight to the tendency to under-price infrastructure services. PPPs do require, however, complex legal structures that clearly define the nature of the operating environment, pricing issues, and government guarantees.²² Where monopoly aspects exist, this creates the need for regulated pricing, which often adds significantly to the private sector's risk-premium. The difficulty of capturing the full complexity of risk outcomes means there have been numerous cases where a disproportionate (and often unplanned) share of the risk-outcome has been borne by the public sector.²³ The prevalence of 'take or pay' contracts is symptomatic of the difficulty of shifting risk to the private sector.

Few emerging countries have a legal environment that can support an effective PPP framework.²⁴ Even in the United Kingdom, with its sophisticated legal system, long history of PPP investment and its well-experienced bureaucracy, PPPs account for only 10-15 per cent of official capital expenditure. No other country seems to have a larger share of PPPs.

While funding constraints are almost always the principal motivation for establishing PPPs, the current margin between official rates and private sector borrowing rates gives the public sector a substantial cost advantage in funding.²⁵ Opportunities to take advantage of this margin have often been restricted by self-imposed debt limits (sometimes reflecting fear of downgrading by credit rating agencies) or budget austerity measures. The outcome has been the use of a more expensive funding source.²⁶

PPPs will find a way to pursue straightforward infrastructure projects,²⁷ but decade-long discussions about the design of PPPs have not produced a widely accepted operating environment or approach which fosters more complex projects. There may be more to be gained by shifting industries from public provision to private provision (where risk-sharing issues become simpler and incentives clearer). The shift of telecommunications to the private sector provides a common example of this sort of re-thinking, which addresses many of the issues raised above. Similarly, where the infrastructure is integral to a private-sector commercial project, such as a mine, the role of the government is to facilitate the project

²² Philippe Burger and Ian Hawkesworth. How to attain value for money: comparing PPP and traditional infrastructure public procurement. *OECD Journal on Budgeting* 2011; Australian Government. *Australia's public infrastructure: part of the answer to removing the infrastructure deficit*. Infrastructure Australia, 2012.

²³ For example, part of the recent rise in Portuguese debt is attributable to contingent risk transferred from failing PPP projects. On risk, see: Infrastructure Finance Working Group. *Infrastructure finance and funding reform*. April 2012: http://www.infrastructureaustralia.gov.au/publications/files/IFWG_Report_FINAL.pdf.

²⁴ See, for example, Nicklas Garemo and Jan Mischke. *Infrastructure: the governance failures*. *Vox*, 30 March 2013: <http://www.voxeu.org/article/infrastructure-governance-failures>.

²⁵ Cost comparisons between PPPs and government procurement are usually based on planned versus actual costs, not the central (and much more difficult) issue which is whether the PPP project would have cost more or less if it had been undertaken by the government itself. See, for example: Colin Duffield. *Report on the performance of PPP projects in Australia when compared with a representative sample of traditionally procured infrastructure projects*. National PPP Forum – Benchmarking Study, Phase II, 17 December 2008.

²⁶ For example, the sale of debt in the already-completed take-or-pay desalination project in New South Wales, Australia.

²⁷ Bhattacharyay suggests that PPPs might in future fund 30 per cent of infrastructure, see: Biswa Nath Bhattacharyay. *Financing Asia's infrastructure: modes of development and integration of Asian financial markets*. ADBI Working Paper Series No. 229 ADBI, July 2010.

through the regulatory process (perhaps including eminent domain issues where necessary) but to leave the funding to the private sector.

(c) The multilateral development banks

The multilateral development banks (MDBs) might also have a larger role to play in financing infrastructure. Although the funding they currently have available for infrastructure is quite limited relative to the need, the MDBs might be able to find a role as an honest broker and technical advisor by standing between the infrastructure projects and the investors, ensuring cost-benefit studies are competently delivered, and providing advice on legal and regulatory issues (including pricing issues, such as the need for projects to generate income flows). Their presence would not provide guaranteed project funding, but would reassure both sides (especially the investors) and bring another layer of technical analysis to bear on the often-complex operational decisions and specifications surrounding infrastructure financing. This ‘technical middleman’ role would give the MDBs the opportunity to build on their existing expertise in this area, such as in the application and compilation of comparative statistics (on costs and technical issues). In this way, they would be able to participate in a wider range of projects, even if their funding remains limited.²⁸

Budget austerity and accounting

One other legacy of the 2008 crisis is the emergence of widespread fiscal austerity in advanced countries. These binding budgetary constraints are much less relevant for emerging countries, although some of the policy messages may have transferred and piqued interest.

One factor that has been unhelpful, at least when it comes to facilitating a sensible debate on official infrastructure expenditure, has been the conventional budgetary accounting which makes imperfect distinctions between routine and capital expenditure. Few countries have developed an official balance sheet in which debt issued to fund infrastructure is seen as offset, or balanced, by an income-earning infrastructure asset. A country that runs budget deficits to fund useful infrastructure assets is, however, in a different position to one that is simply funding routine expenditure.

The general perception that budgets have little capacity to fund infrastructure is fostered by the rating agencies and perhaps even by financial markets themselves (‘bond vigilantes’). It may be helpful to separate out infrastructure funding (perhaps even by issuing separate infrastructure bonds, although these should for all operational purposes be identical to normal government bonds because there will be an advantage in creating depth in the bond market through the development of larger homogeneous assets). The budget accounts could be restructured to make a distinction between current and capital budgets, with an infrastructure balance sheet showing assets and liabilities.

The way forward: what can the G20 do?

There are numerous opportunities to promote more and better infrastructure funding. This includes better project appraisal and preparation, improved governance rules and legislation,

²⁸ See, for example, Priyanka Sood, Marshall M. Mays and Michael R. Lindfield. *Subnational finance for infrastructure: potential roles and opportunities for ADB*. ADB Sustainable Development Working Paper Series No. 20 ADB, April 2012.

the development of bond markets, and the identification of government services that could be better carried out by the private sector.

Most of this lies in the national decision-making sphere. There are, however, opportunities for international cooperation. Greater cross-country uniformity would reduce some of the research and decision-making costs borne by international investors, although broad comparability is usually enough, rather than strict international uniformity. Such efforts are often taking place at the regional level: the Regional Comprehensive Economic Partnership in Asia is one such case.²⁹ Another example of successful regional ‘learning-by-doing’ has been the Asian Bond Fund (1 and 2), a project that has helped to reveal and identify issues hindering the development of Asian markets. Similarly, the technical assistance on infrastructure provided by the World Bank, the IFC and the other MDBs can help in transferring good ideas and practices between countries. Many emerging countries have created specialised infrastructure agencies to coordinate projects and ensure proper appraisal. Where these agencies are prepared to accept coordination and technical support from the MDBs or from counterpart agencies, there is an opportunity to raise the effectiveness of these bodies through imitating the best-practice approach. Regional cooperative approaches such as the ASEAN Infrastructure Fund serve the same purpose in transferring best-practice methods.

The G20 may be able to help in this spreading of best-practice approaches by urging the MDBs to prioritise their infrastructure support efforts, and by promoting national budgetary standards that more accurately reflect the differences between capital and current expenditures. Furthermore, engaging in a dialogue with the credit rating agencies might make them more responsive to the new investment opportunities and stronger credit environments within emerging markets.

Could the G20 tackle a far more ambitious infrastructure-related task? Given the persistent *ex ante* savings/investment imbalance (currently reflected in historically low interest rates), if the G20 were able to initiate and coordinate a substantial expansion of infrastructure spending, this would reduce international imbalances and provide an expansionary boost to the under-performing advanced economies. Greater infrastructure financing could also provide an enhanced outlet for capital flows from advanced countries, and provide a stimulus to their capital goods exporters, while at the same time encouraging emerging economies to expand their current accounts by importing more infrastructure goods. Connecting the surplus saving of advanced countries with the high-social-return infrastructure investment opportunities in emerging countries is an enticing idea. So too is reversing the ‘uphill’ flow of capital from emerging to mature economies. These possibilities may, however, be beyond the G20’s reach. With country-specific factors being the main constraint on access to long-term investment flows, the G20’s contribution to this longer-term challenge is likely to be modest.

²⁹ Ganeshan Wignaraja. *Evaluating Asia's mega-regional RTA: the regional comprehensive economic partnership*. Vox, 6 April 2013: <http://www.voxeu.org/article/mega-regionalism-asia>.

Looking at G20 initiatives on infrastructure investment from a developing country's perspective: Indonesia

Maria Monica Wihardja¹

Introduction

Indonesia is one of the most celebrated champions of initiating infrastructure investment agendas at regional and global forums, including the G20. Indeed, Indonesia has frequently been successful in gaining support within such forums for boosting the priority of infrastructure investment.

Indonesia's push to prioritise infrastructure investment within the G20's post-2008-2009 economic recovery plan is aligned with its own urgent need for more infrastructure investment. Indonesia has struggled to restore infrastructure investment to pre-1997-1998 Asian Financial Crisis levels; over 2010-2011, average infrastructure investment (in real terms) was still only two-thirds of that witnessed between 1995-1997.² As a percentage of GDP, Indonesia's average infrastructure spend (2010-2011) is also low for its neighbourhood, with the level of investment in countries such as China, Thailand and Vietnam approaching nearly seven per cent of GDP, compared to three per cent in Indonesia.

Hence, it would be a mistake to think that Indonesia sought to place infrastructure investment on the G20 agenda because it regards itself as a role-model for infrastructure development. Instead, Indonesia is motivated more by the desire to engage with regional and global partners in furthering debate on infrastructure development so it might: learn lessons from other countries with demonstrable success in the field, build self-capacity in the sector, as well as benefit from any G20 attempt to boost global infrastructure investment. Needless to say, the development of any infrastructure development plan is useful only in so far as it is actually able to be implemented – otherwise, Indonesia's desire to pursue an infrastructure investment initiative through the G20 may end up delivering little more than an 'empty package.'

As such, before accepting the recommendation of negotiators to include an agenda item or 'first-best' solution to the global economic malaise within a leaders' communiqué, serious consideration must be given to the credibility of, and the G20's capacity to implement, the proposed policy. Accordingly, this paper will focus on the specific challenges and prospects that Indonesia, a key emerging economy within the G20, faces in implementing infrastructure development policy and in repairing the poor state of its domestic infrastructure environment.

Infrastructure financing at the G20

As indicated, Indonesia is one of the main pioneers of the G20's post-crisis work on infrastructure investment. At the G20 summit in 2012, Indonesia proposed pursuing infrastructure investment through both the finance and Sherpa streams, within the context of the Framework of Strong, Sustainable, and Balanced Growth (FSSBG), instead of solely through the Development Working Group. The proposal focused on the role infrastructure

¹ Researcher at the Centre for Strategic and International Studies.

² World Bank. *Indonesia economic quarterly: pressures mounting*. Washington, DC, March 2013, p 38.

investment could play in reducing global imbalances and in lifting global growth, principally by redirecting excess savings in some emerging countries to infrastructure financing, rather than financing debts in advanced economies. It was also suggested that investing in infrastructure would assist those G20 members suffering from fiscal policy mismanagement, especially in some developed countries.

These initiatives are reflected in the following G20 outcomes:

- The Los Cabos G20 Leaders' Declaration 2012, Article 9 states: 'We ask finance ministers and central bank governors to consider ways in which the G20 can foster investment in infrastructure and ensure the availability of sufficient funding for infrastructure projects, including Multilateral Development Banks' (MDBs) financing and technical support.'
- The communiqué from the Washington G20 Meeting of Finance Ministers and Central Bank Governors (April 2013), Article 11, states: 'we underscore the importance of long-term financing for investment, including in infrastructure, in enhancing economic growth and job creation. We are taking forward work on this issue, including through the adoption of the terms of reference of the new G20 Study Group, with inputs envisaged from the World Bank Group, OECD, FSB, IMF, UN, UNCTAD, and from participating countries.'
- In February 2013, the G20 finance ministers endorsed the establishment of a new 'study group on financing for investment' that would 'determine a work plan for the G20, considering the role of private sector and official sources of long-term financing.' It was officially set up in March 2013, with Indonesia and Germany as the inaugural co-chairs. The work program of the Study Group includes country-specific factors, capital markets, private sources of financing, official sources of financing, and global financial regulatory reforms.

Domestically, Indonesia has implemented some of its G20 commitments on infrastructure. As part of the G20 Mutual Assessment Process, Indonesia identified the issuance of Presidential Regulation No. 13, 2010 – to strengthen government guarantees and government financing for infrastructure – as one of its structural reform priorities. Accordingly, under the auspices of the Ministry of Finance, a new private non-bank financial institution named 'Indonesia Infrastructure Finance' has been established and tasked with investing in commercially feasible infrastructure projects. The objective of Indonesia Infrastructure Finance (IIF) is to fill a key gap in Indonesia's institutional landscape for infrastructure financing and development, and is expected to become a national repository of experience and skills related to the development and financing of commercially viable infrastructure projects, as well as public-private partnerships (PPPs). In the medium term, the IIF plans to issue rupiah-denominated infrastructure project bonds. Indonesia has also set up an 'Indonesia Infrastructure Guarantee Fund' (IIGF) and a 'Viability Gap Fund' (VGF) so as to lessen the risk-burden associated with investing in Indonesian infrastructure projects.

By placing some pressure on Indonesia to establish a regulatory and institutional framework for enhancing infrastructure investment, as per its G20 commitments, the G20 has contributed to the implementation of positive domestic reform within Indonesia.

Infrastructure financing at APEC

Under Indonesia's chairing of APEC in 2013, APC Leaders have also endorsed infrastructure-financing initiatives such as the APEC Framework on Connectivity and the APEC Multi-Year Plan on Infrastructure Investment and Development.

APEC's stated intention in promoting cooperation on infrastructure development and investment is to take advantage of regional expertise, experience and funding sources, including from multilateral and regional development banks, as well as the private sector. Some examples of public-private joint initiatives within the APEC region include:

- the Asia Pacific Infrastructure Partnership (APIP), where governments have worked with the private sector to boost design, finance and implementation capacity with regards to economic infrastructure; and
- the Asia Pacific Financial Forum, which has been tasked with strengthening the region's financial systems so that the private sector has a greater incentive to invest in new infrastructure projects and thereby enhance policy outcomes in health, social welfare and other similar areas. The forum will work on a 'convergent approach' that encourages regional economic and financial sector integration. The forum's first meeting took place in April 2013 in Australia.

Infrastructure financing at ASEAN

Indonesia has also established and promoted infrastructure-financing initiatives through ASEAN. ASEAN now has the:

- ASEAN Master Plan on Connectivity (AMPC);
- ASEAN Infrastructure Fund (AIF); and
- Asian Bond Initiatives, as part of long-term strategy for infrastructure financing.

All ASEAN member countries (Myanmar is in the process of membership), as well as the ADB, are participants in the AIF. The AIF's objective is to better meet regional financing needs not only through sovereign funds, but also – importantly – through private investment in regional infrastructure development. Specifically, the AIF seeks to improve the utility of local currency bond markets in supporting infrastructure development, as well as attract more project investment from sovereign wealth funds and private institutional investors, such as pension funds and other long-term investors. Indonesia is interested in working with the G20 to 'scale up' this initiative to a global level.

The need for synergy between the infrastructure agendas of regional and global forums

Although infrastructure financing is a multi-faceted issue beyond any single regional or global institution, achieving better synergy between the various comparative advantages of the regional and global institutions outlined below, should be an essential part of future planning.

- As most ASEAN members are developing countries, ASEAN institutions have the advantage of being able to bring 'developing country perspectives' to infrastructure investment projects. ASEAN has also already devised a list of potential projects within its region.

- APEC's strength lies in being able to address private sector concerns about the regulatory and soundness of the regional infrastructure investment climate, particularly those of institutional investors.
- The G20's advantage is that it can assess infrastructure financing within the context of international financing arrangements, imbalances, global financial stability, and fiscal reform.

Infrastructure investment in Indonesia

Indonesia is in a dire need of infrastructure. In recent years it has increased its budget-spend on capital expenditure and has enacted policies and institutional frameworks related to infrastructure development.

Currently, Indonesia has a Master Plan for Acceleration and Expansion of Indonesia's Economic Development (MP3EI), a visionary project on infrastructure and connectivity valued at around US\$468 billion between 2011 and 2025. However, Indonesia's MP3EI relies too much on private sector financing. The private sector is expected to fund about fifty-one per cent of the total project value. This is a very high contribution when compared to other similar regional and global initiatives, and not least within the context of the heavy expectation that has already been placed on the private sector to invest in Indonesia's current medium-term development plan (RPJMN). The RPJMN hinges on the private sector being able to contribute more than seventy per cent of US\$150 billion in investment needs identified by the RPJMN. However it is worth observing that the MP3EI is regarded by some critics as a politically driven project primarily aimed at 'opening corridors' in all major islands in order to win the heart of people (or votes) all around Indonesia. Other analysts view the RPJMN initiative as little more than a fanciful dream or prayer.

