

FINANCING THE MILLENNIUM DEVELOPMENT GOALS: A NOTE ON TWO INNOVATIVE MECHANISMS

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ABSTRACT

In 2000, the international community agreed on a set of poverty-reduction and human-development targets—the Millennium Development Goals (MDGs)—to be achieved by 2015. Official Development Assistance (ODA) is a source of funds for the developing world; however, the amount is not sufficient to cover the yearly \$50 billion needed to meet the goals. To complement ODA, innovative financing mechanisms have been explored. Among others, the idea of a Tobin tax is again being debated. Another mechanism that has been tested since 1 July 2006 is the air-ticket tax. This paper summarises the current trends in ODA and describes how these mechanisms work.

Key words: ODA, Tobin tax, Millennium Development Goals (MDGs), innovative financing mechanisms, air-plane ticket tax.

INTRODUCTION

Many developing countries have made considerable progress towards eliminating poverty through strong economic growth over the past decade. Unfortunately, for the least developed countries, this has not been so. Aware of this, the international community had, in the year 2000, agreed on a set of goals for poverty reduction and human development for these countries. These Millennium Development Goals (MDGs) were unanimously adopted by the United Nations 2000 General Assembly and were to be achieved by 2015. Some of the targets of the MDGs are: to halve extreme poverty (defined as \$1 per person per day) and hunger, to provide universal access to primary education, to promote gender equality and empowerment of women, to improve health (by reducing child and maternal mortality), to combat major infectious diseases (especially HIV/AIDS and malaria), to improve environmental sustainability (by providing sanitation and safe drinking water), and to build up a global partnership for development.

The international community soon realised that, based on the current trends of official development assistance (ODA), there is a strong possibility that the MDGs will not be achieved by 2015, particularly in Africa. The underlying trends indicate that although developed economies have continued to enhance their aid efforts through commitments to further increase ODA, the ODA is expected to decline as a percentage of Gross National Income (GNI) of donor nations. In such circumstances, the financial gap between the ODA and the total amount needed to finance the MDGs will, in the long run, remain.

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As the attainment of the MDGs is targeted for 2015 and the trend of ODA committed by the developed countries is not expected to change substantially in the near future, other financing mechanisms for development need to be devised. These should not be considered as a substitute for ODA, but rather as an additional source of funds for development. Innovative mechanisms for financing development of the poorest countries have been suggested, especially in terms of global taxation. This article focuses on possible new complementary sources of financing, in particular the revised idea of an international currency transaction tax—the Tobin tax. Among other possible innovative sources of financing, an air-ticket tax is being tested since 1 July 2006.

WHAT IS HAPPENING WITH ODA?

Following the adoption of the MDGs in September 2000 by the international community, implementation of pledges by donor countries has been erratic and slow, with only one-third of bilateral ODA being channelled to programmes and project expenditures for the poor countries. The United Nations and the World Bank estimate that an increase in ODA of at least \$50 billion by 2010 is needed. Based on current trends, it is unlikely that the agreed goals and target dates will be met. It was estimated that additional funding through increase of ODA (excluding debt relief) to 0.46% of GNI of donor countries by 2010 will be required (World Bank, 2006).

Some countries have shown greater commitment than others to achieve the target. According to the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD), net ODA contributed by DAC member countries increased by a record \$27 billion in 2005, reaching \$106.5 billion. This represented an increase to 0.33% of GNI from a low of 0.22% in 2001. However, much of this increase was due to debt-relief grants, which totalled \$23 billion in 2005, up from a mere \$4 billion in 2004. This included nearly \$14 billion in debt relief provided to Iraq and a little over \$5 billion to Nigeria by their Paris Club creditors. Such debt-relief and other special-purpose grants accounted for 75% of the bilateral portion of ODA in 2005, well above the 53% average of the 1990s. Excluding debt relief, ODA increased by a modest 8.7% in real terms, up from the average annual rate of 5.6% in 2002–04 (World Bank, 2006). Some of the growth registered over the past years, especially in 2003, was also due to the dollar's decline against the euro, the yen and the UK pound, the currencies in which payments by non-US donors are denominated.

