



Report

Why do Development Finance Institutions use offshore financial centres?

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Acronyms

AfDB	African Development Bank
AML	anti-money laundering
BEPS	OECD Base Erosion and Profit Shifting Project
BIO	Belgian Investment Company for Developing Countries
CDC	UK development finance institution (formerly Commonwealth Development Corporation)
CFC	controlled foreign corporation
CRS	common reporting standards
DEG	Deutsche Investitions- und Entwicklungsgesellschaft
DFI	Development Finance Institution
EAC DTA	East African Community Double Taxation Agreement
EMPEA	Emerging Markets Private Equity Association
ESG	Environmental, Social and Governance standards
ETB	Ethiopian birr
EU	European Union
FDI	foreign direct investment
IADB	Inter-American Development Bank
IFC	International Finance Corporation
IFU	Investeringsfonden for Udviklingslande
IMF	International Monetary Fund
KYC	'know your customer'
LDC	least developed country
MLI	Multilateral Instrument
NGO	non-governmental organisation
OECD	Organisation for Economic Co-operation and Development
OFC	offshore financial centre
PEP	politically exposed person
PIDG	Private Infrastructure Development Group
SDG	Sustainable Development Goal
SIFEM	Swiss Investment Fund for Emerging Markets
SMEs	small and medium-sized enterprises
UN	United Nations
WHT	withholding tax

Executive summary

Development Finance Institutions (DFIs) invest public money in private enterprises, with the aim of accelerating the economic development of low- and middle-income countries. One of the greatest threats to development is popularly perceived to be the network of tax havens that drain billions from developing countries, in part by allowing cross-border investors to avoid taxes. And yet these public institutions that exist to promote development regularly route their investments through tax havens. Why?

The short answer is the one that DFIs have always given: they use intermediary jurisdictions not to avoid tax, but to make up for shortcomings in the legal systems of the poorest and most capital-scarce countries that would otherwise dissuade private investors from entering these markets.

The longer answer involves examining: what these legal shortcomings are; what taxes should be paid and where; how tax havens or offshore financial centres (OFCs) can be used to reduce them; and the economics and politics of taxing capital. However, the most compelling argument concerns what would happen if DFIs stopped using OFCs. DFIs acknowledge that the use of OFCs does sometimes leave developing countries less able to tax the income of foreign investors but the alternative would be to use an onshore OECD financial centre, which would be no more favourable for developing countries. OECD countries have extensive tax treaty networks with developing countries that reduce the taxes that investors pay in these countries.

Private equity funds

DFIs most often use OFCs when they are putting money into private equity funds. Funds exist to pool money from many countries and invest it in many others; these funds are therefore ‘offshore’ for all but one country. Developing countries are often ruled out as domiciles for funds because of unpredictable and inefficient legal systems, and inadequate administration. Funds often need to exchange currencies and move money, and few developing countries have the appropriate legislation and regulatory regimes to do this. In some countries, foreign exchange transactions may require a signed letter from the Minister of Finance, or changes to the size of the fund may require all its investors to attend a meeting in the country. DFIs have made some attempts to establish funds onshore in Africa but, so far, these have largely been unsuccessful.

There are a variety of reasons why funds are an efficient way to organise investing but these would be negated if they were taxed more heavily than direct investments. Funds therefore seek ‘tax neutrality’, meaning that no additional taxes are incurred by the act of pooling investments into a fund. To duplicate the taxation of direct investments, capital income from cross-border investments (dividends, interest payments and capital gains) should be taxed in two places: the ‘source’ country, where the underlying business that generates the income is located, and the ‘residence’ country of the investor – not in the country where the fund is located. While onshore OECD financial centres also offer tax neutrality, the funds that DFIs support are often based in OFCs partly because the professional services they need are cheaper, which matters for smaller funds. Developing countries would be no better off if these funds relocated to London or Amsterdam.

Non-tax motives

DFIs claim that when they manage investments themselves, they prefer to invest directly and rely on local courts. However, sometimes – especially when DFIs are attempting to attract private co-investors – the domestic legal system is regarded as inadequate. An intermediary jurisdiction, on the other hand, can offer predictable and widely understood legal judgements. For a variety of pragmatic reasons, DFIs and their co-investors sometimes want to use pooling vehicles and these entities have similar tax neutrality requirements to funds that typically cannot be met by local legal systems. Foreign investors sometimes fear that local courts will treat them unfairly; at the same time, local project sponsors may also fear home bias (for example, in London) and prefer a third-party jurisdiction. When a project requires debt finance, banks often insist on an OFC because they are unwilling to rely on local legal systems to give them control of the project in the event of default. DFIs exist to find investments that are on the cusp of commercial viability and pull them over the threshold, so it is plausible that these, and other similar concerns, can make the difference between a project going ahead and failing.

DFIs claim that they will sometimes use an OFC without claiming any tax treaty benefits and that they are very rarely exposed to the more worrisome use of OFCs, such as enabling indirect sales of businesses without paying capital gains taxes.

The bottom line

If DFIs stopped routing their investments through OFCs two things would happen, both uncertain. First, the ability of developing countries to tax the capital income of foreign investors would rise, to some degree. However, the arguments presented here suggest that the impact on developing country taxing rights would be minor, as DFIs would relocate funds to OECD financial centres. Second, the quantity of investment by DFIs in developing countries would fall, to some degree. This would come at the cost of lower taxes in developing countries from profits and wages, fewer jobs created and a decrease in the production of goods and services (such as renewable energy). Furthermore, it would be the least developed countries (LDCs), where capital is most scarce and investors are more likely to want to use OFCs, that would be most affected. In the opinion of the author, the risks here look decidedly one-sided, implying that calls for DFIs to stop using OFCs are misguided.

What must change?

The conclusion that DFIs should continue to use OFCs for non-tax reasons, or legitimate tax neutrality, does not amount to concluding that the status quo is acceptable. The fact remains that the use of OFCs does sometimes reduce developing countries' taxing rights.

It is tempting to recommend that DFIs find ways of using OFCs for their non-tax merits without – in those few instances where they arise – also obtaining tax benefits. However, first one must deal with the argument that tax treaties are sovereign decisions that we should presume developing countries have in place deliberately, and that investors are right to obtain the benefits countries wish

to confer upon them. This is a contentious issue: some regard it as ludicrous to suppose tax treaties represent the democratic will; others see it as patronising and neo-colonialist to readily assume developing country governments are inept. There is no easy answer to this debate, but everybody from the Tax Justice Network to the International Monetary Fund agrees that the system of international taxation is flawed and that developing countries are disadvantaged. It therefore seems reasonable to look for improvements.

DFIs cannot solve the fundamental problems of international taxation; this requires multilateral action at the inter-governmental level. DFIs could help by being more transparent about the tax implications of the structures through which they invest. A big problem here is that 'tax advantage' is genuinely difficult to define – for which investors, and judged against what alternative? DFIs should invest some effort in collectively defining and operationalising measures of tax advantage, for both internal decision-making and external communication. Once these measures are in place, it may become easier to move their use of OFCs towards structures that bring legal benefits while avoiding egregious tax implications.

DFIs could also demand more transparency from their co-investors and the jurisdictions that they invest in. There is a clear public interest case for transparency when prominent individuals from the regions that DFIs invest in are involved in their deals. While there are difficult trade-offs – insisting on transparency may prevent some projects from going ahead – DFIs should start experimenting with requiring public declaration of beneficial ownership as a condition of their participation. They could also raise the minimum level of transparency they require from OFCs.

1. Introduction

The popular argument is simple and powerful: tax havens are used by the corrupt and duplicitous to avoid paying their fair shares of taxes, thus draining billions of dollars in public revenue from cash-strapped developing countries. Therefore, government agencies that exist to promote development should have nothing to do with them. This paper seeks to explain why they do.

Taxation is at the centre of global development policy. It is widely recognised that a major improvement in the ability of developing countries to raise tax revenues will be necessary, if not sufficient, to achieve the Sustainable Development Goals (SDGs). As instruments of development policy, Development Finance Institutions (DFIs) are all aligned behind the SDGs and consider generating tax revenues in developing countries to be one of their main objectives. The Addis Ababa Action Agenda on Financing for Development – developed in parallel with the SDGs and covering financial means of implementation – includes the following commitment: ‘We will also reduce opportunities for tax avoidance and consider inserting anti-abuse clauses in all tax treaties. We will enhance disclosure practices and transparency in both source and destination countries, including by seeking to ensure transparency in all financial transactions between governments and companies to relevant tax authorities.’

The tide of public opinion in OECD countries continues to turn against tax dodgers, and governments are introducing new legislation to crack down on tax evasion and avoidance, and increase transparency. The role that offshore financial centres (OFCs) can play in enabling tax evasion and avoidance is widely recognised, and it is easy to see why they attract such opprobrium. It could be argued that OFCs are so harmful that DFIs should not be associated with them, even if DFIs do no harm by using them.¹ Such arguments may hold the greatest sway in public debates, but matters of principle fall outside the domain of research and evidence. This report is concerned with the pragmatic consequences of the use of OFCs by DFIs from a development perspective. In other words, do the costs outweigh the benefits?

The potential benefit of using tax havens or OFCs is that they increase the quantity of investment that DFIs can

conduct in capital-scarce developing countries, thereby creating jobs, producing goods and services, and generating taxes. This is what DFIs are for.

However, the potential costs of using OFCs are broader than the consequences for taxation – for example, secrecy may undermine civic values. From a development perspective, the most important potential cost of OFCs is that they deprive developing countries of the ability to tax foreign investors. Tax is therefore the focus of this paper.

The net impact of OFCs on tax revenues in developing countries will be a combination of the cost of potentially reduced tax rates applied to the capital income of foreign investors, offset by the potential benefit of a larger tax base created by additional investment, including taxes on wages and profits (if OFCs facilitate investments that would not happen otherwise). So, even if OFCs do deprive developing countries of some taxing rights, the net impact on tax revenues may be positive.

DFIs, however, argue that OFCs typically do not deprive developing countries of the ability to tax foreign investors, because the alternative – direct investments or pooled investments made from onshore OECD financial centres – are unlikely to allocate more favourable taxing rights to developing countries.

The question of why DFIs do not choose to invest directly in target countries goes to the heart of the problem. DFIs acknowledge that OFCs do sometimes offer tax advantages to investors.² However, they argue that the real reason for using OFCs is not to avoid paying taxes in developing countries but more to do with the fact that legal and institutional inadequacies in many of these countries make direct investment impractical. OFCs can protect investors against certain risks, such as the inability to seize collateral in the event of a default, and can ensure reliable procedures are in place in the event of a dispute among shareholders, and avoid restrictions on foreign exchange transactions and onerous procedures for transferring money in and out of funds.

One DFI characterised the decision-making process as follows: is there a non-tax need for an intermediary? If yes, find suitable jurisdictions that would not add an additional layer of tax – in other words, jurisdictions with favourable

1 For example, the tax campaigner Richard Murphy argues there are no redeeming features to secrecy jurisdictions (tax havens) and they must be abolished if capitalism and democracy are to survive. He concludes, ‘There can be no excuses: the secrecy jurisdictions that are run from small island states that called themselves international business centres are destroying the world as we know it’.

2 For example, CDC’s policy statement acknowledges that certain investments ‘may include structures that reduce the tax burden on investors’.

holding company or fund regimes. Then, if there is more than one, choose the one with the most favourable treaty benefits.

A primer on taxing cross-border investments and how OFCs can avoid tax is provided in the next section. The remainder of this introductory section covers definitions, scope, methodology and the assumptions behind this paper. Pragmatic legal and institutional motives for using OFCs are tackled in Section 3. Section 4 examines the economics of taxing capital income, particularly the rate that should be paid and whether there is a trade-off between taxation and investment. Section 5 asks whether OFCs deprive developing countries of the ability to tax foreign investors. Section 6 discusses transparency.