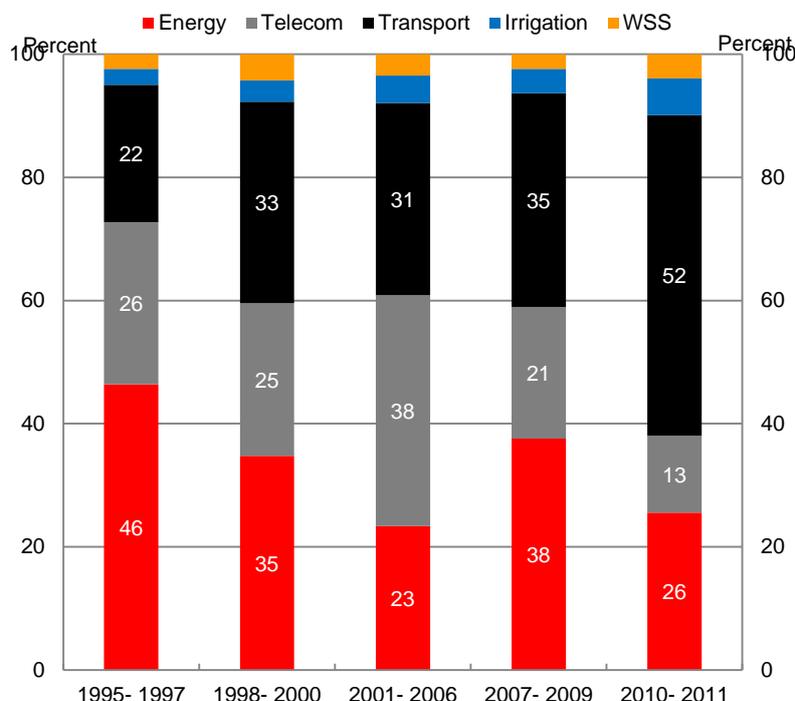
Indonesia's infrastructure problem is not just a matter of sourcing financing, as it also cuts across domestic structural, institutional and regulatory issues. (Some might also say there is a lack of political commitment). For instance, vertical and horizontal fragmentation within the government has been identified as a major roadblock to the successful implementation of infrastructure development. Regulatory barriers, including the land acquisition bill, protection of the services sector, unequal treatment of private sectors that challenge state-owned enterprises (SOEs looking for profitable projects), and matters related to PPPs such as guarantee funds and the viability gap fund (not yet fully operational), are also all major infrastructure issues.

Furthermore, the political popularity of large infrastructure projects, especially roads, affects the incentive structure that political leaders face in allocating funds between projects. For example, at the local level, there is some evidence that once local leaders have been directly elected by constituents, there is an increase in the number of paved roads, but a decrease in the number of passable roads, indicating that road quantity may come at the cost of road quality.³ Nevertheless, the study does suggest that building better roads increases the electability of local leaders in general.

³ Ari Kuncoro, Vid Adrison and Ifa Isfandiarni. Varieties of governance of public goods delivery in Indonesia: the case of roads after decentralization and local democratization. *Working Paper in Economics and Business* 3 (1) 2013.

The story above fits with the empirical data; the World Bank study on infrastructure investment shows that the transport sector, particularly roads, accounts for an increasing share of infrastructure investment in Indonesia.⁴ Its share of total infrastructure investment has gone up from twenty per cent in 1995-1997 to over fifty per cent between 2010-2011. (See Figure 1)

Figure 1: share of total infrastructure investment (per cent)



Source: *Pressures Mounting*. Indonesia Economic Quarterly, March 2013, Figure 56, p. 41.

Much of the increase has been driven by sub-national road investment. Between 2001-2009 the length of districts' roads increased by one third, from 287,577km to 384,810km. However, the same study reported a number of spending efficiency concerns, including: 'insufficient level of operation and maintenance spending, institutional fragmentation leading to new road investment that does not lie within an integrated transportation network, and sub-standard design and road quality.'⁵ Due to institutional issues involving decentralisation (autonomous districts), vertical and horizontal fragmentation between the levels of government, regulatory barriers, etc., it is not surprising that toll road development (that often needs to cross district boundaries), relative to sub-national road building, has been below about a third of the targeted increase.⁶

The role of PPPs in Indonesia

In general, PPP schemes in Indonesia are still weak and suffer from viability issues. Indonesia currently only has one viable PPP project, namely, the Central Java Power Plant, which was put out for tender and is now on the verge of financial close. However, this does not guarantee that the plant will be built soon, as sources familiar with the project have noted

⁴ World Bank, *Indonesia economic quarterly: pressures mounting*, p. 41.

⁵ *Ibid*, p 41.

⁶ *Ibid*, p 41.

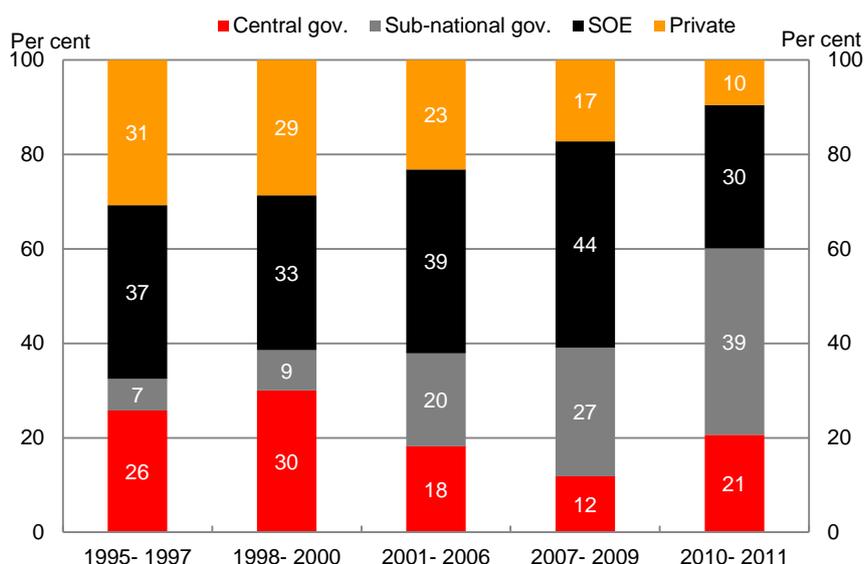
that the average delay between the signing of a contract and the implementation of such projects is about seven years.⁷

Other PPP projects are still either under the ‘project-readiness stage’, ‘financial viability study stage’ (supported by Viability Gap Fund) or the ‘transaction stage’. Projects within these categories include: drinking water initiatives in Umbulan, East Java and in Bandar City, Lampung; the Soekarno-Hatta Airport railway; and a coal railway in Central Kalimantan. It is worth noting that not all infrastructure investment in Indonesia is dependent upon a PPP arrangement: the government is directly funding electricity projects that will allow it to complete the second stage of its commitment to add an additional 10,000 MW to Indonesia’s power supply (otherwise known as the Fast Track Programme II).

One contributing factor to Indonesia’s lack of viable PPP opportunities is the sheer difficulty of developing projects with acceptable rates of return on investment (ROI). Even projects with high economic returns tend not to be perceived as commercially viable, as they are not carefully developed and structured in a way that is attractive to investors. The limited amount of human and financial resources available for project development exacerbates the problem. There is also a large risk-perception gap between private and public sector that needs to be overcome.

Indeed, the shrinking share of private sector investment in Indonesia’s infrastructure has been one of the most notable changes within the composition of Indonesia’s infrastructure investment since the 1997-1998 crisis. The World Bank study on infrastructure notes that the contribution of the private sector, as a proportion of total infrastructure investment in Indonesia, declined from almost one-third in 1996-1997 to ten per cent in 2010-2011 (see Figure 2).⁸ The study contends that the trend ‘likely partly reflects the regulatory and institutional challenges that Indonesia is facing in attracting PPP.’⁹

Figure 2: Share of total infrastructure investment, per cent



Source: *Pressures Mounting*. Indonesia Economic Quarterly, March 2013, Figure 53, p.40.

⁷ Original research of the author.

⁸ World Bank, *Indonesia economic quarterly: pressures mounting*, p 40.

⁹ *Ibid*, p 40.

Meanwhile, Figure 2 also shows that government investment in infrastructure has been increasingly made at the sub-national level, which is not surprising given the big-bang fiscal decentralisation that occurred in 2001. The sharp fall in energy investment (by sixty-three per cent between 1995-1997 and 2010-2011) and the telecommunication sector (by sixty-nine per cent for the same period) accounts for the entire thirty per cent fall in total real infrastructure investment since the Asian Financial Crisis. In part, the decrease in national government infrastructure expenditure is also due to the detrimental effect that inefficient fossil fuel subsidies have had upon the government budget. Despite Indonesia's dilapidated physical infrastructure, almost thirty per cent of the 2013 national budget has been allocated to poorly targeted energy subsidies, with only twelve per cent set aside for infrastructure, and five per cent for social expenditure.¹⁰

Summary

International pressure and cooperation is needed if Indonesia is to effectively reform and improve its own domestic infrastructure environment. Hence, as this paper shows, Indonesia has much to gain from getting infrastructure development issues on to the agenda of regional and global forums. Indonesia's experience is also informative in that the G20 must necessarily recognise and incorporate the particular challenges that Indonesia and other emerging economy members face in order to achieve a consensus outcome on infrastructure financing. However, Indonesia does not explicitly pursue solutions to its own domestic infrastructure situation within G20 leaders' meetings – it usually raises infrastructure financing at a more general 'government-to-government level', within the context of responding to crisis-related and global growth issues, as well as the impact of global financial regulatory reform on long-term financing.

This paper has also shown that there is a clear and essential need to build up greater 'synergies' between the infrastructure work that is already underway in various regional and global forums. At APEC, for example, there is more space to discuss domestic regulatory issues and good regulatory reform practices within the APEC work streams on infrastructure development and investment, as well as in other sub-APEC initiatives that target structural reform, such as the APEC New Strategy for Structural Reforms (ANSSR). Indonesia can facilitate greater inter-forum collaboration by helping to align the infrastructure work of the G20, APEC, ASEAN and the OECD Regulatory Reform Review by discussing the best way forward for implementing domestic structural reforms within each process.

What can the G20 do to help member and non-member countries that face similar infrastructure-financing issues to those of Indonesia?

There are a number of things the G20 could and should do to assist member and non-member countries address infrastructure-financing issues.

- Draw upon its own processes to allocate infrastructure priorities in a more cooperative and coordinated manner. For example, the finance ministers' and central bank governors' channel can focus on the long-term financing issues of infrastructure in the

¹⁰ Needless to say, the subsidies for fossil fuels have other opportunity costs, including degradation of the environment, the lowering of incentives for renewable energy innovation, and the worsening of Indonesia's balance of payments. It was only in June of 2013 that the government finally sought to reduce fossil fuel subsidies, and accordingly revise the national budget.

context of crisis, fiscal reforms and global economic growth (the array of issues that lie within the framework for strong, sustainable and balanced growth – the FSSBG).

- Draw upon the main G20 outreach initiatives to enhance its own process of policy formation: the Think20 can provide input into discussions about the regulatory and implementation challenges of infrastructure financing; the C20 can add-value in locating where the need for infrastructure lies (demand-side issues); while the B20 can bring its expertise to the field of PPPs and any other challenges that the private sector must overcome before investing in infrastructure. Every aspect of infrastructure, from the supply to demand side issues, from financing to regulatory issues, needs to be addressed accordingly.
- Encourage higher-level coordination between different governmental agencies and ministries. In the case of Indonesia, this would mean greater coordination among the Ministry of Transportation, the Ministry of Public Works, the Ministry of Development Planning, as well as the Ministry of Finance. Local governments also need to be engaged more. Hence, stronger coordination among central and local governments, the creation of an applicable coordination monitoring scheme and the contribution of reform-minded champions would all be required to achieve coordination and implementation milestones.
- Recognise that services are inputs to productivity. Regulatory reforms related to service sectors, such as air, land or sea transportation (toll roads, railways etc.), telecommunications, financial, logistics, energy (oil and gas), water supply, etc., are often needed to successfully implement infrastructure projects. Key regulatory uncertainties that involve land, investment and trade restrictions also need to be resolved. In this area, the G20 can draw lessons from APEC, which has completed a sizable body of work on Good Regulatory Practices.
- Encourage competition and the equal treatment of private sector and state-owned enterprises. Institutions that have been developed to support or promote infrastructure investment should be placed under an independent (or more independent) regulator.
- Support the establishment of institutions that can champion PPPs, especially within countries that rely heavily on the private sector to finance infrastructure development. These institutions could take the form of guarantee funds, viability gap financing funds, etc.
- Encourage the development of local currency bond markets, so as to minimise the currency mismatch risks inherent in external financing with foreign currency. Potential maturity mismatches can also dissuade investors from engaging in long-term infrastructure investments. More generally, the G20 should support regional, local and sub-national bond programs that can help finance infrastructure development, especially in the Asian region, given its excess savings.
- Lastly, draw lessons from the ASEAN Infrastructure Fund and consider whether (or how) they can be applied on a global scale.

More than anything else, the G20 needs to maintain its credibility. Only by focusing on specific obstacles to the implementation of its commitments, such as those inhibiting infrastructure investment in Indonesia, can the G20 maintain its credibility and become a real global champion of its own initiatives.

A 7-point plan for the G20 infrastructure financing agenda

Daniela Strube¹

Introduction

At the St Petersburg summit, leaders emphasised the role of long-term investment for sustainable growth and job creation. The focus was on financing for infrastructure investment, but leaders were also concerned about the long-term financing needs of other sectors, such as small and medium-sized enterprises (SMEs). In terms of forward action, leaders committed to ‘identify and start to implement by the Brisbane summit a set of collective and country-specific actions that tangibly improve our domestic investment environments such that they are more favourable to long-term investment financing.’ They also called for an extension of the analysis of challenges associated with the availability of long-term investment financing, and requested finance ministers develop policy recommendations by the next summit. In addition, leaders endorsed the OECD’s High-level Principles of Long-term Investment Financing by Institutional Investors and asked finance ministers and central bank governors to identify updated approaches to their implementation by the next summit. Leaders also called on finance ministers to identify, before the Brisbane summit, measures to facilitate domestic capital market developments and improve the intermediation of global savings for productive long-term investments.

In determining how or whether the G20 can deliver on its commitments, the critical underlying question is ‘where can the G20 add value to the task of facilitating long-term investment financing?’ This paper concentrates on the issue of long-term infrastructure financing.

Where can the G20 add value?

The G20’s structure as an informal, high-level group enables it to assist policy-making in two broad ways, namely through advocacy and coordination. In terms of the former, it can help promote domestic policy measures in any area that the group considers important and/or urgent for its member countries – although the G20 has no power to compel countries to adopt specific policy measures. As such, while peer pressure can assist, for the G20’s advocacy role to be effective, it should be complemented by members making tangible commitments to implement specific policy changes domestically, as well as hold themselves accountable to the rest of the members in delivering on these commitments.

However, a unique advantage of the G20 lies in its second role: the capacity to generate a coordinated response to systemic issues that stem from global public goods (GPGs). Public goods are characterised by non-rivalry and non-excludability. Non-rivalry requires that even when more people start to use a good or service, the benefits from consuming it do not diminish. Non-excludability means that no one can be excluded from using the good or service. There is also an important spatial dimension to consider, as GPG’s create (unintended) effects that have global reach. Consequently, they require globally coordinated responses. The World Bank classifies the environment (climate and biodiversity),

¹ Research Fellow, G20 Studies Centre, Lowy Institute for International Policy.

communicable diseases, international trade, the international financial architecture, and knowledge as GPGs.²

Infrastructure financing is a ‘cross-cutting’ issue

Infrastructure is both rival and excludable. Any immediate effects that it generates are local, or at most regional. Therefore, infrastructure is not a GPG. Nonetheless, infrastructure investment can create unintended consequences, for example, by raising land values in nearby areas or by facilitating additional pollution.³ The G20’s work on long-term investment financing largely recognises that infrastructure is not a GPG. The G20 Study Group’s work has instead concentrated on country-specific factors that affect a country’s ability to attract long-term financing. However, to stimulate infrastructure investment, there must be a sound economic and political framework that can elicit an investor’s confidence. Because this requires policy intervention in a variety of areas, it is still appropriate and consistent to consider infrastructure financing as a ‘cross-cutting’ issue within the context of the G20, as opposed to a ‘work stream’ independent from other policy areas. Placing the cross-cutting nature of infrastructure in its proper context also ensures that two-way spillover effects with other policy areas can properly be taken into account.

As mentioned, the G20 can be effective in supporting infrastructure policy by engaging in both coordination and advocacy. ‘Collective actions’ require the development of a coherent G20 approach in areas such as macroeconomic policy coordination and financial market regulation (coordination). Raising awareness at the leaders’ level and committing to domestic policy changes also are appropriate approaches for implementing ‘country-specific actions’ (advocacy).

One of the outcomes from the St Petersburg summit on infrastructure investment issues was the endorsement of the *G20/OECD High-level Principles on Long-term Investment Financing by Institutional Investors* and the *G20 Workplan on Financing for Investment*. However, the OECD principles are very general in nature, highlighting that progress on infrastructure investment largely depends on there being improvements to a variety of economic policy areas such as financial market regulation, taxation and competition policy. These fundamental economic policy areas are already key components of the G20 agenda.

Nevertheless, consistent with the approach of viewing long-term investment financing as a ‘cross-cutting issue’, and in line with the spirit of the G20’s High-level Principles, the Study Group on Financing for Investment (SG) should focus on identifying where G20 commitments in other policy areas can be ‘infrastructure-friendly’, i.e. identifying which G20 policies are likely to affect infrastructure investment and making sure that the impact on the

² This definition comes from the World Bank. See Independent Evaluation Group. *Shared Global Challenges*. Annual review of development effectiveness World Bank, 2008, p 41.