Although the total commitment to ODA appears to be increasing, the amount of increase is not consistent with the intended target in 2015. Some countries, such as those within the European Union (EU), have decided to go for higher commitments as they have agreed to increase their ODA contribution from 0.35% of GNI in 2004 to 0.7% of GNI by the 2015 target date. Other countries have not shown similar commitments. The United States has, in fact, announced (at the G-8 2006 Summit) that it will reduce its ODA from \$27.5 billion in 2005 to \$24 billion from 2006 to 2010 (in real terms). Its share of total ODA will therefore decline from 25.8% in 2005 to 18.7% in 2010 while the respective share of the EU will increase from 53.9% to 63.4% (Table 1).

Table 1. Percentage Share of Donors' ODA in 2005 and Projected 2010

Country	2005	2005 excluding debt relief	2010
United States	25.8	28.0*	18.7
Japan	12.3	11.4	9.3
United Kingdom	10.1	8.5	11.4
France	9.4	8.2	11.0
Germany	9.3	7.6	12.1
Netherlands	4.8	5.7	4.0
Italy	4.7	4.0	7.2
<i>Total</i>	<i>76.5</i>	<i>73.4</i>	<i>73.7</i>
<i>EU Members as a group</i>	<i>53.9</i>	<i>49.2</i>	<i>63.4</i>

*The higher share is explained by the fact that countries other than the US contributed more to debt relief in 2005 (\$19 billion and \$4 billion, respectively), causing the US's share of the total to fall. Consequently, once the debt-relief figure is removed from the total, the share of the US appreciates compared to that of the other countries.

Source: Projections by the OECD DAC Secretariat.

One of the main reasons why developed donor countries are not meeting their target commitments to ODA is the lack of a stable source of funding to draw from. Recipient countries must have a regular source of funding that can enable them to cover their recurring developmental costs. Interruption in aid flows will strongly reduce the aid's effectiveness. The traditional sources of funding for the ODA are not only inadequate but are also highly unpredictable, with damaging consequences for the recipient countries (see, for example, Ranis, 2006).

On average, ODA volatility is four times higher than the GDP growth of the developing countries (Bulir and Hamann, 2001). This is due to budgetary procedures in donor countries, changes in priorities, and policy-making or implementation delays. As long as aid is conditional and mainly left to the donors' discretion, the volatility of aid flows may be unavoidable. Other forms of aid, even when framed within annual or multi-year programmes, remain subject to the uncertainties of the donors' own goals and priorities, which may change frequently with changing economic conditions. Other sources of volatility include shifting coordination among donors and their dialogue with recipients, which can often lead to unstable contributions to the ODA.

EXPLORING INNOVATIVE FINANCING MECHANISMS

As additional resources will not be spontaneously made available, new mechanisms must be geared towards supplying stable, predictable and substantial developmental assistance to developing countries. The challenge is to ensure that while engaging the international community on new financing initiatives, these must not indirectly decrease the level of ODA funding in the end. In the current foreign assistance environment, some ideas are attracting renewed worldwide attention. A case in point is the taxation of financial transactions or the Tobin tax, which is being reviewed as an important tax instrument to generate revenue for global development.

The Tobin Tax Revisited

In 1972, in the face of growing financial globalization, Professor James Tobin, a Nobel laureate at Yale University, anticipated the dangers of open currency markets and suggested a small tax on currency trading. The idea was formally proposed during his presidential address to the Eastern Economic Association in 1977 (Tobin, 1978). This, he said, was to “throw sand in the wheels” of the currency market so as to slow down speculation, promote long-term investment, and give governments greater autonomy in their monetary policy.¹ The currency transaction tax was initially proposed to be applied on a universal basis to spot transactions. The level of taxation was proposed to be low (around 0.01%) in order to minimise its effects on the market and the risk of evasion, as well as to maintain a broad taxable base.

Since Tobin’s initial proposal, taxation of financial transactions has been one of the most debated mechanisms over the past two decades (Tourres, 2002). On every business day, traders at banks around the world exchange more than US\$1 trillion in currencies. Less than 5% of these transactions are necessary to cover spot international trade, travel and long-term investments. The large remaining balance represents speculative and destabilizing activities such as speculative arbitrage, “noise trading” and high-volume speculation on major currency price changes.