1.1. Definitions: offshore financial centres

There is no definitive definition of an OFC. Some lists are based on assessed malpractice; others are more objective and merely identify territories that offer financial services to non-residents. As the International Monetary Fund (IMF) notes, the broadest definition of an OFC – jurisdictions that provide financial services by banks and other agents to non-residents – would include all the major financial centres in the world; a more practical definition is jurisdictions where the bulk of financial sector activity is offshore on both sides of the balance sheet. In 2000, the Financial Stability Board (FSB) identified 37 territories with significant offshore activities, and although the list is nearly two decades old, it is still probably reasonably accurate (although it omits new entrants such as Qatar and the United Arab Emirates).³

In 2015, the European Union (EU) published a list of 30 territories that feature on at least ten member state blacklists, which proved to be highly controversial, and is currently working on criteria for an EU blacklist, expected before the end of 2017.⁴ The OECD also lists countries that have failed to comply with international transparency standards; the most recent edition contains only one entry – Trinidad and Tobago.⁵

The Tax Justice Network compiles a Financial Secrecy Index, which ranks jurisdictions according to their secrecy and the scale of their offshore financial activities. Many

OECD countries fare badly on that score. Blacklists produced by rich countries are widely regarded as hypocritical and scholars argue that the onshore/good, offshore/bad distinction is without foundation. According to some definitions, countries with DFIs are considered OFCs but, for the purposes of this paper, we refer to these as onshore OECD financial centres (e.g. London, Amsterdam, Brussels).

A precise definition of an OFC is not necessary for the purposes of this paper; it does not matter if the status of some of the territories that DFIs use is ambiguous.

1.2. Definitions: Development Finance Institutions

DFIs are publicly owned entities with a mandate to invest in private sector enterprises in developing countries to promote development. Their objective is not only to finance investments themselves, but also to ‘crowd in’ private investors. This means they want private investors to participate in the projects they support, but they also want their investments to have a ‘demonstration effect’ and catalyse subsequent private investments without DFI involvement. The argument for using OFCs is fundamentally based on the need to encourage private investment. As one interviewee put it: “We must demonstrate that investments can be done cost-effectively. We must take private investors with us. We must pave the way.”

Not all DFIs are alike: some have private sector shareholders and pay dividends, some also invest in public sector projects and some have a mandate to support domestic firms in their overseas activities. DFIs can be either bilateral or multilateral. The biggest multilateral player is the International Finance Corporation (IFC), part of the World Bank Group. Regional development banks, such as the European Investment Bank, the African Development Bank (AfDB), the Inter-American Development Bank and the Asian Development Bank also have private sector operations that are relevant here. The biggest bilateral DFIs by portfolio value are FMO (The Netherlands), DEG (Germany), Proparco (France) and CDC (UK).⁶

3 FSB Report of the Working Group on Offshore Centres.

4 For details see European Commission (2014), ‘Platform for tax good governance: Discussion paper on criteria applied by EU Member States to establish lists of non-cooperative jurisdictions’.

5 OECD (June 2017) ‘Brief on the State of Play on the international tax transparency standards’.

6 For more information, see ‘Institution Ranking by Volume’ on the ‘Development finance institutions and private sector development’ page of the OECD website.

1.3. Methodology

This paper is based on interviews with officials from DFIs, independent tax lawyers, tax campaigners and academics. To allow interviewees to speak freely, nobody is quoted directly.

The purpose of this paper is to examine the case that DFIs make for using OFCs, and to analyse these arguments from a developmental perspective. Although claims have been cross-checked with independent tax lawyers and tax campaigners, and the intention has been to provide a balanced view of the arguments, this paper will inevitably present a partial view of the issues. For alternative perspectives, see Vervynckt (2014) and Oxfam (2016) and references therein.

This paper presents views from rich countries about their own behaviour, which affects poor countries. Except for the African Development Bank, views from developing countries are not represented in this paper, which is an important omission. Gathering a representative sample of perspectives from developing countries on these issues would be a major undertaking, worthy of a paper in itself.

1.4. Scope

DFIs are frequently criticised for using OFCs and urged to stop doing so.⁷ This paper, however, examines these issues from a development perspective. As such, this paper covers:

1. **The behaviour of DFIs as investors, not the tax behaviour of their investees.** The tax behaviour of the companies that DFIs invest in is an important topic and probably consumes the majority of DFIs' internal efforts on tax matters. The tax behaviour of companies, as opposed to their investors, is also the focus of official reform efforts: the OECD's Base Erosion and Profit Shifting (BEPS) Project. However, profit-shifting by multinational corporations, and other forms of corporate tax avoidance and evasion, is not directly related to the practice of 'investing through tax havens'.⁸ The taxes paid by investors and the structures used to avoid them, are introduced in the next section: A primer on offshore financial centres and the taxation of cross-border investment.
2. **The whole investment, not just the portion funded by DFIs.** In quantitative terms, taxes on capital income paid directly by DFIs are not of great importance from a development perspective. DFIs typically only contribute a minority share of the funding for the projects that they

invest in. The OFC structures that they invest through can determine the taxes paid by their co-investors. This paper is concerned with the implications of routing investments through OFCs for the taxes paid by all the investors in projects where DFIs are present.

Multilateral DFIs, such as the IFC or the African Development Bank, are totally exempt from taxes on their income, in all jurisdictions. Many bilateral DFIs are exempt from taxes on capital income in their countries of residence, where the bulk of capital taxes are typically due. Some bilateral tax treaties include clauses exempting the national DFI from certain source taxes (e.g. on interest). However, pooling vehicles do not inherit DFIs' tax exemptions at residence (which is why DFIs sometimes place their pooling vehicles in intermediary jurisdictions where no additional taxes arise).

3. **Taxes paid in developing countries, not in advanced economies.** This paper is concerned with whether the use of OFCs undermines the ability of developing countries to gather taxes on foreign investors' capital income arising from assets located within their borders. OFCs may also potentially be used to evade or avoid domestic taxes that the residents of OECD countries should pay when they invest overseas, but this paper will not be concerned with the implications of OFCs for rich countries. This choice is justified by the fact that DFIs exist to promote development overseas, which includes generating tax revenues in the countries where they invest. DFIs point out that some of the tax structuring they observe exists to minimise investors' taxes at residence in OECD countries, and does not affect taxes at source in developing countries.
4. **The issues, not current practice.** This paper will not attempt to survey and evaluate DFIs' existing formal policies towards the use of OFCs. For such a survey, see Oxfam (2016). Most DFIs will use an OFC if it is compliant with the peer review process of OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes. Some DFIs will not accept structures whose primary purpose is subjectively judged to be the reduction of tax liabilities (revenue authorities will often apply the same test for eligibility for treaty benefits). However, most DFIs route a large percentage of their investments (either in terms of number or volume) through OFCs – figures in the region of 75% are common – primarily because they often invest in funds that operate from an OFC.

⁷ The criticisms are voiced by civil society (Vervynckt, 2014), in the press – Provost (2013) – and in political debates. In a debate about the UK's DFI, CDC, Kate Osamor, the Shadow Secretary of State for Development, argued that 'It is extraordinary that the CDC has routed its investments through tax havens. The CDC and DFID have a moral duty to adopt the highest ethical standards if they are to have moral authority as the UK's leading development actors. We should not be rewarding tax havens with UK taxpayers' money, and the Government could and should lever the CDC away from the use of tax havens. That means that not a penny of the proposed £6 billion should find its way to a tax haven, and the Bill should be explicit in enshrining that principle.' (Commonwealth Development Corporation Bill, Hansard Volume 617, 29 November 2016).

⁸ It is conceivable that 'investing through tax havens' may allow firms to conceal related-party transactions.

5. **Transparency.** Campaigning organisations such as the Tax Justice Network are at pains to point out that tax is only part of the problem with tax havens.⁹ The only harmful non-tax behaviour this paper will consider is the concealment of beneficial ownership. The potential harms of avoiding regulations that do not pertain to taxes or transparency will not be considered.

1.5. A key assumption: Development Finance Institutions are effective

It will be assumed that DFIs are effective in terms of increasing the quantity and quality of investment in their countries of operation, thereby contributing to sustainable development and the eradication of poverty. This assumption is open to question but evaluating the impact of DFIs is beyond the scope of this paper; the Appendix briefly discusses the justification behind this assumption. This assumption implies that if there is a trade-off between the use of OFCs and the ability of DFIs to execute investments efficiently, then we take that trade-off seriously because it could mean fewer people are lifted out of poverty.

Some tax campaigners argue that investments routed through OFCs are likely to have less development impact. It is not obvious why this would be the case, nor what the magnitude of any effect would be. There does not yet appear to be any evidence for this argument but, if true, it would have a large impact on the rationale for using OFCs.

The assumption that DFIs are effective is crucial because the idea that the quantity of investment that DFIs can conduct would fall if they refused to route investments via OFCs, is justification for using OFCs. All DFIs say that generating tax revenues for developing countries is one of their objectives. Many say that they would prefer not to use OFCs, wherever possible. All DFIs argue that they must weigh any preference they may have against using OFCs, and the fact that sometimes OFCs do deprive countries of some tax revenues, against other development objectives. Within the constraints imposed by their formal policies on taxation (legality, compliance with the Global Forum) all DFIs would consider letting a potential investment fall apart by refusing to use an OFC to be a dereliction of their mission to stimulate private investment in developing countries.

⁹ <http://www.taxjustice.net/faq/tax-havens/>.

2. A primer on offshore financial centres and the taxation of cross-border investment

Stories of tax avoidance now feature regularly in newspapers, and tax arcana such as the ‘double Irish with a Dutch sandwich’ and cosy accommodations with Luxembourg are now familiar to many. But such practices are less relevant to DFIs and their fellow investors. The taxes, and the means of avoiding them, are quite different. This section presents a relatively non-technical primer on the basics of taxing cross-border investment and what is at stake.

2.1. What taxes are we talking about?

DFIs and their private sector co-investors primarily do two things: invest equity and debt.¹⁰ The returns on these investments come in three forms: the interest on loans; the dividends distributed to equity shareholders; and capital gains on the sale of equity. This paper focuses on taxes that cross-border investors should pay in the ‘source’ countries (where their investments are located) on these three forms of income. Taxes imposed in the source country on interest and dividends paid to non-resident investors are known as ‘withholding’ taxes. There are also some other potentially relevant taxes – for example, withholding taxes on royalties and transaction taxes such as stamp duty – but these will be ignored.¹¹

For convenience, this paper will refer to these returns on investment as ‘capital income’, following the practice

of economists (Griffith et al., 2010). This may confuse non-economists, who may be more accustomed to referring to interest and dividends as income, and to treating capital gains as a separate category.

Economists also regard corporation taxes that firms pay on their profits as just another variant of capital income tax. But while profit taxes may affect investors, in an economic ‘tax incidence’ sense, taxes on corporate profits are not remitted by DFIs and their fellow investors.¹² The use of OFCs by DFIs only affects the taxes that they and their fellow investors remit.

That is not to say that DFIs and other investors cannot influence the behaviour of the enterprises that they invest in. One thing that emerged clearly from the interviews was that, when it comes to taxation, most DFIs put more effort into evaluating the tax behaviour of a potential investee when it is a multinational enterprise that makes use of OFCs, than they do into thinking about the tax implications of how their investment in that enterprise will be structured.

To get an impression of the relative magnitude of the relevant taxes, one DFI gave the following example for an equity investment.¹³ Consider a \$1,000 equity investment in a high-risk country where investors demand high returns. The business makes \$200 annual profit which is taxed at 35% (or should be) generating \$70 of annual tax revenue. Some portion of the \$130 of post-tax

10 Some DFIs also offer credit guarantees, which we ignore here.

11 Stamp duty can sometimes be very significant, when returns are low. If an equity investor buys shares at £100 and sells them for £102, then a 1% stamp duty applied to the sale at £102 will consume over half of the investor’s return.

12 Tax incidence refers to the idea of identifying who is ultimately made worse off by a tax (before accounting for any benefits of tax-funded expenditure), as opposed to who merely writes the cheques to the tax authorities.

13 Withholding taxes may be more significant for debt investments – it would depend on the relative magnitudes of interest payments and taxable profits.

earnings would probably be retained within the business, but suppose it is all distributed as dividends to overseas investors, with withholding taxes typically around 10%. This would mean a further \$13 of annual tax. The business is then sold five years later at a price multiple of ten times post-tax earnings (\$1,300). This would mean a \$300 capital gain which might be taxed at 35% – approximately a further \$100 of tax.

Of course, the widespread use of tax incentives in developing countries may mean that in practice the \$70 of corporation tax is not collected, and taxes on investors' capital income may also be waived – see IMF (2015) for a survey of this problem. However, the point remains that, before such policy interventions, taxes on profits should typically be substantially larger than taxes on investors' capital income.

Taxes on wages are important too. Many developing countries have very large informal sectors, which largely escape taxation, whereas DFIs' investments in the formal sector generate labour taxes. There may also be additional taxes generated: in supply chains; as workers spend their wages; taxes on imports associated with a project; taxes on certain purchases such as fuel; and withholding taxes charged on fees paid to suppliers on a project.¹⁴ This is why DFIs believe that, from a tax perspective, it is more important to increase the quantity of investment in developing countries than it is to push for higher effective tax rates on capital income – which may come at the price of reduced investment.