³ Physical infrastructure sectors, including transport, communication, water and sanitation and power, are network industries. Network industries are based on a network of production and/or service nodes. The most distinctive feature of network industries is the role of network effects. The value of the (infrastructure) network to users depends on its size. This gives rise to external effects. If a road network, for example, is extended, not only new users benefit, but also the people that were already connected to the network are better off, because they can now reach a larger area. In addition to these positive and (intended) external effects, unintended consequences are also possible. For example, owners of land close to the new roads are likely to see an increase in the value of their land, even without contributing to the project. This is a classic ‘free-rider’ situation. More roads may also increase pollution, negatively affecting not only road users, but everybody in the area. These external effects require targeted regulatory intervention.

environment for long-term investment financing is appropriately considered. This approach avoids the unnecessary duplication of effort. Implementing the Principles will in turn require both collective and country-specific actions. Financial market regulation, for example, is an area where a coordinated global response is essential for achieving an effective policy outcome. Because of extensive international linkages via financial flows, no one country can address this issue on its own.

The Study Group's workplan provides an overview of the large number of reports commissioned by the G20. They address a variety of specific issues, mostly regarding infrastructure financing. This work is clearly valuable in advancing an understanding of the infrastructure investment challenge. However, it does not require extensive discussion at the leader's level. The task that officials face is to identify if there is a significant issue in the area of long-term investment financing that requires the specific attention of leaders at the next summit.

Building on the basis that the G20's work on infrastructure should have a 'cross-cutting' approach across the G20 agenda, below are some suggestions on how infrastructure financing should be taken into account in advancing 'core' G20 work in areas such as macroeconomic policy, financial market stability and climate change.

Infrastructure financing and financial markets

Three priorities can be identified for the G20's work on financial markets. First, the G20 should continue its efforts to promote sound and efficient financial markets. However, to date, the G20's work in this area has been disproportionately focused on the experience of advanced countries, particularly in Europe and the US, and should pay more attention to the challenges faced by emerging economies. This refocusing is necessary if finance ministers are to meet the request put to them by leaders, to identify ways to improve the intermediation of global savings. Emerging economies hold large savings, but have predominantly invested in the advanced world while their own domestic long-term investment projects remain underfinanced. Advanced country investors are still equally hesitant to commit broadly to emerging country markets. Addressing this inconsistency should be a major objective for the G20 in 2014.

Second, consistent with placing a greater focus on long-term investment challenges faced by emerging economies, priority should be given to promoting local currency bond markets (LCBMs) and long-term investment funds (LTIFs). LCBMs have been on the G20's agenda since the Cannes summit, where the G20 LCBM Action Plan was endorsed. The action plan triggered improvements in the coordination of technical assistance among international organisations (IOs), enhanced data availability and led to the development of a common diagnostic framework. Nevertheless, important constraints on both the demand and the supply side of LCBMs remain, and likely require dedicated government intervention before they can be resolved.

On the demand side, investors' concerns about LCBM depth presents a classic 'chicken and egg' problem: investors are reluctant to invest because of insufficient scale, but strong investment is required before the market can 'scale up.' On the supply side, many emerging markets 'have struggled to create LCBM[s] comparable to those in advanced economies,

despite having sound fundamentals'⁴ and scepticism with regard to foreign investment is still widespread. On their own, market forces are likely to achieve only slow growth in LCBMs. The common diagnostic framework that has been developed as part of the G20 LCBM Action Plan highlights how 'a strong high-level government commitment to upgrade and reform LCBM[s] is necessary to ensure sustainability of the reform efforts.'⁵ Given the analytical work that has already been done in this area, the G20 is well placed to promote LCBMs as both promising and financially sensible investment opportunities. This may help to move LCBMs further into the 'mainstream' of what is generally considered to be a safe and financially sound investment strategy. Highlighting best practices such as the Asian Bond Fund 2 (ABF 2) could also be effective.

This promotional work could be supported by a dedicated information campaign, led by national central banks and research institutes. As part of this campaign, institutional investors should be specifically considered as suitable investors for LCBMs. Institutional investors include pension funds, life insurers, sovereign wealth funds and state-owned investment funds, as well as national development banks. Moreover, emerging markets should commit to further develop existing LCBMs like the ABF 2, including opening up to foreign investors. If MDBs and G20 members redirect technical and financial assistance towards LCBM development in future budget allocation decisions, thereby reflecting a new reprioritisation of the issue, then this may provide further momentum to existing global efforts to promote LCBMs and encourage their development in other emerging markets.

Similar efforts are required for promoting LTIFs. This includes both the promotion of existing initiatives, such as the ASEAN Infrastructure Fund , as well as enhanced support for the development of comparable funds. For the promotion of both LCBMs and LTIFs, a continued commitment by G20 member countries to foster a stable enabling macroeconomic environment is vital. For the establishment of nascent LCBMs, the common diagnostic framework suggests that 'a broad sequencing in this context would begin with the appropriate macroeconomic reforms and establishing robust legal, regulatory, and supervisory frameworks before moving to any specific measures of market deregulation or expansion of the investor base.'⁶ The common diagnostic framework also provides an assessment tool for preparing reform efforts in this area. G20 leaders should explicitly commit to apply the recommendations set out in the analytical work that emerged from the G20 LCBM Action Plan.

The St Petersburg leaders' declaration notes that particular attention should be given to improving the design of, and conditions for, productive public-private partnerships (PPPs). In order to facilitate progress in this area, a clear PPP framework has to be developed for individual G20 member countries. There would be value in establishing a set of common principles for domestic PPP frameworks. Some harmonisation of approaches would help reduce search costs for investors and introduce greater certainty into infrastructure investment arrangements. Some of the key elements that should be covered in the development of PPP principles include: the importance of legal certainty; competitive tendering being the instrument of choice for allocating projects; the need for full transparency; and the effective devolution of competencies to other levels of government, in order to enable them to deal with the planning and implementation of infrastructure projects efficiently. Finally, the

⁴ IMF, World Bank, EBRD and OECD. *Local currency bond markets - a diagnostic framework*. July 2013.

⁵ Ibid.

⁶ Ibid.

principles should also acknowledge the advantages of having an independent regulatory body that can deal with infrastructure investment and minimise political and industry capture.

Infrastructure and the environment

The G20's work on infrastructure financing should take into account the importance of avoiding negative environmental (especially climate) impacts as much as possible. One intuitive way of highlighting the efficiency gains that can be made from infrastructure investment can be found in McKinsey's estimate that sixteen per cent of the infrastructure investment that is required to keep energy supply in check with projected growth, could be saved by an alternative plan built around improving the efficiency of existing energy infrastructure assets.⁷

A more efficient use of existing infrastructure requires demand-side policies, whereas many countries have historically focused on the supply side, in particular on urban transport infrastructure. The G20 should promote the importance of demand-side policies and other productivity-enhanced measures, in particular regarding incentives for using mass transit modes of transport, as an effective complement to supply side interventions. Demand-side policies go beyond congestion pricing. Non-price alternatives include using traffic-monitoring technologies for optimising traffic flows. These efforts should be part of a broader strategy, including human capital development and appropriate long-term planning that allocates sufficient financial resources to infrastructure maintenance. Infrastructure development should also be embedded into a comprehensive urban plan. In particular, planning of transport infrastructure and land use should be integrated. Such productivity-enhancing policy principles ought to come under a broad commitment by G20 leaders to address these issues domestically.

One specific area that promises enormous benefits in terms of making transport infrastructure 'greener' is non-motorised transport (NMT) infrastructure. NMT reflects the objective of developing 'smart infrastructure', rather than just building more roads. Not only does NMT infrastructure reduce pollution, but it also improves transport accessibility and safety. While the environmental aspect is generally compelling, accessibility and safety are particularly important issues for emerging market G20 members. Poorer people are disproportionately affected by road hazards. Ninety per cent of all road casualties occur in low-middle-income countries, even though less than half of the global vehicle fleet operates in these countries.⁸ NMT is also more affordable for poorer people and therefore has additional equity benefits. Given that a very high number of people in emerging and developing countries have to rely on NMT,⁹ NMT infrastructure should be more sufficient and a greater policy focus. The G20 should make an explicit commitment to focus on extending NMT infrastructure domestically, ideally setting numerical targets.

Summary – A 7-point plan for advancing the G20's infrastructure financing agenda

In summary, there are seven steps the G20 can take in advancing its work on infrastructure financing:

- View infrastructure as a cross-cutting issue on the G20's agenda. Focus the Study Group's work on integrating infrastructure concerns with other G20 policies, in

⁷ McKinsey Global Institute. *Infrastructure productivity: how to save \$1 trillion a year*.

⁸ UNEP. *Share the road: investment in walking and cycling road infrastructure*. Nairobi, November 2010.

⁹ For example, more than 60 per cent of people living in Wuhan, China, *ibid*.

particular in the areas of financial markets and climate policy, without compromising the overarching policy goals in these broader policy areas.

- Refocus the work on financial markets to pay more attention to the challenges facing emerging markets.
- Promote LCBMs and LTIFs as promising and financially sound investment opportunities.
- Redirect technical and financial assistance to support the development of LCBMs and LTIFs.
- Commit to developing clear PPP frameworks domestically. Agree on joint principles in order to provide an appropriate degree of harmonisation in PPP arrangements across G20 members.
- Commit to improving the productivity of existing infrastructure assets domestically, in particular by promoting demand-side policies.
- Commit to extending NMT infrastructure domestically.

Reforming international taxation: the role of the G20

Mike Callaghan and Marty Harris¹

Introduction

Efforts to combat tax evasion and tax avoidance were a major outcome from the St Petersburg summit on 5-6 September 2013.

This paper reviews the role that the G20 can play in promoting reforms that will combat tax avoidance and evasion and, in particular, the approach Australia should take when it chairs the G20 in 2014.

The G20's involvement in combating tax havens

In 1998 the OECD released a report, 'Harmful Tax Competition, an Emerging Global Issue', marking the start of a substantial amount of work by the OECD on the issue.² Work initially proceeded on three fronts:

- identifying and eliminating harmful features of preferential tax regimes in OECD countries;
- identifying tax havens and promoting tax transparency; and
- encouraging non-OECD countries to participate in this work.

The OECD laid down a set of criteria for identifying tax havens, namely, those jurisdictions with: no or only nominal tax; a lack of effective exchange of information; a lack of transparency; and no substantial activities. The OECD proposed blacklisting and imposing international sanctions on identified tax havens. It was a controversial exercise, and was subsequently 'relaxed'. 'Zero tax' and 'no activities' were dropped as criteria for identifying a tax haven, and the idea of sanctions moved to the background. The OECD's work in this area was largely carried out through the Global Forum, which consisted of 'OECD countries and jurisdictions that had agreed to implement transparency and exchange of information for tax purposes.'³ However, while many tax havens announced their commitment to the OECD's criteria, in many cases implementation remained poor.

The London G20 summit in April 2009 represented a turning point in the international effort to combat tax havens. In the months prior to the summit, tax scandals involving financial institutions in Liechtenstein and Switzerland resulted in significant political pressure placed on the governments of France, Germany and the United States to crack down on the opportunities available to citizens to channel their profits through tax havens, and thereby avoid tax. The global financial crisis compounded the pressure being applied to tax havens. Weak regulation within tax havens was seen to have facilitated the use of risky financial

¹ Mike Callaghan is Director of the G20 Studies Centre at the Lowy Institute for International Policy. Marty Harris is Research Associate at the Lowy Institute for International Policy

² OECD. *Harmful tax competition: an emerging global issue*. Paris, OECD, 1998.

³ OECD. *Global forum on transparency and exchange of information for tax purposes*. 5 September 2013: <http://www.oecd.org/tax/transparency/>.

products, and as fiscal challenges rose, governments had an increased incentive to recover 'lost' tax revenue.

At the London summit, G20 leaders agreed to take action against non-cooperative jurisdictions, including tax havens, stating: 'We stand ready to deploy sanctions to protect our public finances and financial systems. The era of banking secrecy is over.'⁴ In addition, the G20 'took note' of three lists prepared by the OECD that categorised financial centres according to their respective level of transparency. The first was the 'white list', comprised of jurisdictions that had concluded at least 12 bilateral agreements with other jurisdictions that contained provisions on information exchange according to the OECD standard. The second was the 'grey list' – jurisdictions that had committed to, but not yet substantially implemented, internationally agreed tax standards. The grey list contained thirty jurisdictions, including Chile, Singapore, Belgium, Luxembourg, Austria and Switzerland. The 'black list' contained four jurisdictions that had not committed to the internationally agreed tax standard – Costa Rica, Malaysia (Labuan), Philippines and Uruguay.⁵

The preparation and publication of these lists was controversial. For example, the work was targeting countries that were not members of the OECD. In particular, China was concerned about the treatment of the Chinese territories Hong Kong and Macau. The compromise was to put China on the 'white' list with a footnote that Hong Kong and Macau, 'which have committed to implement the internationally agreed tax standard' were not included. In addition, the list was only 'noted' and not 'endorsed' by the G20.

However, the action taken at the London summit was effective. A few days after the summit, all countries on the 'black list' committed to implement the standard, while the number of countries on the grey list declined over time, as identified jurisdictions gradually moved to meet the standard. At the Pittsburgh summit in September 2009, G20 leaders 'committed to maintain the momentum in dealing with tax havens', and stated: 'the main focus will be to improve tax transparency and exchange of information so that countries can fully enforce their tax laws to protect their tax base.' In September 2009, the Global Forum on Transparency and Exchange of Information for Tax Purposes was restructured and had its membership expanded to include all OECD members, G20 countries and offshore jurisdictions. It now consists of 177 members. The Forum has become a consensus-based organisation where all members are on equal footing, serviced by staff from the OECD. The Global Forum has also begun a peer-review process to monitor both jurisdictions' regulatory frameworks and implementation of the agreed standard. As of April 2013, 68 jurisdictions have provided follow-up reports to the Global Forum, outlining actions they have taken to address the Forum's recommendations.

The Global Forum claims that 'since 2009, the capacity for cooperation in international tax matters has improved significantly.'⁶ It also notes that there has been a dramatic increase in the number of bilateral tax information exchange agreements and a number of formerly

⁴ G20. *Leaders' declaration: summit on financial markets and the world economy*. November 2008: http://www.g20.org/Documents/g20_summit_declaration.pdf.

⁵ OECD. *A progress report on the jurisdictions surveyed by the OECD Global Forum in implementing the internationally agreed tax standard*. 2 April 2009: <http://www.oecd.org/ctp/42497950.pdf>.

⁶ OECD Secretary-General. *Secretary-general's report to G20 finance ministers*. Paris, OECD, 2013.

secretive jurisdictions – including Singapore, Austria, and Luxembourg – have agreed to sign the Convention on Mutual Administrative Assistance in Tax Matters.⁷

Notwithstanding this progress, concerns have been raised about the overall effectiveness of the aforementioned efforts in expanding tax transparency. The ‘internationally agreed standard’ of having 12 bilateral agreements is arbitrary and does not guarantee a global system that ensures an adequate exchange of taxation information. Implementation of the agreements is also a concern. In addition, agreements based on exchanging requested tax information currently involve burdensome and lengthy procedures.

For these reasons, the multilateral automatic exchange of information is considered to be a superior approach. Automatic information exchange is a system where a source jurisdiction periodically transmits ‘bulk’ taxpayer information to the taxpayer’s country of residence. This allows tax administrators to determine whether an individual has accurately reported their foreign source income, and to calculate an individual’s net worth with more ease. According to the OECD, automatic information exchange can offer timely information on tax evasion, as well as provide a powerful deterrent to potential non-compliers.⁸

The promotion of automatic tax information exchange has been taken up by the G20. At the St Petersburg summit, leaders endorsed the OECD proposal of a truly global model for multilateral and bilateral automatic exchange of tax information. The aim is to have a new global standard for the exchange of information completed by February 2014, and to finalise technical modalities such that G20 countries can automatically exchange tax information by the end of 2015.

The role of the G20 in promoting the exchange of tax information

The G20 has played a significant role in enhancing the exchange of tax information. The political ‘momentum’ that the G20 has given to this issue demonstrates how G20 leaders can facilitate and boost the work of an international body, even one with a membership that does not include all G20 countries, such as the OECD. Absent the G20’s endorsement and the inclusion of major emerging markets, it is difficult to see how the same progress in advancing the exchange of tax information and reducing bank secrecy would have been achieved. It is also important that the G20 supports the work of the OECD in this area, rather than attempting to set up its own processes. However, the existence of ‘black’ lists and the threat of sanctions are also likely to have played an important role in encouraging action.

As far as implementing the automatic exchange of tax information is concerned, the technical work lies with the OECD. The timetable for implementation is tight, and it will not be met simply because of the political weight that the G20 can provide. A range of controversial issues still need to be resolved, including the establishment of mechanisms that will ensure ongoing confidential and proper use of shared tax information. It is also essential to deliver on the leaders’ commitment at St Petersburg that *all* countries, but particularly developing countries, benefit from the automatic exchange of information. Australia’s priority in 2014 will be to ensure that the G20 delivers on these commitments.

⁷ OECD. Austria, Luxembourg and Singapore among countries signing-on to end tax secrecy. OECD Newsroom, 29 May 2013: <http://www.oecd.org/newsroom/austria-luxembourg-and-singapore-among-countries-signing-on-to-end-tax-secrecy.htm>.