Foreign exchange trading totalled an average daily turnover of \$1,880 billion in April 2004 from \$1,200 billion in April 2001 (Bank for International Settlements, 2005). This large increase in activity in traditional foreign exchange markets represents a 57% increase at current exchange rates and a 36% rise when volumes are measured at constant exchange rates. In addition to valuation effects, factors that have boosted turnover include investors’ interest in foreign exchange as an alternative to equity and fixed-income assets, the more active role of asset managers, and the growing importance of hedge funds. This trend is unlikely to reverse soon as the above factors are stronger than those that tend to contribute to a decline in currency trading activity. The latter factors include consolidation in the banking sector, the growth of electronic brokering, and international concentration in the corporate sector—all of which continue to have an impact today (Galati and Melvin, 2004).

Given the foregoing context, the renewed attention to a financial transaction tax will not come as a surprise although the nature of the debate is still very animated. For its supporters, a tax on foreign exchange/currency transactions is technically feasible. It can be levied either on the trading of the transaction or on settlement. In either case, the transactions would have to be declared. It has been argued that tax authorities can find it difficult to collect such tax, especially because traders can evade the tax via the creation of non-taxable instruments such as special derivatives, and by using tax-free havens such as offshore centres to shelter their trades. But Spahn (1995, 2002) and other tax proponents have made convincing proposals that would block these and other avoidance schemes, by, for example, taxing interbank or wholesale transactions at the point of settlement and imposing a penalty on transactions within jurisdictions that do not impose the tax.

¹These objectives are not under discussion here. The tax is examined only from the viewpoint of raising funds for development, without affecting market efficiency.

Revenue Potential

The surge of interest in a currency transaction tax (CTT) scheme is not surprising given its potential to generate substantial tax revenue, and to more than offset the decline in ODA from OECD countries (the double-dividend argument). A number of recent studies have tried to assess the potential revenue that can be raised. Felix and Sau (1996) estimated potential global revenues from the CTT in 1995 to be between \$302 billion and \$393 billion based on a 0.25% tax, from \$148 billion to \$180 billion from a 0.1% tax, and from \$90 billion to \$97 billion from a 0.05% tax. Using Felix and Sau's estimates for the annual revenue in 1995 from a 0.05% tax on 1995 foreign currency exchange volumes, the total revenue obtained in various countries would have been \$97.1 billion (Table 2).

Table 2. Potential Revenue Generated from Different Countries Based on Felix and Sau (1996) Estimate of 1995 CTT of 0.05%

Country	US\$ (Billion)
A. INDUSTRIALISED COUNTRIES	
United Kingdom	28.7
United States	15.1
Japan	9.9
Switzerland	5.3
Germany	4.5
France	3.6
Australia	2.4
Denmark	1.8
Canada	1.7
Netherlands	1.4
Sweden	1.2
Other OECD Countries	8.1
B. DEVELOPING COUNTRIES	
Singapore	6.4
Hong Kong	5.5
South Africa	0.3
Bahrain	0.1
Other Developing Countries	1.1
TOTAL	97.1

Source: Felix and Sau (1996).

According to a more recent study by Paul and Wahlberg (2002), taxes on currency transactions could raise large revenues even if transaction volumes were lowered by as much as 50%. They estimated revenue based on various assumptions such as different tax rates, different impacts on trading levels, and the number of transactions that would escape taxation through the use of new financial instruments or tax havens. A tax of 0.2%, with a hypothetical 50% reduction in transactions from the current level of about \$300 trillion a

year, would result in an annual revenue of about \$300 billion. A tax of just 0.05%, with a 50% tax-induced reduction of transactions and non-participation by the United States and other major trading centres (a further 50% reduction), would still yield a hefty \$38 billion.

Different revenue figures have been projected in other studies using different assumptions. Using a 0.05% tax rate, Kenen (1996) estimated a tax revenue of 90–97 billion dollars. Spahn (2002) estimated that a 0.1% tax levied throughout the EU (including the UK) and Switzerland can yield 17–20 billion euros or about US\$16 billion. A UN study (United Nations General Assembly, 2001) estimated that a universal tax at the 0.1% rate would yield \$132 billion.