2.2. What structures are we talking about?

Private equity funds are probably the most important structure in this context. When DFIs co-invest alongside private investors, they most commonly invest in private equity funds, which are usually domiciled in an OFC.¹⁵ Many DFIs regard providing seed money to new private equity funds, operating in frontier markets where outside equity is in short supply, as one of the most important ways in which they can achieve development impact.

Funds that take money from investors resident in multiple countries and invest in multiple countries, cannot avoid being offshore (in all but one of the countries). It is

widely regarded as completely legitimate to avoid taxes 'on any income or gains recognised by the fund' over and above taxes charged at source and, when the fund pays out to its investors, at residence.¹⁶ So, funds will generally not establish themselves in countries whose laws do not allow for this.

Why do funds choose OFCs and not onshore OECD financial centres? Part of the answer may be to do with the taxation of the individuals who manage the fund, which is a peripheral issue in this context. But OFCs may also offer cost advantages, by charging lower fees for professional services, which can be important for smaller funds where fees can absorb a large share of returns. The upfront and operating costs of establishing pooling vehicles can be 20% to 50% that of onshore OECD financial centres. OFCs may also offer geographical proximity relative to an OECD alternative, and may establish themselves as the usual route for investing in certain regions. Mauritius, for example, has acquired a reputation for providing services based on genuine knowledge of African markets, useful for due diligence and other purposes.

It is less common for DFIs to invest debt and equity alongside private passive investors in a single enterprise or project, although it does happen. In the case of debt, there will sometimes be a 'DFI tranche', which may be domiciled in a different jurisdiction from other components. Sometimes, the underlying businesses may be spread across a handful of countries or the deal may involve a such a large number of different investors that a pooling vehicle – which may be domiciled in an OFC – is deemed necessary (see Box A: Why do DFIs use pooling vehicles?). Otherwise, DFIs prefer to invest directly, avoiding intermediary entities in OFCs, when they think it is viable. For example, when the UK DFI, CDC, began investing directly in India in 2012, it did so without routing investments via Mauritius despite the existence at the time of a notoriously advantageous tax treaty with India, which was routinely used by private investors.¹⁷ CDC did so because it saw no valid non-tax reason for using Mauritius.

The relative rarity of co-investing equity alongside private investors may be surprising given DFIs' avowed mission of 'crowding in' private investors. 'Crowding in', however, does not always mean investing at the same time. DFIs may provide early-stage equity, for example,

14 In some cases, withholding taxes paid on gross fees and purchases can take the overall effective tax rate above 100%. The full panoply of taxes associated with an investment may also sometimes not be enforced on local firms, but will be demanded of large foreign investments. This combination explains some of the effort firms put into obtaining tax holidays or other tax incentives.

15 The bilateral DFIs make greater use of funds than the multilaterals such as the IFC or AfDB.

16 See Zolt (1998) 'General agreement exists that, at a minimum, tax rules should not unduly hamper or prevent development of investment funds or other financial intermediaries'.

17 The treaty was amended in 2017 to remove those benefits.

in the hope of attracting private debt investors at a later stage.¹⁸ Often the largest private co-investor is the project sponsor.¹⁹ DFIs sometimes invest alongside ‘strategic’ investors – for example, to encourage a European power generator to enter an African market, where the co-investor is the power generator itself. This may require the DFI to route its investment via an existing cross-border corporate structure, such as a regional holding company.

Some of the most complex structures that DFIs are involved with are ‘project financing’ structures: self-contained special purpose vehicles that are established to finance and operate a discrete project (usually infrastructure), where different investors bear different risks, and separate legal entities are used to corral investors according to risk exposure and instrument type.

2.3. Where should taxes be paid?

There are two places where investors could pay taxes on their capital income: at ‘source’, in the country where the underlying business is located; and at ‘residence’, in the investor’s home country. The economists’ view tends to be that it is more efficient to tax investors’ capital income at residence, because doing so does not distort international investment decisions towards countries with lower tax rates; but so long as the total tax rate is set by the country of residence it does not matter if part of that tax is withheld at source and credited at residence (Griffith et al., 2010).

If countries are roughly symmetrical, the choice between source and residence taxation is roughly revenue neutral; it makes sense to focus on allocative efficiency (avoiding taxes that distort investment decisions). However, if some countries are capital exporters and others capital importers, much more is at stake. As the IMF Fiscal Affairs Department puts it: “The allocation of rights is especially important for low-income countries, however, as flows are for them commonly very asymmetric – they are essentially ‘source’ countries, the recipients of capital inflows and the site of production, not investors in business activities outside their borders ... the network of bilateral double taxation treaties based on the OECD model significantly constrain the source country’s rights.” (IMF, 2014)

In the absence of a tax treaty, both the source and residence country may tax the same income – a situation referred to as ‘double taxation’ – which is widely agreed to be undesirable. In some cases, the residence country may issue tax credits against taxes paid abroad, thereby

Box 1: Why do Development Finance Institutions use pooling vehicles?

Private equity and other types of funds exist to pool money from many investors. DFIs use them because it allows them to gain access to the local knowledge and expertise of many investment teams; that way they can invest in many more businesses than if they had to identify and negotiate every investment themselves. DFIs usually use funds to invest in smaller businesses.

But why do DFIs use pooling vehicles when investing directly in larger enterprises?

Many DFIs prefer to make lots of small investments rather than a few large investments because it diversifies risk. To finance a large project, DFIs will often combine their investments. They will sometimes use a pooling vehicle to simplify the management of the investment, perhaps delegating a lead investor to act as focal point for interacting with the enterprise, and to reduce administrative overheads. When there are non-tax motivations to use OFCs, pooling vehicles allow multiple investors to attain these benefits.

Pooling vehicles also allow different assets in different countries to be bundled together so that they can be sold in a single transaction. More complicated structures allow different types of funding, routed to different combinations of the underlying businesses, to be grouped together.

Often a pooling vehicle is used for credit reasons: pooled assets are cheaper to lend against. Suppose five separate underlying businesses are combined in a pooling vehicle; if any one of these defaults, a bank can claim against the other four. If the bank lent to each underlying business separately, it might not be able to recover funds in the event of default.

mitigating double taxation, but this is not always the case. However, increasingly, resident countries waive taxation on overseas dividends and capital gains; a situation which results in ‘double non-taxation’ when there is a tax treaty which also means those gains are not taxed at source. Most tax treaties are modelled either on the OECD Double Taxation Convention or, less often, on the United Nations (UN) Model Double Taxation Convention. In both cases, the weight of taxing rights on investors’ capital income is at residence, while taxing rights on corporate profits are weighted towards the source country.²⁰ Under the OECD

18 OECD guidelines allow DFIs to take credit for mobilising private investments that are made up to two years after the initial investment by a DFI.

19 DFIs have a ‘demand led’ business model, in which they find entrepreneurs or companies that have a business plan and are looking for finance. The person or company behind the project is known as the project sponsor.

20 Hearson (2016) notes that OECD countries increasingly unilaterally offer tax credits or exemptions on foreign income that make tax treaties less relevant for their residents.

model, foreign investors are generally exempt from capital gains taxes, subject to exceptions (e.g. gains from real estate). The UN model is similar but also provides the option to tax foreign investors on capital gains from local shares, when the shareholding exceeds a stated amount.

Hearson (2016) studied trends in tax treaties and found that the restrictions they impose on the rate of withholding tax in developing countries have intensified over time. The picture with respect to capital gains tax is mixed: OECD countries, where DFIs are based, appear to be moving towards treaties with developing countries that impose more restrictions on the latter's taxing rights; treaties with non-OECD countries are more often favourable to the source country.²¹

One motivation for demanding that DFIs stop using OFCs could be the hope that, by doing so, DFIs would move the balance of taxing rights on their investments back towards source countries. However, refusing to use OFCs would do nothing to reverse the trends evident in tax treaties, which govern the allocation of taxation rights between signatories.

What all this means is that the question of whether OFCs deprive developing countries of the ability to tax foreign investors' capital income usually boils down to a comparison of the tax treaties in different potential jurisdictions for the domiciling of investments. The strongest argument for why OFCs do not typically deprive developing countries of taxes on investors' capital income is that the alternative – direct investment from the DFI's country of residence – will usually entail an equally, or more favourable tax treaty. But there is more to the argument, as Section 3 will explore.

2.4. How offshore financial centres can be used to avoid taxes

Tax avoidance is notoriously hard to define. It exists in a grey area of legal yet undesirable practices.²² Some definitions talk in terms of fairness or morality, others the spirit, as opposed to the letter of the law, or of artificial

contrivances that serve no purpose other than to reduce tax liabilities (although such contrivances will often be forbidden by law). Others argue that tax avoidance is a practice that should be illegal and may well be a target of future legislation.²³

The problem is that avoiding (or reducing) tax liabilities on foreign investors' capital income is not particularly complicated. It does not require a team of highly skilled lawyers; the legislation is often easy to understand and openly advertised. To take the brochure of one financial adviser chosen at random as an example: 'For returning capital, African capital gains taxes are generally levied at a rate of 30%. Through use of this structure, the Mauritius tax treaties should restrict gains tax to the country of residence of the seller of the assets, which in this case would be Mauritius and so subject to a 0% gains tax.'²⁴ But, as will be discussed later in this paper, exemption from capital gains tax is not unique to tax treaties with small island states – most tax treaties, including those of OECD nations, offer similar features.

In theory, there are three primary ways in which OFCs might help cross-border investors reduce their tax liabilities: (i) by providing secrecy, (ii) by enabling the indirect sale of assets and (iii) by changing the allocation of taxing rights between source and residence countries (e.g. avoiding withholding taxes).²⁵ It should be emphasised that these three mechanisms are not unique to OFCs – using an onshore OECD jurisdiction as an intermediary may have the same effect.

The first is outright illegal tax evasion. Investors can attempt to evade taxes by simply not reporting capital income to their domestic tax authorities, and some OFCs may enable that (although initiatives such as the Global Forum are making this decreasingly likely). Secrecy may also make it harder for tax authorities to unpick avoidance schemes. This is partly why tax campaigners prefer the term 'secrecy jurisdiction' to tax haven.²⁶ But while DFIs cannot prove that all of their co-investors obey the law and disclose income to their resident tax authorities, there is no serious suggestion that institutional investors of the

21 Hearson notes that non-OECD countries appear to be allowing developing countries to retain more capital gains taxing rights than in the past. However, treaties may grant rights that domestic tax law does not take up – some DFIs argued that domestic law often does not attempt to tax non-resident capital gains, so trends in treaties do not necessarily reflect trends in taxes actually levied.

22 Although some tax lawyers think tax avoidance is easily defined; the problem is that the phrase is used inappropriately.

23 See Devereux et al. (2012) for a discussion of the concept of tax avoidance.

24 Capita Asset Services, 'Solutions for private equity managers investing into Africa: Simple structuring for raising capital from institutional investors'

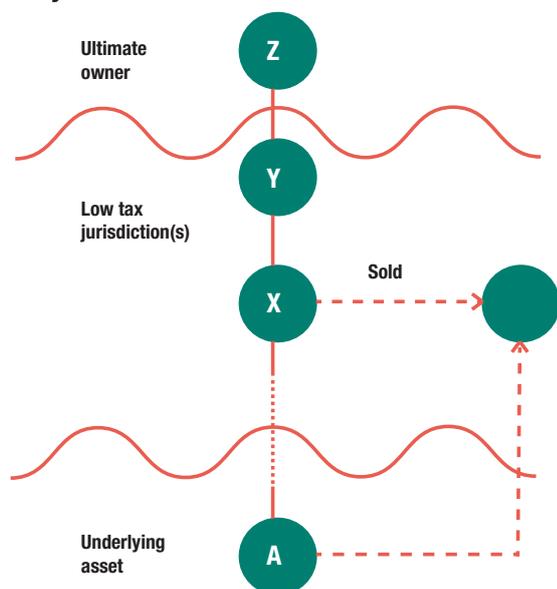
25 There are others. One involves taxes payable at residence, so is peripheral to the main concern of this paper. An intermediary can allow investors to control the timing and nature of returns. For example, if capital gains are taxable but dividends are not at residence, an intermediary vehicle can dispose of the net asset and then distribute the proceeds back as dividends.