⁸ OECD. *Automatic exchange of information: what it is, how it works, benefits, what remains to be done*. Paris, OECD, 23 July 2012.

Base erosion and profit shifting

Base erosion and profit shifting (BEPS) refers to tax planning strategies by corporate entities that exploit tax rule loopholes in order to make profits disappear for tax purposes, or that shift profits to locations where there is little or no real activity and which are lightly taxed, resulting in the payment of little or no overall corporate tax.⁹ The effort to combat BEPS is considered one of the main achievements of the St Petersburg summit (although it was not highlighted as a priority when Russia assumed the presidency in December 2012). However, the issue has been on the G20's agenda for some time and is related to the earlier work by the OECD/G20 on harmful tax practices and improving tax information exchanges.

As part of the Multi-Year Plan on Infrastructure Investment and Development that was released at the G20 Seoul summit in November 2010, the OECD was requested to 'enhance its work to counter the erosion of developing countries' tax bases, and to submit a report to the G20 on the issue by September 2011.¹⁰ The ensuing report largely focused on transparency and the development of tax information exchange agreements, mostly as supplements to already existing double tax agreements that had provided for the sharing of information. The report also observed that corporate non-compliance, due to the use of structures anchored in other countries, as well as abusive transfer pricing, might undermine the domestic tax base of a jurisdiction.

The Los Cabos summit in June 2012 built upon this. Leaders stated: '...we re-iterate the need to prevent base erosion and profit shifting and we will follow with attention the ongoing work of the OECD in this area.' At the time, there was significant and growing concern about BEPS, not just from developing countries, but also due to the emergence of several high-profile cases involving multinational corporations such as Google, Amazon and Starbucks, that had large operations in developed countries but were taking advantage of their multinational arrangements to pay minimal tax. For example, it is estimated that Google's advertising revenue in Australia in 2011 was close to A\$1 billion, yet its filing with the Australian Securities and Investment Commission indicated that it paid tax of A\$74,176 in that year.¹¹

However, beyond the high-profile cases that involve players like Google and Amazon, it is difficult to establish the extent to which artificial profit shifting has eroded the corporate tax base. The Australian Treasury has noted the problem of establishing a relevant benchmark. One approach might be to analyse aggregate trends in corporate tax collections, but it is difficult to isolate the impact of tax planning strategies from other factors. The OECD suggests the revenue at stake is substantial. The IMF cites a study for the United States that estimates the annual revenue loss from profit shifting lies somewhere between \$10 and \$60

⁹ Centre for Tax Policy and Administration. BEPS - frequently asked questions. OECD 2013: <http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm>.

¹⁰ G20 Seoul summit leaders' declaration. 12 November 2010. <http://www.g20.utoronto.ca/summits/2010seoul.html>

¹¹ Mike Secombe. Google: don't be evil, don't pay tax. 7 June 2012: <http://www.theglobalmail.org/feature/google-dont-be-evil-dont-pay-tax/261/>.

billion (the higher figure being about one-quarter of all receipts from the federal corporate income tax in 2012).¹²

The communiqué from the meeting of G20 finance ministers and central bank governors in Mexico City on 5 November 2012 stated: ‘we also welcome the work that the OECD is undertaking into the problem of base erosion and profit shifting and look forward to a report about progress of the work at the next meeting.’¹³

In February 2013 the OECD released a report ‘Addressing Base Erosion and Profit Shifting’.¹⁴ The report states ‘... current international tax standards may not have kept pace with changes in global business practices, in particular the areas of intangibles and the development of the digital economy.’ The report also noted that international tax rules were developed almost one hundred years ago when products were manufactured, physically transported, and sold. Such rules do not easily apply in a digital age where businesses do not always require physical presence in a country to operate, the most valuable assets, such as intellectual property, are not fixed, and it is difficult to establish the value-add that should be taxed at each stage of a long and international production chain.

The OECD report concludes that in order to address base erosion and profit shifting, a comprehensive action plan should be developed quickly, with the basic objective of providing countries with the instruments to better align their right to collect tax with real economic activity. The OECD also notes that the response will require some ‘out of the box’ thinking, ambition, and pragmatism to overcome implementation difficulties.

In February 2013, G20 finance ministers and central bank governors welcomed the OECD report, stated that they were determined to develop measures to address base erosion and profit shifting, and that they looked forward to the comprehensive action plan that the OECD would present to them in July 2013.¹⁵ At St Petersburg, leaders fully endorsed the OECD action plan and the establishment of a G20/OECD BEPS project and ‘encouraged all interested countries to participate’.

OECD action plan to counter base erosion and profit shifting

The OECD action plan lists 15 work streams, each with an accompanying timeline. The work streams broadly work on one of the following four areas:¹⁶

general actions: addressing the tax challenges of the digital economy; neutralising the effects of hybrids; strengthening controlled foreign corporation (CFC) rules; limiting base erosion via interest deductions and other financial payments; and transparency;

- *permanent establishments and transfer pricing:* investigating the artificial avoidance of permanent establishment status; aligning permanent establishment outcomes with value creation; and re-examining transfer pricing documentation;

¹² IMF. *Issues in international taxation and the role of the IMF*. Washington, DC, IMF, 28 June 2013.

¹³ G20. *Communique of G20 finance ministers and central bank governors, Mexico City*. 5 November 2012: <http://www.g20.utoronto.ca/2012/2012-121105-finance-en.html>.

¹⁴ OECD. *Addressing base erosion and profit shifting*. Paris, OECD, 12 February 2013.

¹⁵ G20. *Communique of meeting of G20 finance ministers and central bank governors*. February 16 2013: <http://www.g20.utoronto.ca/2013/2013-0216-finance.html>.

¹⁶ PwC. *OECD's action plan published on base erosion and profit shifting (BEPS)*. Tax policy bulletin PwC, 19 July 2013.

- *treaty actions*: preventing treaty abuse and developing a related multilateral instrument; and
- *data and transparency*: requiring taxpayers to disclose their aggressive tax planning arrangements; and establishing methodologies to collect and analyse data on BEPS and the actions to address it.

This is an extremely ambitious exercise that the OECD is seeking to complete within two years. Some of the reactions to the action plan include:¹⁷

- Bill Dodwell, head of tax policy at Deloitte, who has labeled the plan ‘the most significant potential change to international taxation for decades’;
- Chris Morgan, head of tax policy at KPMG, who suggests there is now ‘potential for [a] seismic shift’; and
- James Anderson from Skadden, who likened the developments to an ‘OECD reboot for [the] 21st century’.

The magnitude of the task being contemplated is reflected in the above comments. This sentiment is echoed by Richard Collier, tax partner at PwC: ‘The BEPS action plan is a movement, not an isolated project. The scale of its ambition means change is not going to happen overnight. Change will come from countries adopting domestic rules, changes to international tax treaties and changes to the practical application of existing rules by both tax authorities and business.’¹⁸ Collier is certainly right when he says that these changes will not come overnight – it will be a lengthy and contentious exercise.

The 15 elements in the OECD action plan are pitched at a very high level, and perhaps the most ambitious of these commitments is to address the tax challenges of the digital age. Here, ‘the devil will be in the detail’, and, more precisely, in getting agreement on the detail. The scale of the challenge is recognised by the OECD when it states that while it has well developed processes for finding consensus on routine matters, it will ‘need to find ways to accomplish the work quickly while seeking consensus’.¹⁹ Moreover, it needs to move quickly in areas where there is currently no consensus on what the tax rules should be, or on how existing tax rules should apply.²⁰ When it comes to international tax reforms, the precedent is for very long timeframes. There will also be strong and active lobbying by corporations about the details of the plan, with the United States Council for International Business and the Confederation of British Industry (CBI) warning that ill-considered measures could hit job creation, trade and innovation.²¹

The role of the G20, and Australia, in addressing BEPS in 2014

¹⁷ Tax Journal. BEPS: who is saying what. *Tax Journal*, 19 July 2013:

<http://www.taxjournal.com/tj/articles/beps-who-saying-what-19072013>.

¹⁸ PwC. *PwC: OECD project could mark biggest reform of global taxation in lifetime*. PwC Blog, 19 July 2013: http://pwc.blogs.com/press_room/2013/07/pwc-oecd-project-could-mark-biggest-reform-of-global-taxation-in-lifetime.html, *ibid*.

¹⁹ OECD. *Action plan on base erosion and profit shifting*. Paris, OECD Publishing, 2013.

²⁰ PwC. *OECD initiative on base erosion and profit shifting (BEPS)*. Tax policy bulletin PwC, April 2013.

²¹ Reuters. G20 to tackle loopholes used by big companies like Google and Apple. *independent.ie*, 19 July 2013: <http://www.independent.ie/business/g20-to-tackle-loopholes-used-by-big-companies-like-google-and-apple-29432677.html>.

Addressing BEPS requires a multilateral response. As the IMF has highlighted, the overarching problem is the ‘fundamental difficulty that national tax policies create cross-country spillovers. The opportunities for avoidance and evasion that are now such a concern are a very high manifestation of such spillovers.’²² In a similar vein, the Australian Treasury concludes that ‘erosion of corporate tax bases raises important global issues and addressing these issues is beyond the ability of any one country acting alone. It is therefore important that Australia’s interests are prosecuted through multilateral forums.’²³

The OECD has taken the lead over many years in pursuing a wide range of global tax initiatives, including producing a model tax treaty and guiding countries in their implementation. The OECD’s Committee on Fiscal Affairs has the technical expertise in this very complex area. The Australian Treasury noted that the OECD’s expertise ‘makes it the logical forum for the development and implementation of technical improvements to the international tax framework.’ Footnote?

However, the OECD is a consensus-based organisation with 33 member states, which does not include the major emerging markets that are members of the G20. And as was evident when the G20 first addressed the issue of base erosion and profit shifting, this lack of representation is a major concern for developing countries.

Accordingly, the OECD action plan recognises the need for an inclusive process. In order to facilitate greater involvement of major non-OECD economies, it will launch the ‘BEPS Project’. Interested G20 countries that are not members of the OECD will be invited to be part of the BEPS Project as ‘Associates’, and they will participate on an equal footing with OECD members. Other non-OECD members will be invited to participate on an ad-hoc basis. The concerns of developing countries are directly mentioned, and the action plan observes that the UN Task Force on Tax and Development and the OECD Global Relations Programme should provide a useful platform for discussing specific BEPS concerns in the case of developing countries.

In terms of the role that the G20 can play, the wider membership of the forum is an advantage. On their own, the OECD members could not deal with the international implications of BEPS. But it is important that the OECD drives the technical development of the BEPS Project, and that there is no attempt by the G20 to duplicate the work of the OECD. The G20 should instead focus on providing political momentum, ensuring there is wide outreach and that developing countries are involved. Drawing from the example of the Global Forum on Tax Transparency, it would be preferable to present the BEPS Project as a broader international initiative designed to modernise international tax laws, rather than as an OECD/G20 branded exercise.

As noted, the area where the G20 can make the biggest contribution on tax reform, but also where it faces its most critical challenge, is in maintaining momentum; not only in getting consensus on new international tax laws, but also seeing these translated into domestic laws. And it is essential that Australia as chair ensures that momentum is maintained in 2014. The G20’s credibility will be severely damaged if what is considered to be a major achievement at one summit is largely ‘dropped’ when the chair passes to another member. But it will be challenging for Australia to maintain momentum; progress will be difficult and controversial,

²² IMF, *Issues in international taxation and the role of the IMF*.

²³ The Australian Government the Treasury. *Risks to the sustainability of Australia’s corporate tax base*. Canberra, The Treasury, 2013.

and there are no quick fixes. A balance has to be struck between being seen to be taking action and sending a clear signal to the community that concerns are being addressed, and not setting excessively tight deadlines that result in the scope of the exercise being reduced and leading to sub-optimal outcomes.

As chair of the G20 in 2014, Australia should focus on three areas in advancing the BEPS Project.

First, while the technical details are being developed, the G20 has to ensure that the project maintains a high political profile and that the emphasis is on reaching early consensus. Throughout 2014, the G20 should focus on ensuring greater transparency at all levels. As the OECD action plan notes, while progress has been made through the Global Forum on the sharing of tax information between authorities, greater transparency on many fronts is required to prevent BEPS. In particular, the G20 could drive requirements for taxpayers in all jurisdictions to disclose more targeted information about their tax planning strategies. The threat of reputational damage that can come from the exposure of aggressive tax planning strategies can be a powerful tool in combating tax avoidance. This should include requirements around reporting on the beneficial ownership of companies. In addition, a major effort should be directed at getting all G20 members to commit to the Extractive Industry Transparency Initiative, which is a global standard for revenue transparency and accountability in the extractive industry sector. Importantly, transparency can be enhanced relatively quickly and does not require the negotiation of an international agreement or protocol.

Second, place the work on BEPS in a broader context, and present it as part of the rapidly changing and increasingly integrated global economy. To date, the core of the problem has been the failure of international tax laws to keep up with global and technological developments, including the rise of the digital economy. The advent of 3D printing will likely further diffuse manufacturing activity across many jurisdictions. But the pace of development will clearly not stop, and it will have implications beyond tax laws. For example, trade policy has also not kept pace with the rise of value added chains, with goods now being 'made in the world' rather than in a single country. As chair of the G20 in 2014, Australia should initiate a more holistic and forward-looking analysis of the implications of corporate and technological developments for economic management.

Third, it is important that the BEPS Project is seen to be a global exercise and not solely a OECD/G20 project. Australia could go beyond including BEPS as part of its broader G20 outreach activities and consider a meeting involving G20 and non-G20 ministers on ensuring that international tax laws keep pace with the developments in the global economy, with a particular focus on the situation confronting developing economies. The G20 members need to avoid giving the impression that they have only allocated a high priority to corporate tax avoidance because there have been high-profile cases inside their own jurisdictions. This will help to address an ongoing and major concern for developing countries.

Conclusion

The G20 has played a significant role in combating tax havens and advancing the exchange of tax information. The G20's work in this area is an example of how the forum can provide political momentum to an issue that extends well beyond its own membership. It is essential for the credibility of the G20 that Australia ensures that the new single global standard for the

automatic exchange of tax information is completed in line with the commitment made at St Petersburg.

The G20 must also continue to provide political momentum to the task of combating corporate base erosion and profit shifting. The G20's endorsement of the OECD action plan was important, but it was an easy first step. The challenge is to develop, agree and then implement the 15 elements outlined in the action plan. But this is a complex and contentious issue, where the history of achieving international agreement is one of slow progress.

When Australia assumes the chair of the G20 in 2014, it must ensure that progress is maintained, but it also has to carefully manage expectations. There are no quick fixes and the BEPS Project has to be seen as a long-term and ongoing movement rather than a one-off exercise. In particular, ill-considered and rushed measures to meet arbitrarily imposed deadlines must be avoided.

The three areas where Australia, as chair, can focus G20 efforts are: making tangible progress in requiring taxpayers to disclose more targeted information about their tax planning strategies; putting the BEPS Project in the broader context of a more holistic and forward looking consideration of the implications of corporate and technological developments on economic management; and ensuring that the concerns and interest of developing countries are adequately taken into account.

Multilateral response to base erosion and profit shifting

Philip Anderson¹

Introduction

Base erosion and profit shifting (BEPS) is the term currently used for all forms of tax avoidance and evasion involving tax minimisation that has been enabled by the international tax planning activities of multinational companies, unincorporated enterprises and individuals.

One form of tax minimisation is straight-out tax evasion, which is generally regarded as activity that is inconsistent with existing taxation laws. Clearly this type of activity is important to tax agencies throughout the world and requires a response with a strong emphasis on tax enforcement and improved collection processes. It is worth noting that large multinational corporations, particularly those that are publicly listed, do not generally engage in this type of activity since the reputational risks are too great.

Tax avoidance, on the other hand is usually regarded as the minimisation of global tax liabilities by exploiting particular features of the tax laws of particular countries, especially where the incentive and ability to do so is enhanced by differing approaches to taxation in different countries. This type of minimisation activity is very common amongst multinational corporations. Indeed, most financial and legal commentators would argue that it is entirely appropriate for companies to take steps to minimise their tax liabilities, in the same way that they should act to minimise their operating costs. Despite this, it is clear that some of the more high-profile corporations that have recently received adverse publicity about their avoidance activities have become more sensitive to public criticism of their tax minimisation strategies.

This article focuses on the so-called tax avoidance activity that arises when multinational corporations, enabled by the international nature of their business models, take advantage of tax system differences between countries to realise a reduction in their effective tax rates, well below the nominal rates of the countries in which they predominately operate. This type of activity has received a great deal of recent attention: in international forums, in the international press, in the work of the OECD, from fiscal departments within specific countries (including the Australian Treasury) and through investigations by parliamentary bodies, such as in the UK and the USA. There is now an increased sense of urgency that action needs to be taken to reduce tax minimisation activity. Governments are concerned that multinational corporations should not be able to reduce their tax liability in this way, both because of unfair advantages that multinational corporations enjoy compared with their purely domestic counterparts, and because of the view that everyone should be contributing their fair share of taxes.

Nature of the Problem

The world has spent almost one hundred years defining international tax rules that were originally intended to reduce the incidence of double or multiple taxation for businesses that

¹ Independent consultant.

operated over multiple jurisdictions. Because of the international nature of these issues, the rules had to be developed within a multilateral framework. The first work in this area was undertaken by the League of Nations in the 1920s.