Nissanke (2004) reviewed the estimates of potential revenues which can be derived from a CTT, and highlighted a few interesting results. Given the substantial changes taking place in market structures in the wholesale interbank segments as a result of new technological developments, she concluded that it is unwise to impose the higher tax rates suggested by Felix and Sau (1996). High tax rates of 0.1% to 1% can trigger significant disturbances to market liquidity in the wholesale segments, and it may be prudent to adopt a phase-in approach whereby markets would have time to respond gradually, and in a stable manner, to the introduction of a CTT. At the same time, Nissanke agreed that, based on calculations by Frankel (1996) and by Spahn (2002), lower tax rates could still provide sufficient disincentives to traders not to over-engage in noise trading.

Using the assumption that tax rates of 0.02% and 0.01% would reduce the volume of wholesale transactions (excluding transactions with non-financial customers) by 15% and 5%, respectively, Nissanke's own calculation of potential revenue from CTTs suggested that a CTT at 2 basis points applied to wholesale transactions would generate an annual revenue of US\$30–35 billion, while a CTT at 1 basis point would yield US\$17–19 billion.

However, Nissanke cautioned that, due to recent structural changes in foreign exchange markets and taking into consideration market efficiency, liquidity, and current technical feasibility, all previous revenue estimates should be revised downward. Consequently, although CTTs have the potential of generating between 15 and 28 billion dollars for global public use, such a tax on its own would not be sufficient as a complementary financing mechanism for development if all countries kept for their own national use 20 and 70 per cent, respectively, of the CTT collected.

A Combined Solution

The revenue estimates from these studies are too wide and uncertain to meet the estimated need to increase the ODA by \$50 billion by 2010. However, the Tobin tax has merits and, as such, should not be abandoned as a complementary source of funding. A multi-tier system and/or a combination with capital controls or security tax may also be worth considering as a more successful solution. On this issue, Spahn (1996, 2002) contributed an important new element by suggesting that the tax should include a second, much-higher rate that would come into force whenever major speculation arises and price movements exceed a pre-established limit.

The minimal-rate transaction tax would function on a continuing basis and raise revenues without necessarily impairing the normal liquidity function of world financial markets. It would also serve as a monitoring and controlling device for the exchange

surcharge, which would be administered jointly with the transaction tax. The exchange surcharge would function as an automatic circuit-breaker whenever speculative attacks against currencies occurred. As stipulated by Spahn, the two-tier tax or other dual taxation schemes would favour long-term investments and loans, and discourage short-term activities and sudden, destabilizing price changes.

If such a dual taxation scheme is successfully administered on its own or in conjunction with other measures such as capital controls or security transaction tax, the potential benefits in double dividends from these measures would ensure substantial support and political feasibility for its implementation. Also, the coordinated approach would have the potential to curtail leakages from these policies, such as asset substitution, market migration, or tax evasion.

Although many powerful forces are still opposed to taxing currency transactions, the movement is gaining ground as a tax instrument for global finance and as a means to raise developmental funds. Many who formerly opposed it unconditionally, like the IMF and the Bank for International Settlements, have now admitted that it may have some merits. This movement for a CTT is aided by a renewed sense of urgency to attain the targets of the MDGs by the year 2015.

THE AIR-TICKET TAX: AN ALTERNATIVE TO GLOBAL TAX

In view of the substantial financial gap to be filled, some countries have taken the lead to move one step further. With the support of the UN Secretary General, countries like Brazil, Chile, France, Spain, Germany and Algeria have subscribed to the 2004 Geneva Declaration which led to the establishment of a Technical Group with the mandate to explore new and innovative financing mechanisms to meet the targets of the MDGs (Technical Group, 2004).

The principle of innovative sources of financing for development of poor countries is now receiving support from a large part of the international community. On 14 September 2005, during the Summit on Achievement of the Millennium Development Goals in New York, another ambitious declaration on innovative sources of financing and international solidarity contributions, co-sponsored by the members of the Group of Six, was supported by 79 countries. The signatories include several European countries (Germany, UK, Spain, Estonia, Austria, Sweden, Luxembourg) and major emerging countries (Brazil, India). Developing countries have shown high expectations for this initiative: 28 of the 47 African countries supported the declaration and it was favourably received by five others.