26 Some DFIs argue the term 'secrecy jurisdiction' is now largely anachronistic and unfairly pejorative because commercially important OFCs are leaders in ensuring that beneficial owners are known to service providers, that the information is available to the government and regulators and that it can be appropriately exchanged with other jurisdictions.

sort that tend to participate in DFI-led investments are tax evaders.²⁷ It is, however, more plausible that local investors – often the project sponsor – may route their investments via an OFC (a practice known as ‘round-tripping’) and may sometimes be able to take advantage of secrecy to conceal income (although attempts at outright evasion are unlikely in DFI projects).²⁸ In most countries firms should report flows of capital income up to the OFC to their domestic tax authority, but not every developing country has the necessary reporting procedures in place.

The second, indirect asset sales, avoids capital gains taxes. A classic structure involves two holding companies, domiciled somewhere offshore (not necessarily in an OFC): when the top-level holding company sells the intermediate holding company, no capital gains tax is levied because the identity of the intermediate holding company has not changed; the tax authorities in the country where the underlying asset is located will not even be aware a change of ownership at a higher level has taken place, of if they are, their legislation may give them no taxing rights. Such an arrangement is depicted in Figure 1, which is taken from IMF (2014).

Figure 1: Avoiding capital gains tax by selling assets indirectly



Company A holds an asset located in a relatively high tax source country that increases in value. The ultimate owner of A, company Z, realises this gain by selling X, an intermediate entity holding A, in a low tax jurisdiction. The result may be that no or little tax is payable anywhere.

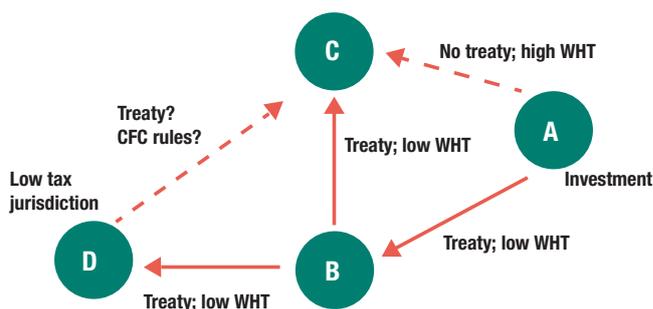
Source: IMF (2014).

In many cases, investors may not even need to exploit structures such as these: most tax treaties exempt non-resident investors from tax on capital gains arising from the sale of non-real estate assets.

When direct investment is not feasible for one reason or another (see Section 3), asking investors to choose an intermediary jurisdiction without a favourable tax treaty is more like asking them to voluntarily pay more taxes than they need to and less like asking them not to undertake convoluted schemes to avoid tax.

The third way in which OFCs can be used to reduce tax liabilities is by enabling ‘treaty shopping’, which entails setting up holding companies in jurisdictions that have treaties in place under which withholding taxes are much reduced. Figure 2, also taken from IMF (2014), illustrates this. DFIs argue OFCs are typically not used for treaty shopping because – with a few exceptions such as Mauritius, Barbados, Seychelles and Singapore – their treaty networks are not especially favourable, and that onshore OECD financial centres are more often used for this purpose.

Figure 2: Treaty shopping



Country A has a treaty with B, but not with C, so that residents of C investing directly in A face the relatively high withholding tax (WHT) rates specified in A’s domestic law. If C has a treaty with B, however, investors there may be able to benefit from A’s treaty-reduced WHT rates by investing through an affiliate in B, which acts as a conduit. It may, moreover, be that B has a treaty with some country D that taxes such income at a low rate; receipts can then be further passed there, without (unless C applies controlled foreign corporation (CFC) rules) attracting any further liability in C.

A limitation of benefits (LOB) provision in the A-B treaty would aim to address this by providing the benefits of the A-B treaty only to those undertaking substantial activity in B.

Source: IMF (2014).

27 The assumption that portfolio investors can escape taxation by holding their investments overseas is shared by economists. Fuest et al. (2005) write: ‘A large part of the literature assumes that income from portfolio investment ... is untaxed. This assumption is usually justified by pointing out that residence-based capital income taxation can be easily avoided by holding bank accounts abroad.’

28 The adoption of common reporting standards (CRS) makes evasion of this type much less likely. In some cases, pooling vehicles will be a reporting entity, and directly report on their beneficial owners; in other cases, the pooling vehicle’s bank will. Most African countries have not adopted CRS and may not have the capacity to process these reports when they do. It would take a brave investor to gamble on this over the lifespan of a project.

2.4.1. The crackdown on treaty shopping

In June 2017, the OECD launched its Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS – commonly referred to as the Multilateral Instrument or MLI. The MLI is designed to enable the amendment of multiple bilateral tax treaties simultaneously. Not every OFC has yet signed the MLI. Mauritius has signed but excluded its African treaties, which it says will be subject to bilateral negotiation – widely seen as a delaying tactic. Some campaigners think the MLI will be too difficult for developing country tax authorities to enforce, particularly a potential treaty amendment known as ‘limitation of benefits’ clauses.

The MLI allows countries to incorporate a clear statement into their treaties that their purpose is not to create opportunities for non-taxation or reduced taxation, including treaty shopping. It also allows for the inclusion of a general treaty anti-abuse rule to prevent arrangements with the principal purposes of obtaining treaty benefits. This resembles DFIs’ practice of rejecting structures with no valid non-tax rationale.²⁹

There are various opt-out clauses and the implementation will depend, in part, on the interpretation of individual tax authorities, so the ultimate impact of the MLI is not yet clear. It is likely, however, that some offshore entities will no longer be able to claim tax benefits under the treaties that motivated their formation. Anti-avoidance measures make it harder for entities with little economic substance to claim the benefits of tax treaties. For example, some pooling vehicles that genuinely coordinate the management of investments across different shareholders may continue to be eligible, whereas ‘brass plate’ companies inserted between a private equity fund and the underlying investment may not.

2.4.2. Private equity funds and treaty shopping

Funds are usually structured as limited partnerships, with investors becoming limited partners. Many jurisdictions treat partnerships as ‘tax transparent’, with investors taxed in much the same way as if the partnership did not exist and they held the assets directly.³⁰ But funds will often establish taxable special purpose vehicles to make the investments: one for each investment or one for a portfolio. These intermediaries may bring some measure of legal protection, for the reasons addressed in the next section, and are not necessarily chosen for tax purposes. However, funds may also use them to indulge in treaty shopping. From the perspective of a fund, the ideal tax arrangements involve paying no taxes at source, so all income within the fund is untaxed, and any taxes are a matter for their

investors and their respective domestic tax authorities when the fund pays out. Attitudes among DFIs are split on this practice: some regard seeking to minimise withholding taxes as a legitimate objective for funds, to maximise the income that can then be reinvested, before finally realising capital income for taxation at residence; others actively discourage it.

2.4.3. Why avoid taxes at source if taxes are paid at residence?

This paper is concerned with the impact of OFCs on the taxing rights of developing countries, which are predominately capital importers. Developing countries are a source of capital income paid to non-residents. DFIs frequently made the point during interviews that the presumption that OFCs are used to avoid source taxes ignores the fact that doing so will fail to decrease an investor’s overall tax burden when there is an offsetting increase in taxation at residence. For example, if capital income is taxed at 30% at residence but 10% is withheld at source, the resident’s tax authorities will often issue credit and reduce its tax rate accordingly. However, despite DFIs’ claims that tax credits at residence often render avoiding source taxes redundant, tax lawyers argue that this perception is outdated and that tax credits at residence are increasingly limited to a small percentage of the withholding tax at source. This recent trend, towards less generous tax credits at residence for withholding taxes paid at source, is motivated by the observation that credits allow source countries to tax as much as they like, with the burden being borne by the residence taxpayer – something residence countries wish to discourage. Nonetheless, there are three other main reasons for seeking to avoid taxes withheld at source:

1. Even when credits are available at residence, withholding taxes are applied to the gross flow; whereas taxes at residence may be applied to net income. For example, a lender may receive £100 of gross interest income but that may only generate a net profit of £30 after overheads and financing costs. If net income is taxed at 30% at residence, that implies £9 of tax. If the withholding rate is 15% that implies £15 withheld. This means there is not sufficient tax charged at residence for a credit to fully offset. In such cases, withholding taxes raise the overall tax burden.
2. Some investors will not be taxed at residence, so there is nothing to offset taxes charged at source. Most OECD countries choose not to tax some forms of overseas income or will exempt certain forms of income.

²⁹ This paragraph draws on a characterisation of the MLI in the Kluwer International Tax Blog by Guillermo O. Teijeiro

³⁰ The main exception to this is Mauritius, where corporate structures for funds are preferred. This means Mauritius’ corporation tax regime is important, in a way it would not be if funds were ‘pass through’ entities.

3. When DFIs and their co-investors invest in private equity funds, any income is typically reinvested over a fixed timescale, after which point the fund is wound up and total accumulated returns are paid out to investors (on which tax should be paid at residence). So, avoiding withholding taxes increases the returns that can be recycled.

2.4.4. Not 'profit-shifting'

It is worth making a distinction between how OFCs help corporations avoid taxes on their profits and how they may help investors avoid taxes on capital income. A defining characteristic of a tax haven is a low or zero rate of taxation on profits. That is why multinational corporations benefit by shifting profits into subsidiaries or affiliated companies in tax havens where they are taxed lightly.

Cross-border investors do not (typically) use tax havens in this fashion. All the profit-shifting tricks that dominate newspaper stories about tax avoidance, such as mispricing inter-group sales, charging subsidiaries for intellectual property or management services or making large inter-group loans from low-tax jurisdictions that wipe out profits in high-tax jurisdictions, are typically not directly relevant here.³¹ The picture gets a bit murkier when DFIs invest into subsidiaries of larger multinational corporate structures.

For this reason, onshore OECD financial centres, which may otherwise be high-tax regimes – the G7 countries have an average statutory corporate tax rate of about 30% – can still be as advantageous to cross-border investors as small Caribbean islands. What matters are tax treaty networks and the tax treatment of pooling vehicles.

31 There is one motivation for routing investments via OFCs which does resemble using loans to shift profits. In jurisdictions that allow deductions for interest on shareholder loans, investors may use an OFC to convert an equity investment into a shareholder loan. Interest deductions on shareholder loans are typically not permitted if the borrower's debt capital exceeds its equity capital by a ratio of 3 to 1. Interest deductibility reduces corporate income tax in the host country, although this reflects the host country's decision to allow deductibility, not the use of the OFC per se. What the OFC brings is the ability to convert interest payments, which may be taxed at residence, into dividends, which may not be. So, the OFC serves to reduce taxes at residence, but the use of debt finance reduces corporation taxes at source in comparison to a counterfactual of equity finance. Shareholder loans resemble equity in the sense that interest payments can be deferred until there are sufficient profits to cover them, and bank debt takes precedence. Shareholders' loans are also used in countries that place regulatory restrictions on making dividend payments but not on interest payments.

3. Importing institutions: non-tax reasons for using offshore financial centres

Decades ago, economists could justly have been criticised for assuming that markets exist in a vacuum, and of ignoring the social and institutional foundations needed to support functioning markets. This is no longer the case. If anything, economists may now err on the side of placing too much emphasis on the role of institutions in development (Booth, 2012).

Popular accounts, such as Acemoglu and Robinson (2012), position ‘good institutions’ as the root cause of development. From the perspective of investors, the two most important aspects of economic institutions are property rights and contract enforcement. Property rights consist of rights of ownership, rights of use and rights of transfer (Ogilvie and Carus, 2013). More important than the *de jure* nature of laws and regulations are their *de facto* application. Economists describe firms in developing countries as operating in an environment of ‘deal making’, where political connections matter and the rules are applied erratically.³²

Risk and uncertainty are especially detrimental to investment; an extensive empirical literature documents all the ways in which risk discourages investment.³³ As Dixit (2010) puts it: ‘insecurity is greater, and has new dimensions, when the activity and transactions cross national borders ... governments may violate the rights of foreigners with less fear of political consequences ... courts may have open or hidden biases favouring their own nationals’.

Tax campaigners, when making the case against offering tax incentives to attract investment, frequently point out that taxes rank rather low down the list of things international investors care about, implying that tax incentives are ineffective. Such claims are supported by surveys in which executives place risk at the top of the list of investment criteria.³⁴ Common complaints include opaque regulatory and rule-making processes in the host country, and receiving arbitrary or discriminatory treatment.³⁵ It is not surprising, therefore, that DFIs argue that legal motivations are usually behind the use of OFCs: they provide reassurance to investors who would be reluctant to rely on host country institutions.