A further milestone was the OECD Model Tax Convention, held in 1963. The OECD model has been maintained over subsequent decades and still forms the basis, with some variation, for most of the Double Tax Agreements (DTAs) that have been entered into by developed countries since that time. Developing countries have generally pushed for additional variations to the OECD model, but the underlying principles are evident in virtually all of the three thousand or so DTAs currently in existence.

The OECD has also led the way in developing transfer pricing guidelines which, while not binding on individual countries, are now widely accepted by member and non-member countries alike.² These guidelines provide a framework that allows for the pricing of transactions between related companies to be evaluated, so as to ensure that the allocation of profits arising from such transactions is fair and reasonable given the nature of the economic factors related to the transactions.

The important single factor linking all of these processes over almost a century is that they have involved the development of multilateral frameworks, within which countries could still frame their own taxation laws. Some of the key features of these multilateral frameworks include the following:

- definitions of the place of residence of companies, so that wherever possible the place of residence of a company can be uniquely defined;
- the concept of ‘source’ – the jurisdiction where income from a transaction is thought to be derived;
- the concept of a ‘permanent establishment’ – part of an entity which is regarded as being resident in a certain jurisdiction, allowing that jurisdiction to exercise its right to tax the business profits of that permanent establishment – to help further clarify residence and source;³
- DTAs typically contains substantial definitions of what is and what is not a permanent establishment; and
- transfer pricing guidelines based around the ‘arm’s length’ principle, which strives to ensure that the pricing of transactions between related parties matches as closely as possible to what would have occurred between unrelated parties dealing at ‘arm’s length’ with each other.

As a result of these multilateral frameworks, the taxation systems of individual countries are interrelated; an outcome that has both advantages and disadvantages. The advantage is that business can be carried out internationally with little risk of double taxation, as profits are taxed only in a single jurisdiction (or at least are maintained via credits for taxes paid in other jurisdictions).

² OECD. *Transfer pricing guidelines for multinational enterprises and tax administrations*. Paris, OECD, 18 August 2010.

³ The Australian Government the Treasury. *Risks to the sustainability of Australia’s corporate tax base*. Canberra, The Treasury, 2013.

The disadvantage is that taxpayers can exploit different interpretations of these multilateral frameworks within different jurisdictions so as to reduce their tax liabilities substantially, in some cases achieving what is referred to as ‘double non-taxation’. The current debate on tax avoidance by multilateral corporations centres around a view that weaknesses in these multilateral frameworks, combined with modern business models, have contributed to an unacceptable level of tax avoidance that needs to be addressed.

The avoidance activities of increasingly globalised businesses have highlighted the weaknesses in existing international tax agreements. Yet having been placed under the spotlight for most of the past year, there is some tendency to view the mounting problems as specific to the information technology industry. However, this categorisation is misleading, as the avoidance problems that are under consideration touch on a much wider spectrum of industries – essentially, any business where global supply chains, intangible property and related party transactions are significant. In this sense, the problems are not necessarily new, but have merely garnered more attention due to several high-profile avoidance cases surfacing in the media at a time when countries are highly focused on weakening government revenue positions. Moreover, there is a concern that if action is not taken now, the situation will deteriorate further.

Recent work by both the OECD and the Australian Treasury has pointed to the difficulty of measuring the overall impact that base erosion and profit shifting have had on government tax revenues around the world.⁴ Other studies have been more definitive, finding that there has been significant erosion in tax revenue, at least in the US.⁵ From the perspective of both equity and economic neutrality, the issue of BEPS needs to be resolved, largely to restore integrity to the tax system, and to head off the possible further leakage of revenue as global business models continue to expand. Nevertheless, the contribution of this to revenue collections and economic activity must be kept in perspective.

Dealing with the problem

There is little doubt that some of the existing bilateral and multilateral approaches to international taxation need overhauling in order to adequately adapt to modern business practices. The OECD has recently proposed a comprehensive fifteen-point action plan⁶ to tackle this problem. The advantage of an OECD/G20 sponsored approach is that it provides for changes to international taxation within a multilateral framework, which will both facilitate improved tax compliance by corporations and increase the effectiveness of the tax system in minimising tax avoidance.

Nevertheless, it is important not to underestimate the problems that lie ahead in completing and implementing the OECD action plan. Many of the fifteen points in the plan require multilateral agreements in order to be effective, and experience has shown the difficulties in developing, negotiating and implementing such agreements. A number of countries have used aspects of their tax systems to attract certain types of international business, such as regional headquarters, financial centres, logistics centres, etc. If the OECD action plan proposes to neutralise the effectiveness of these arrangements, there is likely to be considerable opposition that will delay implementation of the plan. In addition, combined OECD and G20

⁴ OECD. *Addressing base erosion and profit shifting*. Paris, OECD, 12 February 2013. The Australian Government the Treasury, *Risks to the sustainability of Australia’s corporate tax base*.

⁵ IMF. *Issues in international taxation and the role of the IMF*. Washington, DC, IMF, 28 June 2013.

⁶ OECD. *Action plan on base erosion and profit shifting*. Paris, OECD Publishing, 2013.

membership represents only twenty per cent of the countries in the world. Even though this group contains most of the largest economies in the world, it is clear from the current situation that small economies can play a major role in international tax planning. It will be important to ensure that the interests of other countries are taken into account if proposed changes are to be effective. As noted earlier, there are over three thousand DTAs in force around the world. The OECD would like to obviate the need to renegotiate all of these agreements in order to implement changes, but this can only be achieved if all countries with DTAs in force are able to accept the terms of the proposed multilateral instrument. Past experience with such international instruments is that they can take several years to develop, and an even longer period to be validated by a workable majority of countries.

Setting priorities

If the fifteen point OECD action plan experiences delays because of inherent difficulties in overcoming differences, it will be important for both individual countries and the OECD/G20 to look at ways of dealing more effectively with international tax avoidance using tools already available to them. Two approaches are available.

First, tax authorities around the world already have a considerable array of powers to collect taxes from multinational corporations. Some of the problems that have been apparent in individual countries could be dealt with, at least partly, by a combination of modest changes to domestic laws and through more efficient tax enforcement. Even without changes to existing international agreements, many countries could achieve better outcomes by improving enforcement procedures in areas such as: fees charged for the provision of services, payment of interest on intercompany loans, and payment for intangibles. All of these areas are already covered by existing OECD transfer pricing guidelines, thereby enabling countries to achieve more without imposing the burden of double taxation on multinational corporations.

Second, within the proposed OECD action plan, there are some steps that will be easier to negotiate than others. Some of the steps will be best achieved by updating or refining the existing transfer pricing guidelines and the OECD Model Tax Convention, both of which already have support from the OECD and many other countries. Thus, proposals relating to documentation, disclosure of aggressive tax planning arrangements, allocation of risks and capital, dispute resolution mechanisms, and treaty abuse should attract a sufficient level of support that enables substantial progress in a relatively short space of time.

One objective particularly worth pursuing is the facilitation of a more effective exchange of tax information between jurisdictions. Most DTAs include a clause allowing for the exchange of information between the treaty partners, but this has not been well used in the past and is often bogged down in administrative delays. Reform is required, but for the process to work effectively and efficiently, it will probably be necessary to develop internationally accepted templates for requesting the cross-border exchange of information. Even at a domestic level, information requests from corporations typically proceed very slowly. If the process is to work at the international level, the way in which information can be requested will need to be more clearly defined.

Some of the more challenging issues

A number of points within the OECD action plan are likely to prove particularly challenging to certain countries. These include possible changes to the definition of permanent establishments (PEs), proposals to neutralise the effects of hybrid mismatch arrangements and the strengthening of rules relating to the activities of Controlled Foreign Corporations (CFCs). Not only are these technically difficult areas of taxation law, certain countries have used these areas to achieve positive policy outcomes that encourage (or at least do not discourage) business activity. In the case of CFC rules, only a limited number of countries have such rules in place, as the tendency over the past decade has been to relax the impact of these rules out of a concern that they may discourage the international expansion of domestic business. However, by way of countering the effects of BEPS, there is likely to be considerable resistance to an expansion of CFC rules, particularly by those countries that have not sought to adopt such measures in the past.

The reforms under consideration have come at a time when the practice of corporate taxation is being challenged by the international mobility of capital. Over the past decade, corporate tax rates have declined across the board, and no apparent reversal of this trend is in sight. Most countries have responded to this competitive environment by lowering the nominal rate of tax, but tax incentives for such things as capital investment, R&D and employment creation remain important. Hence, as countries are gearing up to deal with international tax avoidance, they are simultaneously facing leakage from the corporate tax base through other channels. Thus, international tax reform should not be seen in a vacuum. Governments need to look at reforms in this area against the backdrop of their overall policies for raising taxation revenue and on tax reform in general.

Most of the focus of the debate on international tax avoidance has been on corporate income tax. However, the OECD has noted that indirect taxes also need to be considered. The OECD has mentioned the challenge of imposing value-added taxes (VAT/GST) on cross border transactions involving the digital supply of goods and services.⁷ This has become an increasingly important issue, as customers are able to order goods online and return them if unsuitable at virtually zero cost. Such developments are beginning to foster a significant leakage of indirect tax revenue, as well as pose a challenge to the competitive position of domestic businesses that are required to charge the relevant rate of VAT/GST on equivalent transactions.⁸ Governments already have the capacity to act in this area by updating domestic legislation, but tax collection remains a problem and it is likely that some international cooperation would improve affairs.

Proposals to tidy up international taxation are also likely to encounter problems in determining which jurisdiction is entitled to the taxation revenue currently being avoided. For example, consider the recently highly publicised usage of the ‘Irish structure’, apparently utilised by some US companies that market goods and services, particularly throughout Europe. The structure involves two parallel Irish companies, one of which is not officially a resident in either Ireland or the USA, such that its income is untaxed in either jurisdiction. By exploiting weaknesses in the legal definition of a ‘permanent establishment’, the company is also able to avoid paying taxes in the countries where the goods and services are being marketed and sold (normally a group of European countries).

⁷ OECD. *Action plan on base erosion and profit shifting*, p 15.

⁸ The Australian Bureau of Statistics has recently released an Information Paper providing estimates of the value of imported goods on which GST is not paid because individual transactions fall under the low value threshold. For more, see Australian Bureau of Statistics. *Measurement of online retail trade in macroeconomic statistics: 8501.0.55.007*. Information paper Canberra, ABS, 2013.

This type of avoidance could be countered in a number of different ways, but there would be different impacts depending on where the income is taxed. In one scenario, the US could change its tax laws, either by modifying its definition of residence, or by tightening its CFC rules – either way, the profits that are currently untaxed would be taxed within the US. Similarly, Ireland could change its definition of residence so as to tax the profits of the company in Ireland. Finally, the European countries in which the goods and services are actually sold could also tighten their rules relating to permanent establishments, thereby allowing for the taxation of any relevant profits. There may already be some scope for doing this under existing laws. If not, international cooperation would be needed to override any obstructions currently embedded in DTAs. In any event, the potential for different outcomes highlights the array of challenges that must be overcome for these problems to be resolved.

Conclusion

International tax avoidance is now perceived as a problem that must be dealt with as a matter of priority. To the extent that reforms are necessary, it is essential that they be carried out within a framework of arrangements supported by most countries. If this does not happen, the problems will not be resolved and international business will be beset with the problems of double taxation and costly compliance. As such, the action plan proposed by the OECD appears to provide the best way forward.

Nevertheless, there is considerable scope for countries to do more, either by increased enforcement of existing measures, or by modest domestic tax reforms that are consistent with existing international protocols, such as the OECD guidelines on transfer pricing or the Model Tax Convention. Each country needs to look closely at their existing tax laws and collection procedures to see if they are achieving the best possible outcomes within the limitations of these existing international protocols.

The process involved in getting multilateral support for changes to international protocols will be challenging and potentially protracted. For this reason, the OECD/G20 group charged with taking this process forward will need to segment tasks, so that areas of reform where achieving an international agreement will be less problematic are not held up by those issues where country differences run deep.

Hard graft: the G20 and anti-corruption

Hugh Jorgensen¹

Introduction

The annual detrimental cost of corruption on international economic growth and fiscal sustainability has been conservatively placed at over US\$1 trillion.² This represents a substantial amount of lost potential, in terms of both global public and private investment activity. Moreover, as the largest share of the corruption burden generally lies with the ‘poorest of the global poor’,³ it is difficult to conceive of a truly inclusive G20 agenda that does not engage with the problem in some way. As such, corruption has officially been a component of the G20 leaders’ agenda since 2009, with three two-year ‘anti-corruption’ action plans released since the Seoul summit in 2010. By way of accountability on its action-plan commitments, the fourth annual ‘monitoring report’ on ‘the individual and collective progress made by G20 countries’ in fighting corruption’, prepared by the G20 Anti-Corruption Working Group (ACWG), is scheduled for release towards the end of Australia’s 2014 G20 presidency. The fourth monitoring report will provide a summary of the ACWG’s work and on progress made in counteracting corruption within and between G20 countries for 2013-2014. However, as the mandates of the ACWG and the most recent G20 anti-corruption action plan are set to expire under Australia’s presidency, leaders at the Brisbane summit will have to decide whether to extend the G20’s current approach to anti-corruption, to place its anti-corruption objectives on hiatus, or to reformulate its approach to combating corruption.

Accordingly, with its presidential prerogative to oversee the G20’s 2014 agenda, Australia will have to form a view on what the G20’s future position on anti-corruption should be. If G20 leaders have a clear sense of ownership over their stated objectives for and outcomes on anti-corruption, as well as a plan for how the G20 can provide a unique ‘value-add’ to anti-corruption efforts that other multilateral institutions cannot, then the case for renewing the G20’s anti-corruption commitments is strong. On the other hand, if leaders believe the ACWG’s work does not meet these requirements, or that its work on anti-corruption is not sufficiently complementary to the G20’s core focus on reinvigorating economic growth, then renewing the group’s mandate without proper critical appraisal would compound perceptions about the G20’s ‘bloated’ agenda.

This paper reviews the G20’s work on anti-corruption. It suggests that given the useful contribution that the G20 has made to galvanising pre-existing anti-corruption initiatives between 2009-2013,⁴ there remain key areas where G20 leaders could, , continue to help to close the gap between commitment and implementation on anti-corruption. The paper concludes with suggestions for how the G20 could better structure its work on anti-corruption.

¹ Research Associate, G20 Studies Centre, Lowy Institute for International Policy.

² World Bank. *Six questions on the cost of corruption with World Bank Institute global governance director Daniel Kaufmann*. World Bank, April 2004: <http://go.worldbank.org/KQH743GKF1>.

³ In the words of Kenneth Clarke, the former British secretary of state for ‘put at its crudest, corruption makes poor people poorer,’ see: Kenneth Clarke. *Address by the lord chancellor and secretary of state for justice to the G20 Anti-Corruption Working Group event*. Lancaster House, London, Ministry of Justice, 2012.

⁴ For more on this contribution, see: Jason Sharman. G20 effectiveness: be careful what you wish for. In *G20 Monitor: rebutting some misconceptions*, G20 Studies Centre, Lowy Institute for International Policy, 2013.

A brief history of the G20's anti-corruption agenda

The G20's first reference to anti-corruption within a communiqué occurred in 2000, when the G20 was still only a forum for finance ministers and central bank governors (it was also only the second ever G20 meeting). However, the allusion was really only part of a scattershot statement against 'financial abuse' that vaguely called for members to 'strengthen ... efforts to combat ... money laundering, tax evasion and corruption...', and that 'looked forward' to a joint paper by the IMF and World Bank on the subject. A similarly abstruse statement was made in 2004, with corruption not featuring in another G20 communiqué until 2009.

The omission of corruption from the earlier G20 agenda is not so surprising; between 2000 and 2003, the anti-corruption community was focused on resolving and ratifying the United Nations Convention against Corruption – the first global legally binding anti-corruption instrument. In deference to the UN's universal precedence, the G20 limited itself to other more pressing forms of financial abuse, such as money laundering and terrorist financing. Nevertheless, while both of these latter forms of criminal activity were subject to commendable attention from the G20 after the September 11 terrorist attacks,⁵ they are, in practice, distinct (albeit often interlinked) or 'post facto' crimes to corruption – loosely defined here as 'the abuse of entrusted power for private gain.'⁶

As such, the first set of G20 commitments that specifically target corruption can be found in the Pittsburgh leaders' communiqué from September 2009. The commitments reside within the 'framework for strong, sustainable and balanced growth' (FSSBG), a document that has increasingly come to be seen as the thematic centrepiece of the G20's post-crisis economic recovery agenda.⁷ Within the FSSBG, G20 members committed to:

- work with the World Bank's Stolen Assets Recovery (StAR) program to secure the return of stolen assets to developing countries;
- ask the Financial Action Task Force (FATF) to help detect and deter the proceeds of corruption by prioritising work to strengthen standards on customer due diligence, beneficial ownership and transparency;
- work to increase the transparency of international aid flows by 2010; and
- adopt and enforce laws against transnational bribery, such as the OECD Anti-Bribery Convention, and the UNCAC.

The latter commitment was significant in that it garnered the consent of four G20 members (Germany, India, Japan and Saudi Arabia) that had, up to that point, failed to ratify UNCAC, as well as five non-OECD members (China, India, Indonesia, Russia, Saudi Arabia) that, unsurprisingly, had not signed up to the OECD Anti-Bribery Convention. Less compellingly, leaders also supported 'voluntary participation in the Extractive Industries Transparency

⁵ For more on the anti-terrorist financing work of the G20 through bodies such as the FATF, see: G20. *The G20: a history*. 2008: www.g20.utoronto.ca/docs/g20history.pdf.