Aside from the tax on international transactions, several other proposals for innovative financing mechanisms for development are under various stages of study. Some of the more important tax proposals are based on creating disincentives and thus, are referred to as “Pigovian” tax (environmental tax, international transaction tax).² While most of these new innovative financing mechanisms are still being debated, the air-ticket tax idea has been implemented since 1 July 2006.

²The desired effect of this tax is to bring private costs in line with the social cost, thus internalising the externality. The tax forces the players to take account of the whole social cost when making their decisions. As such, it does not create distortion but instead restores the efficiency of the market mechanism.

The First International Solidarity Levy: The Air-Ticket Tax

Some general and specific taxes on certain modes of transportation (such as road and rail) are designed to reduce fuel consumption and, at least in part, to internalise their negative effects on the environment. Their emissions are also included in the Kyoto emissions quotas. The aviation and shipping sectors, however, are exempted from the Kyoto Agreement, the argument being that their international character goes beyond the reach of national sovereignty. This does not mean, however, that it is technically impossible to envisage some form of taxation.

Air transport is one of the industries that has benefited most from globalization, making it legitimate for the sector to contribute to efforts to assist poorer countries left behind by globalization. Indeed, air transport has experienced a long period of rapid expansion. Global traffic has grown by 8% annually since 1960 in value terms, and its volume is forecast to grow by 5% between now and 2015 (Landau, 2004). The growth in intercontinental flights is especially pronounced and in recent years this growth has been primarily in the first- and business-class passenger segments, which on average represent two-thirds of airline revenues. Air transportation is also a source of significant environmental damage, which has a high social cost—estimated at 32 billion euros a year for the EU alone. This damage includes local pollution in the form of air and noise pollution near airports, and global pollution from the emission of carbon dioxide, a greenhouse gas.

Several countries have introduced low taxes that partially compensate for local pollution. However, where global pollution is concerned, air transport falls outside the Kyoto protocol. To balance this shortcoming, there are three possible ways to tax aviation-related pollution: first, a tax on kerosene consumed; second, taxing the use of air corridors; and, third, direct taxation of tickets. According to the Landau report (2004), a worldwide tax of the first two categories are estimated to yield around \$10 billion. As a rough guide, these taxes would add nearly 20% to the cost of kerosene, and the average price of a ticket would rise by approximately 2.5%. In the third category, a 5% tax on first- and business-class tickets would yield approximately \$8 billion.

A group of pioneering countries have implemented the air-ticket tax, also called the air-ticket solidarity contribution. They were led by Germany and France who started applying this air-ticket contribution on 1 July 2006 in the form of an increased civil-aviation tax for airline passengers. The French law, which was approved by the French Parliament on 22 December 2005, sets out the rate caps for all flights departing from French territory.³ Rate caps are differentiated according to the flight destination and travel class, and the actual rates were finalised by a 2006 decree. For domestic flights or intra-European flights (EU including Iceland, Liechtenstein and Norway), the capped rate is 1 euro per passenger in economy class and 10 euros in first and business classes. On non-domestic or outbound EU flights, rates will be four times higher. These capped rates are expected to generate revenues of up to 200 million euros per year.

The supporters of this tax highlight three key points, namely, that it is easy to implement, flexible and fair, and has limited economic impact. The mechanism is easy to implement by raising existing airport taxes and charges. Collection costs are minimal and

³This law exempts passengers on connecting flights, e.g., all those with less than 12 hours between the scheduled arrival time at a French airport and the scheduled departure time from the same airport.

national tax sovereignty is not affected. Internationally, differentiation between rates makes it possible to consider the specific characteristics of all countries implementing this contribution, especially their level of development. One other advantage is that it can be implemented without waiting for global participation by all countries.

The air-ticket tax is progressive since higher rates are applied to passengers travelling in first or business class. At an international level, the tax will be implemented by countries of both North and South. However, rates can be differentiated according to the level of development of the participating countries. Chile will levy a contribution of 4 euros on international flights only, half of which will be allocated to the promotion of tourism and half to development. Countries with larger surface area will not be penalised since different rates can be applied to domestic and international flights, as in Chile.