Seen in this light, OFCs serve as a means for countries with inadequate institutions to import better institutions to facilitate cross-border investment. Sharman (2012 a,b) argues that China deliberately tolerated the use of offshore centres like the Caymans Islands and the British Virgin Islands for this purpose. Sharman shows that comparing trends in investment flows with the timing of changes to the tax advantages conferred by using the Caymans and other such jurisdictions, shows that ‘round-tripping’ and other tax-based explanations for using tax havens, are not consistent with the data.³⁶ The volume of investment routed via intermediaries was going up while the tax benefits of doing so were being reduced.

32 The evidence suggests that variability of policy implementation is strongly correlated with firm performance (Hallward-Driemeier et al., 2010).

33 The World Bank’s 2014 World Development Report, *Risk and opportunity: Managing risk for development*, provides a good survey in the context of developing economies. Daude and Fratzscher (2008) report how different aspects of risk affect different varieties of cross-border investment.

34 For example, a survey conducted by the Economist Intelligence Unit on behalf of the Rule of Law and the Investment Treaty Forum found the top three factors were political stability, ease of doing business and rule of law. Academic empirical research also tends to find that taxes are relatively low down the pecking order in determining Foreign Direct Investment decisions, although some association between lower taxes and increased investment is often found (Kinda, 2016)

35 Ibid.

36 Round-tripping refers to domestic actors routing their investments via overseas territories to benefit from tax advantages intended for foreigners.

3.1. What offshore financial centres offer

One of the most attractive features of (some) OFCs is that they model their laws on New York or English law, and that all the relevant laws and regulations have been tried and tested many times. Many OFCs used for developing-market deals are common law jurisdictions that have maintained close links to the English legal system; in some cases, they still use the Privy Council as the ultimate appeals body.³⁷ Investors know what to expect and do not have to hire expensive lawyers to understand unfamiliar legislation and provide legal opinions. They can have confidence that if certain events occur (for example, disputes break out between shareholders) they are resolved in a reasonably predictable fashion. The degree of legal and tax certainty that investors desire is a high bar for developing countries to reach – tax lawyers claim that many investors would regard the French or Italian systems, for example, as falling short.

An investment will be subject to the local laws of the country, and most disputes regarding an investment will come before local courts. But some disputes may come before the courts of another country, if contractually agreed. Co-investment with third-parties creates potential for disputes between shareholders. DFIs and their co-investors will sometimes require an offshore pooling vehicle so that disputes between them do not come before local courts, particularly where they are regarded as unpredictable and inefficient. Occasionally, project sponsors act opportunistically and use the threat of long and uncertain litigation to push investors into buying them out at an inflated price or selling out at a discounted price, or to block the exercise of put options by investors. Strong legal enforcement reduces such risks. In some cases, local laws that govern all aspects of investment relationships simply do not exist. As one interviewee put it: ‘we need an enabling legal environment where you can conclude complex contracts and enforce them, which regulates all relationships between the investors, between investors and manager, what they have to do, how returns will be allocated among investors, and so on.’ Certain financial instruments – varieties of mezzanine finance, for example – may have no legal basis in local law.³⁸ In some cases, OFCs may have more modern legislation than OECD financial centres – for example, before English partnership law legislative reform in 2017, some investors disliked English limited partnership rules, which had not been materially changed since 1907 and which sometimes made it difficult to return profits to investors. OFCs often compete to adopt legal innovations useful to investors.

Some OFCs also have Investment Promotion and Protection Agreements (IPPAs) with developing countries. These protect against expropriation risk and allow for free transfer of monies between investor and investee, among other things.

DFIs claim that by using OFCs they are usually responding to the desires of other parties in the deal. For example, in some cases, banks refuse to lend to projects in certain territories unless OFCs are used to add reassurance. Banks usually favour security over equity so that, if there is a default, they can take control of the project and attempt to recover the loan. Enforcement over shares in many developing countries is difficult and highly uncertain, and when things go wrong the banks want immediate control, rather than spending years in litigation. Hence, the banks demand security over shares in an offshore pooling vehicle, in a jurisdiction with straightforward enforcement measures.

Familiarity also matters because if investors are asked to house their money in unfamiliar jurisdictions, they may want to obtain expensive legal opinions before proceeding. Anybody setting up a private equity fund, for example, will want to minimise any such costs imposed on investors.

In some cases, DFIs and their co-investors want to create intermediate legal entities to pool their investments (and rights of ownership, control and transfer), often to enable delegation of various tasks to a single lead investor. In these cases, the features of OFCs that usually attract criticism – ‘postal box’ companies with local directors to rubber-stamp decisions for a low fee – are attractive. Investors do not want a substantial and costly company that performs meaningful operational tasks; they just want the existence of a legal entity. Sometimes, intermediate legal structures are put in place to create a legal blocking mechanism, to segregate liability between individual investments. Investors will want to prevent any local dispute over one investment having an impact on other, unrelated investments. OFCs are the obvious choice for such entities.

Of course, these and other legal requirements could also be satisfied in onshore OECD financial centres, like London, but DFIs see no developmental benefit to using more expensive legal, accounting and tax services in advanced economies. Most DFIs expressed a preference for avoiding OFCs, and spoke about how over time they hope to make more use of local legal systems in their target countries.

³⁷ Luxembourg is the most important fund domicile that is not a common law jurisdiction. Mauritius, another important fund domicile, combines common and civil law.

³⁸ ‘Mezzanine finance’ refers to hybrids of debt and equity financing.

3.2. Neutrality

The idea that OFCs provide neutral territory for investors from different countries comes up frequently in discussions with DFIs. If foreign investors are being asked to participate in a project in a country where the project sponsor is a prominent citizen or the project is connected to a state-owned enterprise, then investors may fear the local courts will have a home bias. This works both ways: the project sponsor may also fear home bias if a DFI proposes domiciling holding companies in their own OECD home territory. An OFC can be a neutral third party, acceptable to all. For investments in countries with questionable reputations for legal impartiality, this can be a deal-breaker.

Neutrality matters even for publicly owned bodies like DFIs. At least one multi-donor public entity was established in an OFC, rather than being based in the territory of one of the shareholders, because none of the contributing governments liked the idea of their taxes indirectly generating tax revenues for another government.

3.3. Private equity funds

Funds are a special case. They exist to pool investors from many countries and make investments in many others. Hence, they are offshore to all but one country. The concept of neutrality is again relevant here: if, for example,

the Dutch DFI, FMO, establishes a fund in Amsterdam, it may suit domestic constituents but it is offshore from the perspective of every other DFI which FMO might wish to attract as co-investors.

Funds have quite specialised legal requirements that even OECD financial centres may sometimes lack. For example, the Swiss DFI has set up funds in Luxembourg because Swiss law does not have all the required attributes. OECD tax systems can also be complicated, requiring a considerable amount of expensive legal advice to provide assurances to investors about tax treatment. The choice of the Cayman Islands over London, for example, is often driven by the desire to save fees, not tax.

UK dependencies like the Caymans Islands or the British Virgin Islands are much less likely to have useful treaties, but host a very large proportion of offshore funds. In the grand scheme of things, Mauritius is not a big funds centre, though it receives a lot of attention because of its importance to Africa. Popular locations for funds include Guernsey, Jersey, Singapore, Luxembourg, the Netherlands and Hong Kong. There is also a small but growing domestic private equity industry in Africa, with South Africa being the most popular domicile.

Private equity funds sometimes operate two parallel vehicles, one offshore and one onshore. The offshore structure caters to international investors, while the onshore structure caters to domestic investors. A survey

Box 2: Attempts at going onshore

DFIs would prefer to use local legal systems where possible and have invested in a few locally domiciled private equity funds in Africa and other developing regions. Countries such as Kenya and Nigeria are home to small but growing private equity sectors, but the most important onshore domicile is South Africa. But there have also been some unsuccessful attempts in more 'frontier' markets, which have served as cautionary tales in the industry.

A few DFIs supported attempts to establish a \$10 million fund for investment in small and medium-sized enterprises (SMEs) in Mozambique, but after spending two years meeting documentary requirements and securing regulatory approvals, the fund was abandoned after it emerged that the Bank of Mozambique required a local \$1 million deposit. Investors will not usually put money into a fund until its first investments are ready to execute, which may be years after the fund is set up, because money sitting in bank accounts eats into returns. The project sponsor was only willing to put up the deposit on the condition it would be returned once the fund was up and running. However, making the relatively minor changes required to arrange this meant re-starting the whole application process, which the project sponsor and prospective investors were not willing to do.

More recently a DFI explored the possibility of establishing a 'parallel' structure, whereby a Mauritian fund would have an Ethiopian counterpart. The hope was to have a share of the total capital commitments originate in Ethiopia. This would strengthen the fund manager's ties and alignment within the country. Ethiopia currently has capital regulations which prohibit local investors from participating in US dollar investments. At the same time, there exists significant capital in the country with limited options on investment instruments. To address this, a parallel Ethiopian structure investing in Ethiopian birr (ETB) was considered.

Even though the Ethiopian commercial code provides for private equity fund structures, the legal framework on this has not yet been tested and it is therefore not clear how it will function within the Ethiopian legal system. Structures of this kind have so far only been applied to professional partnerships, such as lawyers and accountants, not investment vehicles.

After a review, the DFI concluded an Ethiopian-domiciled fund was not yet viable. In addition to regulatory uncertainty, it was considered too difficult to find competent fund management services locally. There was also insufficient clarity around repatriation of funds, with local funds being invested from the same pool as international investments.

conducted in 2015 revealed that 26% of fund managers investing in Africa had used such a dual structure, and 20% an exclusively onshore African domicile (EMPEA, 2015b).

The basic functions that funds need to perform, with the minimum of difficulty, are capital increases and decreases (accepting money from investors and paying it back out), and converting and distributing currency. Many developing countries have strict controls on foreign exchange transactions and may require a letter of permission from the ministry of finance or the central bank. Others have strict rules governing capital increases and decreases. DFIs have attempted to establish private equity funds outside the usual OFCs and their negative experiences serve as cautionary tales within the industry.

3.4. Cost and convenience

Often, using local legal systems may be possible, but the requirements are much more onerous and time consuming. But shouldn't DFIs be expected to bear the burden of the extra costs involved for the benefit of local development? This leads on to the question of whether avoiding OFCs would have a greater development impact, perhaps in the form of more tax revenue. The next section presents the argument made by DFIs that this is typically not the case. Supposing for the sake of argument that using local legal systems with onerous procedures would confer some sort of developmental benefit, then DFIs face a trade-off similar to that between taxing investors and attracting investment. DFIs themselves only have finite staff resources and can achieve more if each project demands fewer internal resources. They are also trying to attract private investors who can choose to invest their money anywhere in the world, and who do not need to make investments where the associated administrative costs are especially high.³⁹ So DFIs regard using OFCs to reduce the difficulty and cost of investing in frontier markets as perfectly legitimate – with the proviso that by doing so, they are not also depriving developing countries of taxes or undermining local capacity development.

Costly inconveniences are especially important for small private equity funds set up to target SMEs in developing countries. Such funds are widely seen as the type of investments that DFIs ought to be making to have the greatest development impact. These funds must cover their costs from the returns they make on investment, while still offering investors sufficiently high returns to attract their money. This is a classic 'fixed costs' economies of scale problem. For a large fund, administrative costs and professional services fees are immaterial; for a small fund, they can absorb a high share of the fund's income. Imposing higher costs on such funds would push up the returns they require from their investees, thereby shrinking the set of viable investments and the quantity of much-needed investment in smaller businesses in developing countries.

3.5. Capacity building

Imports give countries access to things they cannot produce domestically but competition from imports may also stifle domestic production. Some tax campaigners argue that, as agents of development, DFIs should invest directly and rely on local judiciaries and legislation, and thus build domestic institutional capacity. It is, however, not obvious that direct investment is an effective means of building capacity – there should be no presumption that merely using a system will help to change it. DFIs have tried to invest directly in challenging places before, which has not always turned out well, and there is no reason to think these experiences spurred local institutional change.⁴⁰ Moreover, whilst a case could be made in some countries, in others it would be irresponsible to place public money at the mercy of incompetent, inefficient and corrupt systems.

These questions will be picked up again in the discussion section, under the heading 'Taking the world as they find it or building capacity', where it will be argued that DFIs should act as pioneer direct investors in countries that are trying to improve their investment environment, but that this does not necessarily imply they should stop using OFCs.

39 Investors will be willing to bear high costs if the returns are also high. However, DFIs do not want to limit foreign investments in capital-scarce developing countries to only those where investors make high returns.

40 There is no evidence either way.

4. The economics of taxing capital income

Before tackling the question of whether OFCs are being used to deprive developing countries of their taxing rights, this section examines the economic consequences of taxing capital income.