⁶ This definition is Transparency International's, but it has come to gain wide currency among the anti-corruption community. Transparency International further delineates between 'according to rule' and 'against the rule' corruption, where the former broadly covers the exchange of 'facilitation' bribes in return for preferential treatment in an otherwise legally established process, while the latter involves bribery in return for illicit or explicitly prohibited transactions. For clarity, in this paper, unless otherwise specified, 'corruption' refers to both 'according to rule' and 'against the rule corruption'. For more on link between money laundering and corruption, see: FATF. *Laundering the proceeds of corruption*. Paris, FATF, July 2011.

⁷ Mike Callaghan. *Strengthening the core of the G20: clearer objectives, better communication, greater transparency and accountability*. Sydney, Lowy Institute for International Policy, April 2013.

Initiative' (EITI), which calls for 'regular public disclosure of payments by extractive industries to governments and reconciliation against recorded receipt of those funds by governments.'⁸

However, while the anti-graft policies outlined at Pittsburgh embodied a greater appreciation for the negative economic effects of corruption than any previous G20 communiqué, it was not until 2010 that leaders' consciously sought to articulate a link between anti-corruption and the FSSBG's raison d'être: reinvigorating global economic growth. The establishment of this 'link' occurred in two stages. First, leaders at the Toronto summit in June 2010 identified corruption as a threat to 'the integrity of markets, [that] undermines fair competition, distorts resource allocation, destroys public trust and undermines the rule of law.'⁹ Concomitantly, leaders established an 'Anti-Corruption Working Group'¹⁰ and tasked it with delivering 'comprehensive recommendations' to the next leaders' summit in Seoul on how the G20 could 'lead by example' via 'practical and valuable contributions' to the fight against corruption. Leaders requested the ACWG to focus on 'areas that include, but are not limited to:

*adopting and enforcing strong and effective anti-bribery rules, fighting corruption in the public and private sectors, preventing access of corrupt persons to global financial systems, cooperation in visa denial, extradition and asset recovery, and protecting whistleblowers who stand-up against corruption.'*¹¹

Five months later, the ACWG produced a two-year 'G20 Anti-Corruption Action Plan' that was adopted by leaders and included in the annex of the official 'Seoul summit document.' The introduction to the action plan clarified the link between anti-corruption and the G20's leader-driven objective of achieving strong, sustainable and balanced growth:

'Corruption is a severe impediment to economic growth ... As leaders of major trading nations, *we have a special responsibility* to prevent and tackle corruption ...'¹²

True to the G20's now well-established penchant for appropriating architectural terminology, the plan rested on 'three pillars':¹³

- establishing a common approach to building an effective global anti-corruption regime, the principles of which are enshrined in the provisions of the UNCAC;
- committing to taking action in high priority areas that affect global economic growth; and
- committing to directly engage with private sector stakeholders in the formation of anti-corruption policy.

⁸ G20. *Leader's statement: the Pittsburgh summit*. 24-25 September 2009: <http://www.g20.utoronto.ca/2009/2009communique0925.html>, clause 42.

⁹ G20. *The G20 Toronto summit declaration*. 27 June 2010: <http://www.g20.utoronto.ca/2010/to-communique.html>, clause 40.

¹⁰ Taking the number of G20 working groups to four, the other three being the 'Framework for Strong, Sustainable, and Balanced Growth,' 'Development' and 'International Monetary Fund Quota and Governance Reform' working groups. In 2013, the 'Energy Sustainability' and 'Climate Change Financing' working groups were also added to the G20 policy hydra.

¹¹ G20. *The G-20 Toronto summit declaration*.

¹² Emphasis added

¹³ FATF, *Laundering the proceeds of corruption*.

While the 2012-2013 action plan makes it clear that the G20's contribution to anti-corruption is grounded within UNCAC principles, there is a clear underlying assumption that because of the sheer scale of the G20's global economic footprint, anti-corruption policies implemented within the G20 are expected to have positive 'UNCAC plus' effects beyond the G20 economies. As such, the nine areas in which G20 leaders initially elected to 'lead by example' on anti-corruption are:

- prompt and full ratification of the UNCAC by all G20 members, as well as participation in individual reviews of each country's anti-corruption policies in accordance with UNCAC requirements;
- the criminalisation of bribery of foreign public officials, as well as providing support to other international anti-bribery instruments outlined by the OECD and UNCAC;
- the prevention of corrupt officials from accessing the global financial system, in addition to increased cooperation with the Financial Action Task Force (FATF) and the implementation of FATF standards for 'transparency of cross-border wires, beneficial ownership, customer due diligence, and due diligence for "politically exposed persons;"'
- the denial of entry and safe haven to corrupt officials, through bilateral cooperation;
- the particular promotion of UNCAC provisions related to extradition, mutual legal assistance and asset recovery, and the provision of technical assistance on these matters where needed;
- the adoption of measures 'related to, inter alia, preventing and detecting transfers of proceeds of crime', including the establishment or designation of an appropriate authority or agency that can provide international mutual legal assistance on matters related to corruption and asset recovery;
- the preparation and implementation of corruption whistle-blower protection legislation by the end of 2012;
- the establishment of anti-corruption agencies with law enforcement power, replete with the necessary independence to fulfill their duties free from undue influence;
- the promotion of 'integrity, transparency, accountability and the prevention of corruption, in the public sector, including in the management of public finances.'

The action plan also advocates for greater dialogue with and between international organisations so as 'to encourage that they operate with transparency,' as well as for greater involvement of the private sector in the work of the ACWG.

The G20's anti-corruption commitments have not fundamentally changed in intent throughout the Cannes, Los Cabos and St Petersburg summits, held in 2011, 2012 and 2013 respectively. However, further details to the G20's anti-corruption action plans have been added at these summits, mostly clarifying how the G20 would seek to realise its objectives in the nine areas listed above, and how civil society and the business community were encouraged to work with the ACWG. Essentially, the updates called for greater cooperation between the designated anti-corruption law enforcement agencies in G20 jurisdictions, and the creation and sharing of best-practice guides on fighting corruption. Of particular note, though, the Los Cabos summit extended the ACWG's mandate for an additional two years until 2014, and released an updated action plan that, although somewhat longer than the original, was substantively a reaffirmation of the commitments outlined in the previous version.

Despite dedicating eleven clauses to the topic of anti-corruption, the most recent St Petersburg leaders' communiqué offered no discernably unique contribution beyond reiterating previous G20 commitments. And although eleven clauses is a distinct increase in 'volume' from the two sentences dedicated at Cannes, that the clauses themselves numbered 103-113 out of a communiqué total of 114, tends to suggest anti-corruption remained a low-level priority at St Petersburg. However, St Petersburg did at least see the delivery of a 'Strategic Framework for the G20 Anti-Corruption Working Group,' which does attempt to demarcate a space for the ACWG that does not involve a duplication of other ongoing global anti-corruption work. It also raises the status of the ACWG to that of the G20's other working groups and prioritises implementation of the UNCAC and cooperation with the OECD Working Group on Bribery.¹⁴

The next section examines the actual impact that the G20's anti-corruption commitments have had on the global movement to stymie corruption.

Achievements, outcomes and problems with the G20's anti-corruption plan

While the G20 can lay some claim to having contributed to the global anti-corruption movement, its work in the area has been mostly incremental, frequently piece-meal, and sometimes haphazard. Hence, as has been acknowledged by the G20, its current priority on anti-corruption must be to close the gap between the rhetoric and actual implementation of its commitments in the Seoul and Los Cabos G20 anti-corruption action plans. Failure to do so will undermine the legitimacy of the G20 as an anti-corruption actor and, more damagingly, will give further succour to critics looking to paint the G20 as 'invertebrate, flabby and toothless.'¹⁵ Yet before offering suggestions on how the G20 can close the rhetoric-implementation gap in the lead-up to the Brisbane summit, this section offers a review of outcomes from the G20's anti-corruption workplan to date, which could potentially provide a platform for future G20 work in the area.

By way of accountability on their anti-corruption commitments, G20 members consented in 2010 to provide annual individual and collective progress reports on the implementation of the anti-corruption action plan. At the time of writing, three self-assessment reports have been prepared and released by the ACWG, under the French, Mexican and Russian presidencies respectively. The self-assessments contain a summary of ongoing work occurring within the ACWG. As the remainder of this section shows, some of the 'outcomes' listed within the self-assessments justify a continuation of the G20's work on anti-corruption, while a far greater number are of dubious consequence, or simply applaud activities whose provenance and responsibility for implementation lies outside of the G20 process.

Examples of useful outcomes from the G20's anti-corruption work

The G20's most valuable contribution to the global anti-corruption agenda has been in alleviating any 'silo-mentality' from compartmentalising anti-corruption initiatives undertaken by institutions like the UN, IMF, World Bank, OECD or the FATF. The call for greater inter-agency dialogue was a key component of the 2010 action plan, and as the G20's own self-assessment reports show, the aforementioned agencies not only cooperated on

¹⁴ G20. *St Petersburg strategic framework for the G20 anti-corruption working group*. G20, September 2013: <http://www.g20.org/load/783340260>.

¹⁵ Robin Davies. What plot? - rationalising the G20's development agenda. In *G20 Monitor: development and the G20*, G20 Studies Centre, Lowy Institute for International Policy, 2013.

providing technical input and assistance to the ACWG, but they have also begun to integrate their anti-corruption work with one another in a more collegial way. Indeed, as Jason Sharman has noted in an earlier G20 Monitor, galvanising and integrating pre-existing global initiatives is something to which the G20 is particularly well-suited; G20 leaders do not have to ‘reinvent the wheel’ in order to make a meaningful contribution to global economic stability, as their collective political weight can generate a sufficient amount of pressure on multilateral bodies to produce results in an accelerated timeframe of ‘weeks or months’, as opposed to years or decades.¹⁶

For example, spurred on by the political uprisings in the Middle East and North Africa (MENA) region in early 2011, the French and Indonesian co-chairs of the ACWG called upon a number of multilateral agencies to work on freezing and/or repatriating the assets of corrupt leaders. The FATF immediately commenced work on reconciling its guidance on anti-money laundering policy to better encompass the task of exposing funds ‘secreted away’ by corrupt governments and ‘politically exposed persons’ (PEPs), while the World Bank and the UN Office on Drugs and Crime (UNODC – the designated ‘guardian’ of the UNCAC) quickly moved to provide practical assistance and expertise to officials from the MENA region on ‘tracing and repatriating the proceeds of corruption held abroad.’¹⁷ The near-immediate impact that G20 leaders had in pressuring tax havens ‘black-listed’ by the OECD into implementing internationally agreed tax standards, discussed elsewhere in this Monitor by Callaghan and Harris, further points to the unique ‘weight’ that G20 leaders’ can bear in exposing irregular financial activity.

However of all the multilateral-body initiatives that the G20 has sought to invigorate, it is the UNCAC that has garnered the most attention. Of the four G20 members that had not yet ratified the UNCAC, but that committed to do so at Seoul, half remain. India ratified the convention in May 2011, thereby setting in train the implementation of UNCAC requirements such as: establishing specific anti-corruption law enforcement agencies, developing public service codes of conduct and creating more stringent standards for procurement.¹⁸ Saudi Arabia commenced the process of ratifying the convention in January 2013, having accepted the recommendations of its own ‘National Anti-corruption Commission’ that it had established in May 2011, in line with its G20 commitments.¹⁹ Should the G20 be able to pressure the two recalcitrants, Japan and Germany (a curious anomaly, as both regularly feature at the top of ‘least corrupt’ indexes), to ratify the convention in the near future, and commence work on fulfilling its requirements, this would be a legitimate and commendable ‘win’ for the G20, and its anti-corruption agenda. This would also allow the G20 to genuinely ‘lead by example’ on anti-corruption, and speak with a unified voice in pressuring the fifty countries that have not yet ratified the convention, to do so.

Countries that have ratified the UNCAC have also taken further steps in line with their G20 commitment to ‘lead by example’ on better fulfilling the obligations and overall intent of the

¹⁶ See Sharman, G20 effectiveness: be careful what you wish for.

¹⁷ Ibid; FATF, *Laundering the proceeds of corruption*, p. 11.

¹⁸ Ministry of External Affairs. India ratify UN conventions against transnational organised crime and corruption. Press information bureau, government of India, 13 May 2011: <http://pib.nic.in/newsite/erelease.aspx?relid=72119>.

¹⁹ Transparency International Secretariat. *Transparency international says Saudi Arabia's steps toward anti-corruption treaty a good first move*. Transparency International, 31 January 2013:

http://www.transparency.org/news/pressrelease/transparency_international_says_saudi_arabias_steps_toward_anti_corruption.

convention. In line with the UNCAC schedule for undertaking peer-reviewed self-assessments of progress in implementation of the convention, thirteen G20 countries will have completed an in-country review by end-2013, with the remaining four UNCAC signatories expected to conclude their first review by end-2014.²⁰ A number of valuable pieces of anti-corruption legislation have since been introduced within G20 countries in order to redress identified legal gaps, a summary of which are included in the monitoring report from 2012.²¹

The criminalisation of foreign bribery, a core tenet of the OECD Anti-Bribery Convention, has also received a significant lift courtesy of G20 support. As stated in the 2012 monitoring report:

‘By criminalising foreign bribery we show that we are ready to take responsibility for the action of our citizens and companies overseas as we do in our own countries. Alongside the requirement in UNCAC to criminalise foreign bribery, the Anti-Bribery Convention ... is the benchmark.’

As indicated earlier, this is particularly striking in that non-OECD countries in China, India, Indonesia and Russia have begun to work with the OECD Working Group on Bribery on this issue – and on anti-corruption more generally – with Russia fully acceding to the OECD convention in April 2012. As per the requirements of the OECD convention, Russia, alongside other signatories, must now participate in the OECD Working Group on anti-bribery’s ‘three-phase’ peer review monitoring system. Phase one and two reviews involve the evaluation of the adequacy of a country’s legislative capacity to implement the convention, and whether it is applying this legislation effectively, while a phase three review focuses on remedying identified gaps in the overall enforcement of the convention. For example, as a current phase one participant, Russia must now consider removing or modifying legislation that currently incentivises foreign bribery – such as tax deductions for foreign bribes, as well as establish legal penalties for companies or individuals that participate in foreign bribery. Fifteen G20 countries have undergone phase one and two reviews, with a further ten advancing to phase three. As far as non-signatories to the OECD convention are concerned, China amended its criminal code in 2011 to make the bribery of foreign officials an offence,²² and India has begun the process of passing such legislation.²³

The third major ‘value-add’ that the G20 has brought to the global anti-corruption effort, is in establishing more effective links between anti-corruption law enforcement agencies within G20 jurisdictions. This theoretically eases the path towards exposing and recovering assets and funds siphoned off through corruption, as well as enabling the legal sanctioning and pursuit of individuals and entities engaging in foreign corruption – outcomes that are positive for more than the just the G20 countries. In terms of institutional collaboration, this has involved the G20 working with the World Bank’s stolen asset and recovery (StaR) initiative, as well as the FATF, to better identify the sources of money laundering operations and whether they are linked to corrupt behaviour. The likely adoption by the G20 of an automatic

²⁰ See annex ii of: Conference of the States Parties to the United Nations Convention against Corruption. *Report of the implementation review group on its fourth session*. Vienna, United Nations, 27-31 May 2013.

²¹ G20. *G20 anti-corruption working group monitoring report*. Paris, G20, 2012.

²² Ibid.

²³ Yogima Seth Sharma. No place for India on OECD bribery convention unless it enacts stricter laws at home. *The Economic Times*, 24 May 2013: http://articles.economictimes.indiatimes.com/2013-05-24/news/39502234_1_oecd-bribery-indian-parliament.

tax information exchange will further boost the G20's cross-country cooperation in exposing corrupt activity.²⁴

The G20 has also adopted 'a set of principles' with a view to denying visa entry and financial system access, within G20 countries, to 'corrupt officials and those who corrupt them.'²⁵ However, although these principles extend beyond the requirements of the OECD Anti-Bribery Convention or the UNCAC, they are yet to have an impact outside of the 'expert panel' currently tasked with designing a plan for their implementation. Nevertheless, the UK and Canada have recently begun to implement some of the most stringent anti-foreign-bribery legislation in the world (the UK more-so, but both have outlawed 'facilitation payments'²⁶) and, alongside the US, have moved to combat the payment of bribes to both public and private foreign entities, as well as authorise the legal pursuit of any parties involved. These three countries, alongside Australia, have also established a joint 'International Foreign Bribery Taskforce' (IFBT), that allows key anti-corruption law enforcement agencies in each country to cooperate on exposing acts of foreign bribery by domestic entities.²⁷ The IFBT is in part an outcome stemming from the G20's commitment to establish better channels of mutual legal assistance with one another in dealing with corruption.²⁸

Problems with the G20's approach to anti-corruption, and what to do about it

Despite the positive progress outlined above, there are questions as to how uniquely valuable the G20's contribution to anti-corruption actually is, and whether the G20's anti-corruption workplan has been integrated into the G20's agenda in a sufficiently coherent way, such that it does not diminish the forum's claim to be a 'leader-driven' process for confronting systemic challenges to stable global economic growth.