The air-ticket contribution will not trigger any distortion in competition between airline companies because it is based on territorial aspects rather than nationality. All airline companies, regardless of nationality, will have to levy the solidarity contribution when one of their airplanes departs from an airport located in a participating country. Even with a limited number of participating countries, the air-ticket contribution does not result in any rerouting of traffic. Exemption of passengers on connecting flights ensures that airports located in participating countries will not be penalised. Also, countries generating large revenues from tourism will not be penalised: the air-ticket contribution is very low compared to the average total cost of a holiday.

Following the French proposition, the participating countries have decided that part of the revenue generated from the air-ticket contribution can be channelled to help achieve the MDGs by 2015, especially its goal of fighting pandemics in developing countries via an International Drug Purchasing Facility (IDPF).⁴ One objective could be to facilitate access to HIV/AIDS treatment by assuring the long-term production of anti-retroviral drugs, which are presently available to only about 1 million of the 6.5 million people who need them immediately.

The support for an air-ticket tax is growing very fast. At the Brasilia conference held on 6 and 7 July 2006, only five months after the Paris conference in which 13 countries set the tone for this tax, six additional nations have joined the movement (Table 3).

Table 3. Countries Implementing the Air-ticket Tax

Pioneer countries		New countries
France	Jordan	Cambodia
Chile	Luxembourg	Guinea
Brazil	Madagascar	Gabon
United Kingdom	Mauritius	Guatemala
Congo	Nicaragua	Mali
Ivory Coast	Norway	South Korea
Cyprus		

⁴The IDPF was officially established at the UN General Assembly in New York on 19 September 2006.

Although the future of the tax seems promising as one of the complementary financing mechanisms for the MDGs, the lack of political will by other major industrial economies to implement the air-ticket tax will lead at this point only to modest additional revenues for the achievement of the MDGs. Further, although the decision to channel the tax revenue into an IDPF is firmly set, the Brasilia conference in July 2006 showed that the scope of the facility and its governance structures remain undefined (Schroeder, 2006).

CONCLUSION

The purpose of this article is to describe two innovative financing mechanisms to reduce the gap between the amounts required and available to meet the MDGs. The Tobin tax has been considered for its revenue potential and no longer solely as a currency transaction tax to combat financial volatility. Attention has also been paid to the air-ticket tax which is a totally new financing mechanism for development. The Tobin tax has not yet been implemented, whereas the air-ticket tax has. A comparison of these two ways of funding the MDGs permits one to draw a few conclusions.

First, the political economy surrounding the chosen innovative financing mechanism plays an important role. As such, the degree to which the taxpayers accept the objective for which the taxes are raised influence their ultimate acceptance. The Tobin tax remains associated with currency volatility and consequently with curbing speculation. It has a better chance to gain momentum if it is made to raise revenue for development, as suggested here.

Second, a Tobin tax can make a major revenue contribution at a much lower rate when it is earmarked for development than when it is implemented to stabilise exchange rates. This lower rate for development can ease acceptance of this financial instrument. However, even if a solution such as the two-tier rate structure is adopted, the tax rates remain to be agreed internationally. The progressive nature of the air-ticket contribution makes its acceptance easier. Internationally, differentiation between rates makes it possible to consider the specific characteristics of all countries implementing this financing mechanism, especially their level of development. At the same time, national tax sovereignty is not affected with each state adopting the tax in accordance with its own laws and constitutional requirements.

Third, it remains difficult to evaluate the final distribution effects of a Tobin tax on real transactions whereas the air-ticket tax will have a limited economic impact on air transport, which is structurally very dynamic. The latter will not affect competition between air carriers or between the major airports.

Fourth, whereas the implementation of a Tobin tax can be affected by specific national or regional capital-flow regulations and laws, the international air-ticket contribution does not raise legal problems. None of the international aviation convention, bilateral agreements and treaties prohibits the creation of such a levy on either international or domestic flights.

Last, the Tobin tax involves an administration at a global level which requires a worldwide agreement. The air-ticket tax offers an alternative to global taxation as it can be implemented without waiting for universal participation by all countries. This point is the main reason why the air-ticket tax has become a reality as an innovative financing mechanism but the Tobin tax has not.

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