On the narrow question of taxation, the case against using OFCs can be broken down into three steps: capital income should be taxed; it should be taxed at source; OFCs are used to avoid such taxes.

Each of these steps can be challenged, but a response to the first two points – possibly the correct response – is that taxes are a sovereign decision: if a country wants to tax capital income at source, then those taxes should be paid regardless of beliefs about whether doing so is in the country's best interest. This line of argument does not settle matters because how a country wants to tax foreign investors is expressed in the tax legislation, and treaties and tax incentives that OFCs utilise. So DFIs can argue that if what they are doing is legal, then they are respecting sovereign decisions. DFIs argue that when a developing country signs a tax treaty with an OFC, offering reduced rates of withholding tax or capital gains tax, it knows what to expect.⁴¹ African countries do not sign tax treaties with Mauritius because they are hoping to attract Mauritian investors; they are hoping to attract international capital routed through Mauritius. Yet some DFIs, and many tax campaigners, feel the idea that 'anything legal is acceptable' is inadequate and that development actors have a duty to help shift the balance of capital income taxing rights back towards source countries.⁴²

Questions around sovereignty are addressed below, but setting them aside for now, it is worth considering the economics of capital income tax because some interviewees suggested that using OFCs to reduce capital income tax rates may be desirable from a development perspective.

It is 'folk economics' that capital should not be taxed to maximise productivity over the long run. This is a misconception. That said, conventional wisdom among economists has been that taxes on capital income come at a high price in terms of economic efficiency, especially when capital is mobile and can easily be relocated to lower-tax territories.⁴³ In theory it would be desirable to tax immobile capital more heavily than mobile; Dharmapala (2008) argues that the combination of OFCs and tax treaties effectively allows countries to do just that.

Some of the highly simplified theoretical models which suggested that a zero rate of capital taxation is optimal, turn out to have been misunderstood, and actually implied positive rates of capital taxation (Straub and Werning, 2014). Other 'zero tax' results may rest on unrealistic assumptions, such as labour income being the only source of inequality. It does not take many theoretical steps towards greater realism, including the idea that capital ownership is highly concentrated and society may have some interest in equity, to imply that capital income could optimally be taxed as highly as labour income (Saez and Stantcheva, 2016).

More importantly, such theoretical treatments are unsuitable for analysing taxation in developing country contexts, because they abstract away from the problems of tax administration in low-capacity environments, in economies with large informal sectors and narrow tax bases. In these circumstances, it may be necessary to sacrifice 'production efficiency' (taxes that confer the right incentives to maximise productivity), for the sake of 'revenue efficiency' (the ability to raise revenues when constrained by administrative capacity) (Best et al., 2015). The International Growth Centre calls this 'third-best' taxation and it implies that potential sources of revenue

41 This view is contested by scholars, who point out that many treaties are very old and hard to change, and failed to anticipate the realities of contemporary cross-border investment. Negotiators may also be inexperienced and under-resourced.

42 For example, in the context of the tax behaviour of the underlying businesses that they invest in, a number of DFIs now conduct a subjective review of whether the business is shifting profits to low-tax jurisdictions, which may then become a reason to stipulate changes as a condition of investment, even if those transactions are wholly within the law.

43 See Roger H. Gordon 'Capital income taxes' NBER Reporter: Research Summary Fall 2003, for a good statement of the consensus view. Economists also point out that when taxes reduce investment it is not just the capitalists that suffer, but also workers.

where relatively large sums can be collected from relatively few transactions (such as the capital gains of foreign investors) may be especially valuable in developing country contexts.⁴⁴

It is impossible to say quite what the optimal rate of tax on capital income is, but the point to take away is this: if there is a trade-off between the need to raise tax revenues and the need to attract investment, and if the socially desirable point on this trade-off implies a positive rate of capital taxation, then, at the optimum position, taxes will have a negative impact on the quantity of investment, and that's how it should be. Put differently, a DFI might truly say that by using OFC structures to reduce tax liabilities they will increase the quantity of investment, but that this does not necessarily always justify doing so. Publicly-owned development agencies should be doing what is socially optimal and that may not coincide with maximising the quantity of investment.

Of course, this is begging the question of whether DFIs are using OFCs to reduce tax liabilities, which DFIs argue is typically not the case.

4.1. Empirical evidence on the trade-off between taxation and investment

If investors are using OFCs to reduce the taxes they pay on capital income at source, then by refusing to use OFCs, DFIs would raise the effective tax rates paid by their fellow investors. On the basis that investors care about post-tax returns and have thresholds below which they will not invest, this would increase required rates of pre-tax returns and thus reduce the set of viable investment projects.

Research into the empirical relationships between taxes and investment is voluminous and has produced a bewildering set of estimates, covering different varieties of tax and different varieties of response.⁴⁵ In this context, what matters most is the relationship between the taxes that source countries charge on the capital income of foreign investors and the quantity of investment in those countries. This question can be approached by looking at the impact of statutory rates, tax treaties or deal-specific tax incentives.

The taxes that corporations pay on their profits are also relevant to the returns that ultimately flow back to investors, but are not affected by using OFCs as the location of holding companies or funds. Unfortunately,

most empirical research into the responsiveness of FDI to taxation uses corporation taxes, not the withholding taxes and capital gains regime relevant in this setting.⁴⁶ The bulk of research tends to find that corporate tax cuts have a strong and robust impact on the quantity of inbound FDI.⁴⁷

The literature on the impact of bilateral treaties on investment is inconclusive. Busse et al. (2010) found that treaties do attract investment to developing countries, although whether tax rates or other attributes such as dispute resolution mechanisms are responsible, is not clear. The authors argue that other negative results reflect differences in sample or methodological problems.

The view from International Financial Institutions is that tax incentives are costly and inefficient, and evidence from surveys often finds them to have been redundant (IMF, 2015). The evidence supports DFIs' claim that investors are often offered tax incentives that can render any advantages that OFCs offer unimportant; over 80% of developing countries offer investors some form of tax holiday (*ibid.*). Tax incentives are found to be more effective in attracting 'mobile' and 'efficiency seeking' investments that are not drawn to the attributes of any one country (as opposed to investment that exploits local resources or access to local markets).

It is not easy to translate empirical evidence based on aggregated investment data to the specific context of DFIs. If research finds that overall levels of investment are relatively unresponsive to tax rates, it may be because many investment opportunities offer pre-tax returns that are far above investors' relevant thresholds; only a few projects are on the margin where small changes in tax rates make the difference between being viable or not. But by their nature, DFIs (are supposed to) operate at the margin where investments need some assistance to get over the threshold of commercial viability, and could easily fail to get there if additional impediments are placed in front of them.

Although DFIs argue that their use of OFCs typically does not serve to reduce effective source country tax rates on capital income, there is *prima facie* plausibility to the argument that the level of investment they can conduct, and hence their ability to fulfil their development mandate, would be more sensitive to effective tax rates than the empirical evidence (based on aggregated investment data) suggests. There is no empirical evidence concerning the

44 First-best taxation is utopian and may involve taxing unobservable quantities such as 'ability'; second-best taxation confines itself to taxing things that tax inspectors can realistically measure; third-best taxation is a term coined by the International Growth Centre (ICG) (Kleven et al., 2016).

45 See Mooij and Ederveen (2008) for a survey.

46 In the context of domestic investment, Yagan (2015) found dividend tax cuts had no impact.

47 However, as tax campaigners are at pains to point out, this is not synonymous with being economically beneficial. Becker et al (2012) show how the effect of tax cuts on the quantity and quality of FDI may move in opposite directions. For an example of how tax campaigners view the issue of corporate taxation, see 'Ten reasons to defend the corporate income tax' by the Tax Justice Network.

responsiveness of investment to taxation specifically for the set of investments relevant to DFIs.

It is worth stressing, however, that if the investments that DFIs target are highly sensitive to tax rates, this would not in itself legitimise avoiding taxes that sovereign nations have chosen to impose. Nonetheless, the fact that DFIs deliberately target investments that are just below the cusp of commercial viability may justify using OFCs to reduce legal and administrative costs that similarly reduce returns to investors and push some projects below required returns thresholds.

4.2. Which rate should be paid?

Vervynckt (2014) argues that ‘DFIs should respect the tax system in the developing countries in which they – or their clients – operate, and accept that this might result in a lower return on their investments’. But how does the position that taxation is a sovereign decision that DFIs should respect, regardless of opinions about the economic implications, deal with the problem that there is no single legally required rate of capital income tax? Different rates will be payable under different structures, all of them legal, all of them reflecting sovereign decisions.

If we require DFIs to respect sovereignty and pay whatever taxes national legislation requires, it is hard to see how, in practice, this differs from the rule that anything legal is acceptable. If national legislation stipulates that different taxes are due under different cross-border structures, including direct investment from onshore OECD financial centres, respecting sovereignty does not rule out using tax treaties in the way the signatories presumably intended. It is one thing to argue that DFIs should respect sovereign decisions, it is another thing to argue that DFIs must look across the set of possible legal tax structures and pick one that would result in relatively high-tax liabilities. An OFC may confer a tax advantage relative to some alternative structures, but not others. The question of which counterfactual to judge the use of OFCs against will be tackled in the next section.

However, it is perhaps inconsistent for DFIs to argue that political and economic institutions in target countries are so inadequate that the use of OFCs is justified, while taking the stance that anything legal is acceptable because existing tax legislation is the perfect manifestation of sovereign will. Institutional inadequacy implies that DFIs and other investors with developmental objectives might not always want to take advantage of the opportunities afforded to them by a country’s tax legislation. Hence,

Box 3: BIO and the tax haven blacklist

One DFI that has come closest to banning the use of OFCs is the Belgian Investment Company for Developing Countries (BIO), which is prohibited under Belgian tax law from using entities based in jurisdictions considered tax havens, including Abu Dhabi, Dubai, Guernsey and Jersey, among others.

BIO executives, and others who have observed its activities, were positive this has constrained BIO’s ability to execute its mandate. This means BIO has been unable to invest in some projects that it would have otherwise chosen, if its only objective had been to maximise its development impact. However, BIO is a relatively small DFI, so has been able to maintain a reasonable level of business fishing in a smaller pool. Hence its experiences do not tell us much about what the consequences would be if many, or every, DFI did the same.

There have been examples in which BIO has removed a proscribed OFC from the structure of a deal and replaced it with a Belgian holding company, only to benefit from a more advantageous tax treaty between Belgium and the source country in question.

whilst it could be perceived as paternalistic, there is a case to be made that DFIs should look across the set of possible legal tax structures and sometimes reject those where taxes are too low.⁴⁸ Requiring DFIs to exercise subjective judgement could also legitimise using OFCs to avoid certain taxes: if we want DFIs to avoid legal arrangements where taxes are deemed to be egregiously low, then ought DFIs not also be permitted to avoid taxes that are deemed egregiously high?

4.3. Inconclusion

There is no consensus among DFIs on these issues. The type of policy DFIs should adopt towards OFCs hinges on whether one thinks they ought to regard the law as an adequate benchmark for acceptable tax behaviour. Some DFIs state they will not accept structures created for tax purposes; others see (for example) treaty shopping by funds to minimise withholding taxes as perfectly legitimate. Some see a grey area of legal yet potentially undesirable arrangements, others see things in black and white.⁴⁹

Some interviewees suggested that if legislation allows investors to reduce their capital income tax liabilities

48 It would be interesting to know how citizens of developing countries view these questions – would they object to DFIs thinking they know better than local politicians or would they agree that the right thing to do is regard tax legislation as flawed?

49 More precisely, there can sometimes be uncertainty around whether certain structures are legally entitled to the tax benefits that they are claiming, and even those DFIs inclined towards a black and white view of the world will avoid structures at risk of litigation; but if the legal position is clear, they are considered acceptable.

Box 4: A grey area: avoiding Nigerian mortgage tax

In most OECD countries, the act of securing a debt against assets is not taxable (or subject to a small fee). In Nigeria, a tax equal to 5% of the asset is charged; other African countries have similar taxes. Banks routinely secure debts against collateral, and if charged 5% for doing so, will pass that cost on to the borrower. To avoid this tax, a holding company in an offshore financial centre can be established and the bank can lend against shares in this company, which it would seize in the event of a default on the loan. Another way of avoiding the tax is to understate the value of collateral and only correct this undervaluation in the event it is called up (which is apparently possible under Nigerian law).