For example, a recent Transparency International progress report on enforcing the OECD Anti-Bribery Convention suggests only four of the eleven G20 countries that are party to it are *actively* enforcing their stated obligations.²⁹ In other words, just because the G20 has galvanised its members that are not OECD convention signatories into sending participants to OECD anti-bribery workgroup meetings, or passing OECD-compliant legislation, does not mean anti-corruption laws are actually going to be any more strictly enforced within G20 countries that suffer from corruption. That Japan and Germany rate so low on Transparency International's corruptions perception index, despite not being signatories to the UNCAC, highlights the difficulty of implementing meaningful anti-corruption reform beyond signing agreements or conventions.

In addition, a simple investigation of the G20's own action plans and ACWG monitoring reports reveals an ambiguity even in the strength and intent of the G20's anti-corruption commitments, with a number of clauses failing to call for anything more strident than

²⁴ See (this publication): Mike Callaghan and Marty Harris. Reforming international taxation: the role of the G20. In *G20 Monitor: tax, infrastructure, anti-corruption, energy and the G20*, G20 Studies Centre, Lowy Institute for International Policy, 2013.

²⁵ G20, *G20 anti-corruption working group monitoring report*.

²⁶ Facilitation payments fall within the 'according to rule' category of corruption described earlier in footnote 5.

²⁷ Respectively: the City of London Police's Overseas Anti-Corruption Unit, the Royal Canadian mounted Police, the US Federal Bureau of Investigation and the Australian Federal Police.

²⁸ See: G20. *Requesting mutual legal assistance in criminal matters from G20 countries: a step-by-step guide*. G20, 2012.

²⁹ Fritz Heimann and Gillian Dell. *Exporting corruption? Country enforcement of the OECD Anti-bribery convention progress report 2012*. Berlin, Transparency International, 6 September 2012.

‘examine the possibility of’, ‘explore areas of overlap in’, ‘propose best practice guides on’, ‘call for dialogue over’ or ‘welcome voluntary participation in’ whatever (otherwise) noble objective is being addressed.³⁰ As has been observed many times within G20 Monitor papers, for the G20 to credibly claim to be the ‘premier forum for economic cooperation’ between its members, it must actually produce meaningful and tangible outcomes that go beyond writing endless reports and commissioning investigations – a requirement that the bulk of limpid pronouncements within the G20’s anti-corruption action plans, and in the leaders’ declarations, currently do not meet.

There is also the question of how strongly G20 leaders are interested in, or feel they have ownership over, the ACWG and the anti-corruption action plans. The G20’s institutional comparative advantage is, after all, that it brings together the preeminent political leaders from twenty of the world’s most powerful economies. It is doubtful that analysing and honing the finer details of domestic anti-corruption legislation within G20 countries is an appropriate use of the extremely limited time that G20 leaders’ have together at summits. This ‘ownership’ problem is compounded in that the G20 anti-corruption self-assessment reports are not even necessarily presented to leaders for their review, or even finalised by the time of the leaders’ summits. In 2012 the report was presented to sherpas after the Los Cabos summit, for example.

In other words, the G20 would likely be more effective as an anti-corruption actor, if it undertook to critically appraise its approach to anti-corruption and whether its anti-corruption work appropriately reflects the G20’s comparative advantage as a leader-driven process. In particular, whether the biennial release of ACWG-prepared anti-corruption action plans, and the associated renewal of the ACWG’s mandate, is an approach that maximises the political authority of twenty of the world’s most powerful leaders. For example, the anti-corruption clauses contained within the recent St Petersburg communiqué are arguably little more than a summary of the third monitoring report, and thus reveal little of the ‘breakthrough’ capacity that G20 leaders wield. Is it really worth assembling world leaders once a year so they can endorse the timid findings of working groups?

If the leaders’ communiqués are to have any clout on any issue, they must become more concise and outcome-oriented, and reflect a willingness to confront systemic challenges. Sizable roadblocks to fighting anti-corruption, like full ratification of the UNCAC and the OECD Anti-Bribery Convention by all G20 members, as well as the implementation of a credible ‘denial of entry and safe haven to corrupt persons in G20 countries’ initiative, are matters worthy of leaders’ attention, and of being included in the leaders’ agenda for Brisbane. A serious commitment to implementing the EITI, that demands more than voluntary participation, is another area potentially worth pursuing.

Lower-level ‘policy refinement’ issues, especially those that are now primarily a matter for G20 members’ legislatures, are better fitted to the work of sherpas and similarly ranked officials or ministers, rather than being forced up to the leaders’ agenda and communiqué. However, any potential redistribution of ongoing anti-corruption work to a ‘lower-level’ should not be seen as an indication that the relevant issue is no longer of value. Rather, by restricting the elevation of anti-corruption measures to the leaders’ agenda to only those systemic, deadlock items that are worthy of their limited time, the saliency of anti-corruption

³⁰ A similar point is made by Robin Davies with regards to the G20 and the Development Agenda, in Davies, What plot? - rationalising the G20's development agenda.

policy within the G20 would hopefully receive a boost, as would the coherency of the G20's overall organisational structure and modus operandi. In the same way, future G20 anti-corruption action plans should be made more concise and accessible, by ensuring outlined commitments are limited to systemic problems that either go beyond, or are not being dealt with by other institutions.

As such, the G20 might be best placed to direct the ACWG to more effectively integrate its work into the G20's overall 'framework for strong sustainable and balanced growth,' and to produce a more limited set of recommendations for submission to the actual leaders' agenda. Indeed, it is unfortunate that there is not more cross-pollination of ideas between the various G20 working groups in the first place. By pursuing more collaboration and consultation between the G20 streams that have been tasked with pursuing the various components of 'the framework', the ACWG would likely be able to attain greater clarity of purpose on why its objectives were worth pursuing in the overall context of the G20's agenda, and how they could be best pursued.

For example, commitments around exposing money laundering and bringing greater transparency to illicit financial flows might be better dealt with at finance ministers' and central bank governors' meetings, as these matters lie within the purview of financial regulators and would benefit from the added financial expertise. The prosecution and sanctioning of politically exposed persons and corporate entities that are involved in corruption, and the recovery of stolen assets, are areas that would likely benefit from input from the development working group, as these are essentially matters of good governance and fiscal sustainability. Yet whatever the mode of 'mainstreaming' or 'diffusing' the G20's corruption-focused responsibilities into the most appropriate G20 work-streams looks like, the point is that Australia has an important opportunity and incentive to align anti-corruption more effectively with the overall G20 agenda.

Naturally, any decision to 'mainstream' anti-corruption within the G20 process should be done with care and consideration for ensuring the G20's work on anti-corruption is not diminished. Certainly, the G20's working groups are not created with the intention of lasting until perpetuity (and given they are created to help *resolve* a global challenge, nor should they be). But in so far as the G20 is able to make a unique *leader-driven* contribution to the global anti-corruption agenda, there is a case for the ACWG to retain a place within the G20 process, so as to ensure the G20's commitments are being pursued at some level, and to lay the groundwork for future anti-corruption action plans. Regardless, The Strategic Framework for the G20 Anti-Corruption Working Group released in St Petersburg appears to have bolstered the ACWG's status by noting that 'G20 leaders hereby agree ... that the Anti-Corruption Working Group will have the same status of other G20 working groups.'³¹

One way to help ensure the anti-corruption work of the ACWG and the G20 as a whole remains on track is to make its work program more transparent to, and inclusive of, NGOs and business interests who have an interest in engaging with the working group. Essentially, working with stakeholders to collectively ensure any 'mainstreaming' of anti-corruption work in the G20 does not result in the issue being prematurely abandoned, and that the G20 remains accountable for its commitments on anti-corruption, is essential. Fortunately, The Strategic Framework does also suggest a more inclusive-outreach process is at least on the agenda for the ACWG.

³¹ G20. *St Petersburg strategic framework for the G20 anti-corruption working group.*

In short, the G20 has brought value to the anti-corruption agenda. Yet whether it can continue to do so will require leaders to push for a more specific and outcome-oriented set of objectives, that will have a tangible and meaningful effect within (and preferably beyond) G20 countries. The positive contribution that the G20 has made in invigorating its own members' efforts in meeting their UNCAC and OECD Anti-Bribery Convention obligations, as well as the potential delivery of a framework for denying visa and financial system access to corrupt persons and entities, all indicate that the G20 can play a role in hampering corruption. These achievements can also provide a basis for future work. The challenge for G20 leaders, officials, business stakeholders and those in the broader global anti-corruption community, will be in articulating a clear explanation as to why the political capital of *leaders* is required to pursue new and other ongoing anti-corruption policy objectives, specifically within the context of the G20's already large agenda in bringing about strong, sustainable and balanced growth.

G20 and global energy governance

Mike Callaghan and Marty Harris

Introduction

The global energy environment is changing. Emerging nations are consuming more energy, and with this their stake in the global energy market is continuing to grow, and the relative energy share of developed nations is continuing to fall. At the same time, concern over human-induced climate change is pressing countries to increase energy efficiency and to develop and expand renewable sources of energy production. A policy tension appears to exist between combating climate change and the current approaches to economic development. The governance of the global energy system has an important role to play in resolving this issue.

The current arrangements for governing the international energy system are exceedingly complex, and in some cases archaic and ineffectual. The G20, due to its political power and diverse membership, is in a position to push for increased interconnectedness among the various institutions involved in the 'global energy matrix', and could play a lead role in formulating and driving an overarching vision of the future of global energy.

This paper does three things. First, it briefly outlines 'the problem': the dramatic shifts in the global energy environment and the lack of institutional capacity to deal with these changes. Second, it looks at the possible role the International Energy Agency (IEA), as the most advanced and broad energy institution, could play in coordinating any reform effort, as well as discussing the possible limitations of that role. Finally, it considers the role of the G20 in reforming global energy governance.

The problem

Henry Kissinger, in a speech commemorating the 35th anniversary of the establishment of the IEA, stated in 2009 that 'the energy system is on an unsustainable path, threatening the political, economic and social stability necessary for continued world progress.'¹ Similarly, Neill Hirst and Antony Froggatt, in a joint Chatham House/Grantham Institute report from December 2012, noted that:

International energy governance has not kept pace with the emergence of major developing nations, with the changing relations between oil producers and consumers, with the emergence of climate mitigation as a central energy policy issue, and with the technology revolution that is required.²

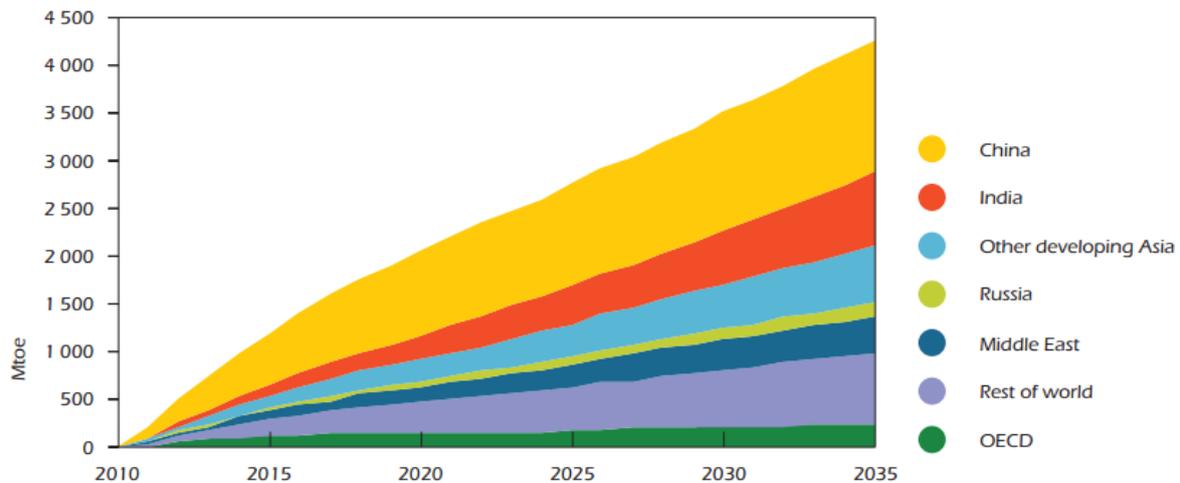
The source of 'the problem' can thus be summarised: dramatic shifts are taking place in the realm of energy.

¹ Henry Kissinger. *Speech by Henry Kissinger at the IEA ministerial*. Paris, International Energy Agency, 14 October 2009.

² Neil Hirst and Antony Froggatt. *The reform of global energy governance*. Grantham Institute for Climate Change, discussion paper no. 3 London, Imperial College, December 2012.

First, the centre of global energy consumption is shifting eastward. As the major Asian economies have grown, their relative and net consumption of energy has increased. China is now the world's largest energy consumer, and is set to become the biggest importer in coming years. Eighty per cent of world energy growth in 2011 is solely attributable to China.³ At the same time, energy demand in Western nations is flat lining: OECD members accounted for approximately 60 per cent of total world energy consumption in 1973; it now accounts for just over 40 per cent.⁴ According to the IEA, China, India and the Middle East are expected to account for 60 per cent of increased energy demand by 2035.⁵ The following graph shows this predicted growth in demand for energy.

Figure 1: Future growth in energy demand according to the IEA⁶



Second, corresponding with this geographic shift in energy consumption, energy demand is expected to increase by one third between now and 2035. Energy-hungry developing nations will put pressure on existing supply, possibly fostering geopolitical tension over access to energy.

Third, the traditional relationship between energy producers and energy consumers is changing. Due to the shale gas revolution, as well as other reforms, US oil imports are declining. The IEA predicts that the United States will become a net exporter of energy by around 2030.⁷ At the same time, many of the largest energy producers, particularly in the Middle East, are witnessing a rapid increase in their own energy demand, further blurring the consumer-producer relationship.

Fourth, 'energy access' has emerged as a key theme in international debates on energy. Currently, more than a 1.2 billion people do not have access to electricity: increasing access

³ Enerdata. *Sluggish growth of world energy demand in 2011*. 24 May 2012: <http://www.enerdata.net/enerdatauk/press-and-publication/publications/2011-g-20-energy-demand-decrease-vs-china-increase.php>.

⁴ IEA. *Key world energy statistics*. Paris, IEA, 2013, p. 30.

⁵ IEA. *World Energy Outlook 2012*. Paris, IEA, 2012.

⁶ Mtoe refers to Million Tonnes of Oil Equivalent; graph from: IEA. *Worldwide engagement for sustainable energy strategies: 2012*. IEA, 2012:

http://www.iea.org/publications/freepublications/publication/worldwide_engagement.pdf.

⁷ IEA, *World Energy Outlook 2012*.

to reliable and clean (or cleaner) forms of energy is now a key focus of development policy.⁸ This was recognised by Hillary Clinton during her Congressional confirmation hearings for the position of Secretary of State in January 2009:

As developing countries address energy poverty, the United States should do all it can to promote the adoption of clean energy technology and best practices. The full suite of energy sources – oil, gas, coal, nuclear, and all renewables, in tandem with conservation and efficiency improvements – will be necessary to meet projected global and domestic energy demand over the next 25 years.⁹

Finally, the threat of climate change, as well as the threat of increased competition over limited fossil fuel resources, has resulted in the rise in importance of renewable and lower carbon sources of energy. Demand for natural gas is increasing, while much of the world is searching for cleaner and more sustainable sources of energy. Climate change mitigation has emerged as a central energy policy issue – fossil fuel-based energy production accounts for about 70 per cent of all greenhouse gas emissions¹⁰ – and the goal of environmental sustainability has been described as the single most dramatic shift in the global energy landscape in recent decades.¹¹

To summarise the problem, the global energy system, and mechanisms in place to govern it, is immensely complex. The variety of energy sources – oil, natural gas, nuclear, coal, renewables – each have different trading systems, and mostly have different governing bodies. The addition of environmental concerns, and the pursuit of international arrangements for managing threats to the environment and to mitigate the impacts of climate change, complicates the situation further. A useful simplification of this complexity is provided by Cherp, Jewell and Goldthau, who state that current global energy challenges, and the global governance arrangements associated with them, can be broken down into three distinct and relatively autonomous arenas:

- energy security – ensuring secure access for all nations to reliable sources of energy, and being able to cope with energy emergencies;
- energy access – enabling access to modern forms of energy to the world’s poor; and,
- climate change – minimising the impact of increased energy consumption on ecosystems and the climate.¹²

‘The problem’ can be readily identified. However ‘the solution’ – how to increase the coordination among these three arenas and increase the effectiveness of global energy governance – is not straightforward.

⁸ World Bank. *Energy overview*. World Bank, 26 September 2013: <http://www.worldbank.org/en/topic/energy/overview>.

⁹ Committee on Foreign Relations. *Nomination of Hillary R. Clinton to be secretary of state: hearing before the committee on foreign relations, United States Senate, one hundred eleventh congress, first session*. Washington, DC, U.S. Government Printing Office, 13 January 2009.

¹⁰ IPCC. Summary for policymakers. In *Climate change 2007: mitigation. Contribution of working group III to the fourth assessment report of the Intergovernmental Panel on Climate Change*, edited by Bert Metz et al. Cambridge, Cambridge University Press, 2007. pp 1-23.

¹¹ Navroz K. Dubash and Ann Florini. Mapping global energy governance. *Global Policy* 2 2011, pp 6-18.