This situation comes up in the context of renewable energy investments where loans are secured against expensive physical assets. When the 5% charge on those assets is added to the costing models used to set prices, it will be translated into higher energy tariffs, which works against the DFIs' objective of bringing power to the Nigerian economy as cheaply as possible. Because the charge is passed on in prices, returns to investors are unaffected. Of the DFIs interviewed, most said they would choose the structure that avoids the tax because they regard supplying power at a lower price as more important. But generating revenues for the Nigerian government is also an aspect of development impact, so this decision is open to question.

by routing investments through OFCs, the presumption should be that that is intentional, and it is not the place of DFIs to challenge these decisions. Many interviewees argue that if countries do not want foreign investors taking interest income in jurisdictions where withholding taxes are reduced by treaty, or if they want to tax capital gains arising from assets located in their borders, regardless of the jurisdiction where the sale takes place, it would be straightforward to amend the relevant legislation. If they lack the technical capacity, plenty of bilateral donors and international financial institutions would be happy to supply it; but this is not the job of DFIs.

If we accept that legislation governing the taxation of cross-border investments is flawed, DFIs argue that the appropriate solutions are legislative. For example, after some contentious legal disputes, the 2017–2018 Indian budget proposes tightening and clarifying legislation that makes the indirect sale of assets located in India, but held offshore, liable to taxation.⁵⁰ Other countries could follow this example if they wished to. However, India also proposes to exempt certain categories of foreign portfolio

investors from the indirect transfer provision, and DFIs would argue it is perfectly legitimate to take advantage of these provisions, if they apply.

An alternative perspective is that developing countries are trapped in a 'race to the bottom' and cannot afford to unilaterally change their laws to raise the taxes paid by foreign investors. Therefore, some form of coordinated action is required and – despite the appearance of neo-colonialism – DFIs could have some role to play in pushing things in that direction. The view expressed by DFIs, that anybody signing a bilateral treaty with an OFC knows what to expect, is hotly contested by tax campaigners. They claim treaties are frequently signed by politicians who have been lobbied by corporate interests, with no understanding of the consequences, and without consulting their own tax authorities. They say African nations have been bamboozled by Mauritius into signing inappropriate treaties. So, developing countries are stuck with treaties they would prefer to change but lack the political space. Others, however, consider this view to be grossly patronising.

50 See 'India's 2017-18 budget includes major international tax changes', *Multinational Tax and Transfer Pricing News*, 1 February 2017.

5. Are offshore financial centres being used to avoid taxes?

This chapter will analyse how the tax treaty networks of OFCs differ from those of OECD countries, and discuss the instances where DFIs say they use OFCs for tax purposes.

The DFIs interviewed for this paper all claimed that for their investments, OFCs are not typically used to confer source country tax advantages, although DFIs also recognise that sometimes OFCs do reduce source taxes on capital income.

No quantitative evidence is available to answer the question posed in the title of this section. At the time of writing, none of the DFIs have data on effective source country tax rates paid by all investors in each project, matched to the use of offshore structures, available for public consumption – effective tax rates paid by private co-investors is confidential. Data on taxes paid by DFIs themselves in source countries would be helpful but insufficient, because they may differ from taxes paid by co-investors. For example, a DFI can provide a loan into a structure designed to confer tax advantages to private equity investors.

When using OFCs, it is not always clear what the right ‘counterfactual’ for comparing tax payments against would be. In the context of profit-shifting by multinationals, researchers often compare reported taxes against a counterfactual based on profits being aligned with indicators of economic activity, such as assets or employees (Dowd et al., 2017). The most natural counterfactual to set against investors’ use of an intermediary OFC is a direct investment. But DFIs often want to use a pooling vehicle for ease of management, so a counterfactual of multiple investors, each investing separately and directly in the target enterprise, is not obviously relevant. When a pooling vehicle is involved, this raises the question of whether the right counterfactual is a pooling vehicle domiciled in the country where the target enterprise is located, or in an OECD member country where a pooling vehicle would most likely be based, if an OFC was not used. However, OFCs are typically used when the legislation and institutions of host countries are deemed unsuitable for pooling vehicles.

5.1. What does ‘tax advantage’ mean?

Table 1 below illustrates some hypothetical scenarios, comparing the withholding taxes required (e.g. on dividends) under a tax treaty with an OFC against six onshore OECD jurisdictions. In which of these scenarios does the OFC confer a tax advantage? In scenario A, it plainly does. In scenario E, it plainly does not: it would be perverse to evaluate tax liabilities against a single outlier. The scenarios between are ambiguous. In scenario B, if DFIs based in the six OECD countries were stopped from using the OFC, they may invest via a pooling vehicle in country 1 or 2. Judged relative to that, the OFC confers no tax advantage; but, seen differently, it is one of three jurisdictions that confer a tax advantage.

Table 1: When does the OFC confer a tax advantage?

	A	B	C	D	E
OFC	5%	5%	5%	5%	5%
OECD 1	15%	5%	5%	5%	5%
OECD 2	15%	5%	5%	5%	5%
OECD 3	15%	15%	5%	5%	5%
OECD 4	15%	15%	15%	5%	5%
OECD 5	15%	15%	15%	15%	5%
OECD 6	15%	15%	15%	15%	15%

Which is the correct perspective? If what we are interested in is the amount of tax investors would actually pay if they stopped using OFCs, then the right counterfactual is what they would actually do instead, not what observers might prefer them to do.

The core argument that DFIs present – that the use of an OFC rarely deprives source countries of taxing rights – is based on the assumption that the alternative to using an OFC is usually an OECD jurisdiction with an equally advantageous tax treaty (and that in some source countries no attempt would be made to tax non-residents’ capital

income, whether by dint of legislation or project-specific tax incentives).

In the real world, choices are more constrained because not all OECD jurisdictions are equally suitable for housing pooling vehicles (and may come with other regulatory or administrative burdens). Germany, for example, has some favourable treaties but its laws dissuade non-resident investors from using it as a base. With access to sufficient data, there may be methods for estimating the impact of OFCs on the tax revenues of source countries without having to postulate what alternative arrangements would look like if OFCs were not used. Otherwise, identifying a relevant counterfactual is likely to involve close familiarity with the deal and require subjective judgements.

Most DFIs emphasised that archetypal ‘tax havens’ tend to have fewer treaties with developing countries than OECD nations. The Action Aid tax treaty dataset (Hearson, 2016) supports this claim. The dataset only includes a handful of OFCs and only looks at treaties with low- or lower-middle-income countries. The dataset contains 14 financial centres which would fall under popular definitions of a tax haven.⁵¹ Excluding Mauritius, each jurisdiction had an average of four treaties in force when the dataset was created. These are concentrated in four countries: Kuwait, Singapore, Seychelles and the United Arab Emirates, each of which have around 10. The average for OECD countries is 11.

5.2. Mauritius

Mauritius is a special case. It has 16 treaties in the Action Aid dataset, and more signed and waiting to come into force. It markets itself as the ‘gateway to Africa’ and is frequently used by DFIs and other investors seeking access. The African Development Bank insists that any investment it participates in is domiciled in Africa, and when investing in African countries deemed to have inadequate local laws and institutions, Mauritius is typically the default choice.

Table 2 compares withholding taxes on dividends from FDI under treaties with Mauritius against treaties from the OECD countries with a DFI. In some senses, this comparison is unfair: most OECD treaties are old and the withholding rates in new treaties have been trending downwards for years (Hearson, 2016). Any country recently agreeing a new treaty would probably look more advantageous judged against OECD treaties, not just jurisdictions trying to become a tax haven. This means that investors shopping for favourable treaties are more likely to choose recently signed treaties.

Table 2 shows that Mauritius typically offers the lowest available withholding rates on FDI dividends, and in six

cases (highlighted) it is not possible to match that rate by investing from an OECD country.

How often routing investments via Mauritius reduces the taxing rights of these lower-income source countries depends, among other things, on whether tax incentives have been offered to foreign investors that override treaty rates. Not every investment routed via Mauritius is destined for a country with a treaty in force (because Mauritius may be used for other reasons and not every Mauritian entity is eligible for treaty benefits). However, the data illustrate how routing investments via Mauritius can sometimes result in lower capital income tax liabilities in source countries than via other alternatives. The flip side of this is that, despite its treaty network, for most African countries Mauritius does not offer the lowest source country tax rates, so when used for investment in those countries minimising source country taxes is not the motivation.

Box 5: Norfund and offshore financial centre restrictions

Following a public commission that in 2009 proposed stricter restrictions on Norfund’s use of OFCs, the Norwegian government imposed new guidelines: Norfund could only invest via countries in the OECD or countries with which Norway had a tax (or tax information exchange) agreement. The guidelines prevented Norfund from investing via, among others, Mauritius, with which Norway at that time had no tax information exchange agreement.

The practical consequences of limiting the use of OFCs made it more difficult for Norfund to invest in a number of enterprises in Africa. During 2010 and 2011, no new investments domiciled in Mauritius were made. Norfund made fewer fund investments than planned in Least Developed Countries (LDCs) and sub-Saharan Africa, and issued more loans compared to equity. Investments in SME funds and in the agribusiness sector were particularly adversely affected.

However, one fund investment in Africa that was close to being finalised when the new restrictions came into force was successfully moved from Mauritius to the OECD member, Luxembourg.

A tax information exchange agreement between Norway and Mauritius came into force in May 2012. Consequently, Norfund was again allowed to invest via companies domiciled in Mauritius. Norfund’s equity investments in sub-Saharan Africa and LDCs have subsequently increased.

⁵¹ Bahrain, Barbados, Brunei, Hong Kong (China), Kuwait, Luxembourg, Macau, Malta, Mauritius, Monaco, San Marino, Seychelles, Singapore and United Arab Emirates.

Table 2: Mauritian tax treaties compared to OECD treaties

	Mauritius	Belgium	Canada	Denmark	Finland	France	Germany	Italy	Netherlands	Norway	Portugal	Spain	Sweden	Switzerland	UK	USA
Bangladesh	10	15	15	10		10	15	10	10	10			10	10	10	12.5
Benin										18						
Cameroon			20													
Cape Verde											10					
Congo (Dem. Rep.)		10														
Congo (Rep.)	0					15	8									
Ethiopia						10	10	5	5						10	
Gambia									5				5		0	
Ghana	5	5	5		7.5	5	5	5					5	5	6.25	
Guinea						15										
Guinea-Bissau											10					
Ivory Coast		15	15			15	15	15	15					15	15	
Kenya	5		15	20		10	15	15	15				15		15	
Lesotho	10														10	
Liberia							10									
Madagascar	10					15										
Malawi									5							
Mongolia		5	5			5	5	5						5	5	
Mozambique	8						15			10						
Nepal	5								5							
Nigeria	7.5	12.5	12.5			12.5			12.5			7.5	7.5			12.5
Pakistan	10	10	15	15	12	10	10	15	10	10	10	5	15	10	15	
Papua New Guinea			25				15									17
Philippines		10	15	10	15	15	7.5	15	10	15	10	10	10	10	15	20
Rwanda	10	0														
Senegal	0	16	16				15	15	16	16	5	10				
Sri Lanka	10	15	15	15	15	15	15	15	10	15	10	10	15	10	15	15
Sudan																15
Swaziland	7.5															
Tanzania (United Rep.)			20	15	20		10	10	20				15			
Timor-Leste																
Uganda	10	5		10			15	15	0	10						15
Viet Nam		5	10	10	10	10	5	10	5	10	10	10	10	7	7	
Zambia	5		15	15	5		5	5	5	15			5		5	
Zimbabwe	10		10			10	10	10	10	15	10		15		5	

Source: Hearson, M.

5.3. Development Finance Institutions do not refuse tax advantages

All the DFIs were asked to imagine the following scenario: An investment team brings you a proposed deal that uses an OFC, perhaps for a holding company for an operating company in Africa or a private equity fund targeting Africa. This location (A) has the following features:

1. There is a valid non-tax reason for being there.
2. It is on the Global Forum or your DFI-specific white list.
3. It confers some sort of advantage with respect to taxes at source.

Tax ‘advantage’ is taken to mean more than merely avoiding an additional layer of taxation in a pooling vehicle; it confers some sort of an advantage in comparison to a direct investment (this is a benchmark; we are assuming here an OFC is being used because direct investment is not feasible).

Now suppose that another location (B) also exists which also has features (1) and (2) but does not confer the same tax advantage (3).

The DFIs were then asked the question: Have you ever made using B a precondition of your participation?

All DFIs responded ‘no’, although they all said this situation rarely arises (because DFIs may be using an OFC that confers no tax advantage or because ‘B’ does not always exist). Interviewees also said that when they are involved in the early stages of a project where an OFC is deemed necessary, then they do sometimes push for ‘better’ choices, but they are often being asked to invest in structures that have already been chosen by the entrepreneur or project sponsor. The above scenario would not constitute a red line, especially when they are trying to ‘crowd in’ private investors. The question of how much leverage DFIs have over project structure will be discussed later.