¹² Aleh Cherp, Jessica Jewell and Andreas Goldthau. Governing global energy: systems, transitions, complexity. *Global Policy* 2 (1) 2011, pp 75-88.

How to reform global energy governance?

Some commentators are not convinced that a comprehensive international institution should or could be created with the capacity to address the problem – one that could tie together the various strands of global energy policy, promote better coordination, and articulate and track the implementation of a broad vision for global energy governance. British Prime Minister David Cameron, in his 2011 report to the G20 on global governance, argued:

There are a large number of established institutions and processes, especially those tackling challenges in cross-cutting areas such as energy, the environment and development: the essential challenge is to make these institutions work better together. The solution in many cases is not formally changing mandates or creating new bodies. Such changes can consume huge amounts of political energy. And in today's fast-changing world, challenges often evolve more quickly than institutions can be restructured to address them. Rather, existing institutions must be given clearer and stronger political direction to work together, analysing global problems and proposing actions in a more joined-up way to achieve common goals.¹³

As noted, there is little support for the creation of a 'World Energy Organisation'. Due to the conflicting interests and goals of many in the energy game, creating such an institution would be exceedingly difficult.¹⁴ Therefore, the best course of action may involve using the G20's political influence to establish a greater coordinating or linking role for an existing international institution.

The International Energy Agency: the only available option

The IEA is by far the most significant and powerful international energy body, and is probably the only body currently viewing the energy problem holistically. Initially dedicated to responding to physical disruptions in oil supply, it now has a broad agenda. Described as a body representing the interests of energy consuming nations (although its members include some major energy producers – Canada, the US, Australia and Norway, for example), it has six traditional functions:

- coordinating oil emergency preparedness and a collective response to supply interruptions – all IEA members are required to hold strategic stocks equivalent to 90 days worth of oil imports;
- reporting on short- and medium-term energy market outlooks;
- acting as an authoritative source for international energy data;
- coordinating energy policy through discussion, analysis and peer review;
- managing a network of over 40 technology collaboration networks; and
- reviewing international energy developments and publishing the authoritative World Energy Outlook.¹⁵

¹³ David Cameron. *Governance for growth: building consensus for the future*. London, Prime Minister's Office, November 2011, p 9.

¹⁴ Dries Lesage. *Global energy governance by the year 2020*. Paper presented at the Re-engineering of the global governance system seminar, Bellagio Conference Centre, Bellagio, 23-27 November 2009.

¹⁵ This list is based on Hirst and Froggatt, *The reform of global energy governance*, p 8.

The IEA's role and focus has broadened substantially over the years.¹⁶ In its 1993 'Shared Goals' agreement, the IEA committed to the three E's – energy security, economic development and environmental protection – and it now describes itself as having four main functions relating to:

- energy security – promoting diversity, efficiency and flexibility within all energy sectors;
- economic development – ensuring the stable supply of energy to IEA member countries and promoting free markets to foster economic growth and eliminate energy poverty;
- environmental awareness – enhancing international knowledge of options for tackling climate change; and
- engagement worldwide – working closely with non-member countries, especially major producers and consumers, to find solutions to shared energy and environmental concerns.

Despite its expertise and broad conception of the global energy system, there are hurdles to overcome if the IEA is to play a more central role in international energy policy and governance.

The Agreement on an International Energy Program – the IEA foundation treaty – explicitly restricts full membership to OECD states.¹⁷ It cannot, therefore, currently bring China and India on board unless they join the OECD. This is a problem, as these countries will provide the bulk of future energy demand; China is already the world's largest energy consumer. Allowing those outside the OECD to join the IEA would require treaty amendment, which would be difficult and likely take a long time.

Nevertheless, the IEA does have a significant international outreach program, which focuses on Russia, China and India. It has signed 'joint statements' with each country, which allows them to attend a limited number of meetings and take part in a range of collaborative projects. It is currently attempting to have Russia, China, India, Brazil, South Africa, Mexico and Indonesia join a formal association with IEA.¹⁸ However, efforts to better incorporate emerging markets have run into problems in the past.¹⁹

Moreover, even if IEA enlargement was likely, its role as a consumer-orientated organisation makes it difficult to see how it could effectively include major producers such as Russia and Saudi Arabia. The inclusion of major producers would radically change the nature of the organisation. And, as Henry Kissinger notes, one of the reasons the IEA has been so

¹⁶ For more information on the broadening of the IEA's agenda and work see: Thijs Van de Graaf and Dries Lesage. The International Energy Agency after 35 years: reform needs and institutional adaptability. *The Review of International Organizations* 4 (3) 2009, pp 293-317.

¹⁷ Chapter VII in IEA. *Agreement on an international energy program*. IEA, 25 September 2008: <http://www.iea.org/media/aboutus/history/agreementIEA.pdf>.

¹⁸ Ajay Maken. IEA toils over emerging market membership. *Financial Times*, 7 June 2013: <http://www.ft.com/intl/cms/s/0/ba2ddba4-cf48-11e2-be7b-00144feab7de.html?siteedition=intl#axzz2duwWiuX4>.

¹⁹ *Joint Statement by the Minister of Power, India and the International Energy Agency*, signed in Paris, 18 October 2011; *Joint Statement by the Minister of Energy of the Russian Federation and the International Energy Agency*, signed in Paris, 18-19 October 2011; and *Joint Statement by the National Energy Administration of the People's Republic of China and the International Energy Agency*, signed in Paris, 14 October 2009.

successful is because its members have shared goals and a ‘common vision’.²⁰ Naturally, any effort to holistically reform international energy governance, or to craft a broad policy vision for the future of the global energy system, would need to have major energy exporters centrally involved. Hence, the IEA has a problem.

Despite these significant obstacles, the desire or necessity for IEA reform that goes further than the ambitions described above is well recognised. The former US Secretary of State Hillary Clinton noted in 2009 that:

the IEA should be laying the groundwork now for eventual Chinese and Indian membership ... The IEA was created as an institution that represents the interest of the major energy consuming nations. If its membership does not change to reflect who those nations are today, its authority and effectiveness will erode.²¹

According to Clinton, the inclusion of China and India would enable increased consumer-nation policy coordination, further the opportunity for agreement on transparency in energy markets, enhance the market-stabilising effectiveness of emergency oil stocks (as China and India would be required to hold them), and maintain the centrality of the IEA in the international energy system. Kissinger similarly argues that ‘the IEA must evolve to incorporate those countries that will drive the future of global energy.’²² China and India’s full participation in the IEA would increase that organisation’s share of world energy consumption to about 63 per cent (from its current total of 45 per cent).²³

Another organisation that could possibly act as a leading knowledge centre, as well as support any G20 involvement in energy policy, would be the International Energy Forum (IEF). France and Venezuela jointly formed the IEF in the 1990s, with the intended purpose of fostering dialogue between energy producers and consumers.²⁴ Saudi Arabia financed the establishment of a secretariat in Riyadh in 2003, and the IEF now has 89 members.

Its major success was the establishment or coordination of the Joint Oil Data Initiative (JODI). JODI was set up in 2005 to ‘build the timely, comprehensive, and sustainable energy data provision architecture which is a prerequisite for stable energy commodity markets.’²⁵ The JODI oil database features information on monthly oil production, consumption, stocks and trade from about 90 countries. The G20 has commended JODI and ‘welcomed’ IEF efforts at consumer-producer dialogue on a number of occasions.²⁶ The success of the JODI oil database has led to a separate database being developed to cover natural gas (‘JODI Gas’).²⁷

²⁰ Kissinger, *Speech by Henry Kissinger at the IEA ministerial*.

²¹ Committee on Foreign Relations, *Nomination of Hillary R. Clinton to be secretary of state: hearing before the committee on foreign relations, United States Senate, one hundred eleventh congress, first session*.

²² Kissinger, *Speech by Henry Kissinger at the IEA ministerial*.

²³ Anup Rao and Andrew Ludwig, Does the IEA have the energy to compete in the future? *International Affairs Review*, 29 July 2013: <http://www.iar-gwu.org/node/485>.

²⁴ IEF, *International Energy Forum charter*. 22 February 2011:

http://www.ief.org/_resources/files/content/about-ief/ief-charter.pdf.

²⁵ JODI, *About JODI*. JODI, 2013: <http://www.jodidata.org/about-jodi.aspx>.

²⁶ G20, *The G20 Seoul summit leaders' declaration*. 2010. Also see: G20, *Cannes summit final declaration - building our common future: renewed collective action for the benefit of all*. 2011: <http://www.g20.utoronto.ca/2011/2011-cannes-communication-111104-en.html>.

²⁷ For more on the JODI Gas initiative see JODI, *Update on JODI-Gas*. JODI, 5 June 2013: <http://www.jodigas.org/update-on-jodi-gas-05-june-2013-web.pdf>.

The IEF is, however, a relatively new organisation with a small secretariat, and would need to quickly expand if it was to play the coordinating role that is required to increase linkages between the various multilateral energy institutions. However, this should not preclude the IEF from playing a crucial part in discussions relating to the future of energy. Clearly, as the leading forum for consumer-producer dialogue, the IEF will play a central role in the future of energy governance.

What role can the G20 play?

The G20 includes the largest IEA energy consuming economies: the United States, the major EU countries and Japan. While the global share of energy use and imports of these countries is in decline, they are, nevertheless, at the forefront of producing renewable energy technology. As indicated earlier, the United States is also undergoing a revolution in energy production, and is predicted to again become a net exporter of energy in coming years, decreasing its dependence on foreign sources of energy.

Saudi Arabia, the world's largest oil exporter and a key OPEC member, is also in the G20. Saudi Arabia's membership means that any initiative in reforming energy global governance must account for the views of OPEC members. For example, any G20 proposal to expand the role of the IEA, particularly in terms of global energy governance, would need Saudi Arabia's support. Likewise, Russia, a G20 member and one of the largest energy producers and exporters outside OPEC, and a key natural gas supplier to Europe, will be a key player in any moves to reform energy governance.

China and India, the two emerging giants of energy consumption and importation, will account for a large chunk of the growth in energy demand in the coming decades, and for a large chunk of carbon emissions as well. Any G20 initiative that aims to ensure a sustainable energy future must involve India and China. Finally, the G20 economies collectively account for the vast majority of global energy consumption and greenhouse gas emissions, with a responsibility for slightly less than 80 per cent of both.²⁸

Finding a way forward through the G20

The diverse membership of the G20 can be seen as having both positive and negative implications for the effort to reform global energy governance. On the negative side, because the forum contains the largest energy producers and consumers, with a significant gap in policy outlook between the two, attempts to drive global energy governance reform within the G20 will be difficult. But this diversity also highlights the G20's potential strength, as its composition provides the opportunity to bridge the divide in a way that other forums cannot. Moreover, the G20's inherent strength as a leader level forum is that it has the potential political power to drive reform.

The G20 has undertaken to implement a significant number of energy-related commitments. The 2009 Pittsburgh summit launched initiatives covering the phasing out of fossil fuel subsidies and the promotion of energy market transparency to combat price volatility, and drew a link between energy efficiency, encouraging renewable energy technologies and

²⁸ Thijs Van de Graaf and Kirsten Westphal. The G8 and G20 as Global Steering Committees for Energy: opportunities and constraints. *Global Policy* 2 2011, pp 19-30; Dubash and Florini, *Mapping Global Energy Governance*, p 21.

combating climate change.²⁹ Work has continued in all these areas. In 2013, Russia established a G20 Energy Sustainability Working Group.³⁰ The group's focus is on building up transparency in energy markets, energy efficiency and green growth, and protection of the marine environment.

As this paper has outlined, the next initiative for the G20 could be to use its political muscle to push for greater linkages between energy-related international institutions, initiate IEA reform and to articulate a broad policy vision for international energy governance.

In 2009, the idea was raised of establishing a G20 Task Force on Energy, which could provide the political leadership and strategic thinking for the future of global energy governance.³¹ The proposal was for the G20 to create a permanent high-level body to review the global energy challenge and draw together the work of the various concerned institutions – the UNFCCC, IEA, World Bank, IAEA, Energy Charter Secretariat, WTO, OPEC, International Energy Forum, the IPCC and others. However, this proposal involves the establishment of a small G20 secretariat that would likely be located within the IEA in Paris. Many G20 members have resisted the idea of establishing any form of permanent secretariat for the forum, arguing that such a move would undermine the G20's fundamental strength as a political forum that directly involves political capitals, particularly their leaders.

The G20 should use its 'political power' to provide a strong impulse for change in global energy governance. It is the only body that can overcome the many problems associated with the current complex arrangements governing the international energy system. But it will be difficult. Either way, a start has to be made, and the G20 should place a review of global energy governance onto its work program for 2014.

²⁹ G20. *Leader's statement: the Pittsburgh summit*.

³⁰ Russian Presidency of the G20. *The Russian presidency of the G20: outline*. December 2012: http://www.g20.org/docs/g20_russia/outline.

³¹ Lesage, *Global energy governance by the year 2020*.

Contributor biographies

Philip Anderson

Philip Anderson is an independent consultant on transfer pricing and taxation policy, based in Sydney and Paris. He was, until recently, a senior partner with Ernst & Young and in charge of their transfer pricing practice for Asia Pacific. He has practiced mainly in Australia and China but has also advised multinational corporations on transfer pricing in most of the major economies. He was formerly involved in public policy and taxation policy while with the Australian Treasury in Canberra and with the OECD in Paris. He holds a Master of Economics from the Australian National University.

Mike Callaghan AM, PSM

Mike Callaghan is the Director of the G20 Studies Centre at the Lowy Institute and Editor of the G20 Monitor. Prior to taking up this position, Mike was Executive Director, International, in the Australian Treasury and Australia's G20 Finance Deputy. He was also the Prime Minister's Special Envoy on the International Economy. From 2005 to 2007, Mike was Executive Director, Revenue Group in the Australian Treasury. In 2006 he was appointed by the IMF Managing Director and the President of the World Bank to an eminent persons group to report on improving cooperation between the World Bank and the IMF. From 2000 to 2004 Mike was Executive Director at the International Monetary Fund, Washington, DC. Mike has served as Chief of Staff to the Australian Treasurer, the Hon. Peter Costello. He has economic and law degrees from the Australian National University and is a graduate of the Royal College of Defence Studies, London.

Stephen Grenville AO

Dr Grenville is a Visiting Fellow at the Lowy Institute for International Policy and works as a consultant on financial sector issues in East Asia. Between 1982 and 2001 he worked at the Reserve Bank of Australia, for the last five years as Deputy Governor and Board member. Before that, Dr Grenville was with the Organisation for Economic Co-operation and Development in Paris, the International Monetary Fund in Jakarta, the Australian National University and the Department of Foreign Affairs.

Marty Harris

Marty Harris is a Research Associate at the Lowy Institute. He works to the Strategic Communications Manager, the Director of the G20 Studies Centre, and the Blog Editor. Prior to joining the Institute, Marty worked as a researcher in the Foreign Affairs, Defence and Security section of the Commonwealth Parliamentary Library. He holds a Bachelor of International Relations (first class honours) from La Trobe University and a Master of Arts (first class honours; Middle East and Central Asian Studies) from ANU.

Hugh Jorgensen

Hugh Jorgensen is a Research Associate with the G20 Studies Centre at the Lowy Institute, where his work focuses on economic, political and governance aspects of the G20 agenda. He holds a double degree in Economics and Arts (Political Science/International Relations) from the University of Queensland and was awarded first class honours for his thesis on 'the institutional evolution of the G20 post the global financial crisis.' Hugh has previously worked as a researcher for an ARC-funded comparative banking project (looking at the pre- and post-crisis experience of banks in Australia, Canada, the United States and the United Kingdom), as a project spokesperson for the United Nations Department of Public Information and as a tutor of globalisation and international political economy.

Daniela Strube

Daniela Strube is a Research Fellow with the G20 Studies Centre at the Lowy Institute. Her work focuses on contributing to distinctive perspectives and critical analysis on the role of the G20 in global economic governance, in particular against the background of the Australian G20 presidency in 2014. She completed her PhD in Economics researching how macroeconomic models and analysis can better reflect local economic development conditions. A large part of her research has been conducted as a visiting researcher at the London School of Economics and the Australian National University. She also holds a Master's degree in Economics from the College of Europe, Belgium, and a Bachelor's degree in Economics from the University of Maastricht, Netherlands. Her graduate and doctoral studies were sponsored by several awards and scholarships from leading European funding organisations. Daniela has previously worked for the European Commission and the German federal government on issues relating to telecommunications regulation, research policy as well as development cooperation and economic development policy.

Maria Monica Wihardja

Dr Monica Wihardja, is a researcher at the Centre for Strategic and International Studies and teaches at the University of Indonesia. She is also an associate editor, Indonesia desk, for the East Asia Forum, an on-line forum based at the Australian National University. Her research interests are institutions, decentralization and development, as well as regional and global architecture. She has been a consultant for Bank Indonesia (2012) and the World Bank (2013), and is actively engaged with the Indonesian government on the G20 and APEC issues. She has represented Indonesia at the Think 20 meetings in Mexico City and Moscow. She has published at the Journal of East Asian Studies, Journal of Economic Development, Bulletin of Indonesian Economic Studies, Economics and Finance in Indonesia, and regularly writes in newspapers and on-line forum. She received her B.A. from Brown University, Master of Philosophy from Cambridge University, and PhD from Cornell University.

LOWY INSTITUTE

FOR INTERNATIONAL POLICY

WWW.LOWYINSTITUTE.ORG