When DFIs have refused to invest in structures that use an OFC with tax advantages, it has been because they served no reasonable non-tax purpose.⁵² Most DFIs recognised that the question, ‘Does this structure serve a legitimate non-tax purpose?’, is a test that is hard to fail, because by their nature OFCs offer better-developed legal environments than most LDCs. They also emphasised that their procedures must permit the use of OFCs to meet the legitimate legal requirements of investors.

Most DFIs say that they prefer not to use OFCs, but if it comes down to a choice between using an OFC to facilitate an investment (and hence creating jobs and generating corporation and payroll taxes) and refusing to use an OFC (and hence losing the deal), there is no contest. Taxes paid

by investors on capital income are relatively low down the list of priority development outcomes (they are often much smaller sums than other taxes generated by investments).

5.4. Capital gains

Data concerning the taxation of capital gains is harder to come by. The Action Aid dataset contains a binary indicator to show whether a treaty contains a provision that allows for the taxation of capital gains arising from the indirect sale of ‘immovable’ assets in a source country (such as a mine or a hotel) or an enterprise more generally. Around half of the treaties in the dataset allow for source taxation of capital gains from indirect transfers of immovable assets and around a third for enterprises in general. DFIs say they rarely invest in immovable assets (although some countries classify wind farms as immovable, which is increasingly an important area for DFIs).

There is a trend for countries to claim more capital gains taxing rights: countries with no capital gains taxes for non-residents are introducing them; countries that tax capital gains but not on indirect transfers are moving towards extending it to indirect transfers.

All DFIs were asked the same question as above, with respect to the use of OFCs where capital gains are exempt from taxation at source (perhaps by treaty or because they facilitate the indirect sale of assets) and again all DFIs responded that they would not rule out such a structure, if it also served a non-tax purpose.

5.5. When offshore financial centres are used for tax purposes

DFIs use OFCs for tax purposes in a manner that they consider legitimate. Many DFIs benchmark their tax arrangements against the taxes that they would pay if they invested directly. This also seems to be the benchmark that tax campaigners have in mind: they would prefer DFIs to invest directly without using an OFC. DFIs regard it as quite legitimate to use an OFC to avoid creating an additional tax liability because, for business reasons, they have chosen to collaborate with other investors and establish a pooling vehicle.⁵³

The principle here is that capital income should be taxed at source and at residence, as required by relevant legislation; but when capital income moves up through a holding structure, as it flows back to investors, there should be no additional taxation en route. This is a basic requirement for private equity funds.

52 And, from time to time, project sponsors propose something of dubious legality, which DFIs will also refuse to participate in.

53 There are many reasons why DFIs want co-investors. The most basic one is that having smaller shares in many companies is less risky than having large shares in a few companies. DFIs are also encouraged by their shareholders to mobilise private capital to invest alongside them.

DFIs may also use OFCs to preserve their tax exemption, when there are perceived gaps in legislation. For example, both Norfund and CDC are exempt from taxation at residence, but if they jointly establish a subsidiary, it is not tax exempt. Neither DFI wishes to use its public funds to pay taxes into the other's Treasury. Therefore, when Norfund decided to acquire a 30% stake in the power company, Globeleq Africa, and CDC also decided to acquire a direct 70% stake, having previously owned an interest in the company via an infrastructure fund, they did so using a holding company domiciled in Guernsey. This meant they did not have to use public funds to pay VAT on a considerable professional services bill that would otherwise have been due if they had used a holding company domiciled in London. This arrangement, of course, complies with the letter of the law,

but also (arguably) with the spirit: the UK and Norwegian governments have no wish to tax CDC or Norfund, but the legislation which granted them tax exemptions did not anticipate them establishing joint ventures with other publicly owned DFIs.

The question in the title of this section – are OFCs being used to avoid taxes? – has not been answered satisfactorily. The consensus view expressed by DFIs is that their use of OFCs is not typically motivated by the desire to reduce tax liabilities on capital income at source, although they do sometimes have that effect. The crucial claim is that if DFIs did stop using OFCs, the increase in tax revenues experienced by developing countries would be small, even if the quantity of investment was held constant. There is no quantitative evidence to support that claim, but the arguments seem plausible.

6. Transparency

Campaigners are at pains to point out that the problems created by ‘tax havens’ go far beyond tax; the Tax Justice Network prefers the term ‘secrecy jurisdictions’.⁵⁴

In this context, there are two relevant aspects to transparency: do source country tax authorities know everything they need to know to collect taxes due and should the identity of DFIs’ co-investors be public knowledge? Tax evasion aside, if OFCs are being used to reduce capital income taxes at source, it is not because of a lack of transparency – it is because of bilateral tax treaties which are public knowledge.

If we consider the possibility that source tax authorities may lack the information they need, using OFCs that have bilateral treaties with the source country actually helps to improve transparency, because treaties typically contain exchange of information provisions, whereby information is provided either on request or automatically. Treaties may also include ‘assistance in the collection of taxes’ provisions, whereby the residence tax authority will collect taxes on behalf of the source if, for example, the recalcitrant taxpayer has sold up and left the source country.

It is usually the responsibility of the taxpayer themselves to report to the tax authorities. When the underlying investee – a company in a developing country – pays dividends or interest to non-resident investors, they should report these payments to their domestic revenue authority so that they can charge any withholding taxes that are due.⁵⁵ The transparency of the jurisdiction where that capital income is being paid may be relevant if the tax authority needs to verify the information and identity recipients. When shares in a company are sold, the company should notify the domestic shareholder register and this should trigger an assessment by the tax authority of whether capital gains taxes are due.

Problems arise when the sale is indirect, so that the name on the shareholder register has not changed (but a holding company has changed hands higher up the structure). If the seller is anonymous, there may be no way for the tax authority to go after capital gains, if due. Although the information may be provided to tax authorities if they request it, automatic exchange of information as currently conceived would not prompt the

source country tax authority by informing it of an indirect sale (the flow of information is from source to residence, not residence to source). Registers of beneficial ownership – public, automatically exchanged or readily available to tax authorities on request – would enable tax authorities to look for changes of ownership above the level of the holding company on their domestic shareholder register. This issue is not unique to OFCs: until recently, most financial centres would not have made such information available.

Interviewees argued that DFIs’ fellow investors are typically institutions (such as pension funds, insurance companies and endowments) that would not risk illegally concealing capital income (tax evasion). The picture gets murkier in the case of private individuals (who may invest via intermediate entities), who occasionally participate in DFI investments, and some of who may attempt to evade taxes at residence. New evidence combining random audits with leaks from OFCs and population-wide wealth records in Scandinavia has revealed that individual tax evasion rises sharply with wealth (Alstadsæter et al., 2017). But other than in cases of ‘round-tripping’ – where a domestic investor routes their money via an OFC and back into their own country – any reduction in tax evasion as a result of greater transparency, would benefit OECD countries where DFIs’ high net worth investors tend to be resident. Progress towards automatic exchange of information, combined with anti-avoidance clauses in treaties, should make round-tripping less problematic. However, it is likely to be a long time until the countries where DFIs invest have automatic information exchanges up and running with the OFCs that DFIs use.

These problems would not obviously be solved by a blanket ban on OFCs, which are not always the worst offenders (a fact that the Tax Justice Network’s secrecy index attests to). Although the picture varies from country to country, most DFIs will not invest through jurisdictions that are not compliant with the OECD Global Forum on Transparency and Exchange of Information peer review process. Oxfam (2016) explains what this means in more detail. Most tax campaigners argue that the objective is to increase transparency across the system rather than push investors towards onshore OECD financial

⁵⁴ <http://www.taxjustice.net/faq/tax-havens/>

⁵⁵ This is a question of domestic law. If a payment to investors is taxable under domestic law, there will also be a legal responsibility to report it.

centres; although blacklisting particularly uncooperative jurisdictions may be part of the solution. In the long run, the solution is to automate the exchange of information between LDCs and all financial centres. Progress on this front is slow, but would not be accelerated if DFIs stopped using OFCs. Some recommendations regarding how DFIs might play a more constructive role will be made in the concluding section of this paper.

DFIs are often called upon to ensure that all ‘beneficial ownership’ information (the identity of the ultimate owners of investments) is made public, for all the investments that they are involved in. Ownership information is tremendously important in the wider illicit flows agenda. Anonymous shell companies are the favoured tool of money launderers. There are other reasons why ownership matters: for example, it may transpire that a company’s trading partners secretly have the same owner and have been passing-off related-party transactions as arm’s length.

The DFIs interviewed argued these sorts of concern are less relevant to them. If an OECD-based high net worth individual puts money into a private equity fund targeting African SMEs, where is the risk in keeping their identity secret? Fund managers do not want their competitors seeing who their investors are, for fear they will try to poach them; and investors sometimes do not want their identities known either, because they do not want rival fund managers bothering them, angling for business. Some well-known philanthropists always invest anonymously. Institutional investors may wish to keep their asset allocation decisions secret. DFIs also pointed out that

confidentiality clauses are routinely present in contracts and, in many cases, they would not be able to divulge the identities of their fellow investors.

The risks of secrecy are more obvious when secret shareholders are prominent individuals from countries or regions where the underlying investment is located. DFIs all have procedures for dealing with politically exposed persons (PEPs) and will not invest if they identify a risk.⁵⁶ But there may be situations where individuals are deemed acceptable following PEP screening but where there would, nonetheless, be a public interest in having their participation in investments known to the local population. Developing countries are often characterised by the politics of patronage, and business and politics are often intertwined. Citizens have valid reasons to want to know the identity of individuals who own large enterprises in their countries. The case for transparency of beneficial ownership seems strongest when DFIs are involved in large direct investments.⁵⁷

From the point of view of DFIs, insisting on deviation from market norms on confidentiality would mean putting another impediment in front of investors they are trying to attract. Some DFIs believe that insisting on public disclosure of beneficial ownership would have a major impact on their ability to ‘crowd in’ private finance; others argue that only a few investors would be troubled by it. None have put the idea to the test. Again, this is an area where some DFIs argue the proper solutions are legislative and it is not their job to push beyond what is required by law.

⁵⁶ Funds present a problem because DFIs delegate due diligence and AML/KYC checks to the fund manager, which must comply with the AML/KYC regulations applicable to the fund. Some non-governmental organisations (NGOs) have suggested that DFIs should insist that the funds they support divulge beneficial ownership information for all the business they invest in.

⁵⁷ A counter point is that individuals living under a predatory state have good reason to put assets beyond its reach.

7. Discussion

This section reflects on the arguments presented thus far from a wider perspective and represents the views of the author, not of the DFIs interviewed. It begins by considering the argument that DFIs are legitimising tax havens. It then considers whether DFIs have a duty to rely on local institutions because they should be trying to build local capacity. Finally, it shows how DFIs may face a collective action problem.

7.1. Signalling: legitimising tax havens

The harm done by OFCs is hard to deny; although the magnitude of harm is contested. Zucman (2015) estimates that 30% of Africans' and 22% of Latin Americans' financial wealth is held offshore (the figures are 10% and 8% for Europe and the USA).⁵⁸ Even if the use of OFCs by DFIs did not deprive developing countries of taxes, there is an argument that they should not route investments via OFCs because doing so legitimises or otherwise enables these jurisdictions, which do harm in other ways. By this logic, by using OFCs, DFIs may indirectly undermine the development goals that they exist to achieve.

Vervynckt (2014), for example, regards DFIs 'helping to legitimise the offshore industry' as more important than 'the possibility of a significant loss of tax revenues' and urges DFIs to 'set an example of best practice in establishing the highest standards of responsible finance' – a position that does not necessarily imply that the use of OFCs by DFIs is directly harmful.

It is hard to know what evidence could be brought to bear on these arguments. The investments which DFIs participate in are a fraction of the wealth held in tax havens – estimates of which range from \$4.5 trillion (Zucman, 2015) to \$32 trillion (Tax Justice Network). Likewise, the professional service fees they generate are immaterial set against the overall market. Who is going to do anything differently, if DFIs change their behaviour? How should these speculative effects of an intangible signal be weighed against the potentially beneficial role OFCs play in enabling a greater quantity of investment in the poorest, most capital-scarce countries?

DFIs argue that it is not their role to contradict the signals sent by their shareholders. Their shareholder governments participate in various multinational fora, where they can address these questions, define acceptable behaviour and identify acceptable jurisdictions. NGOs may regard the Global Forum (for example) as inadequate, but as agents of the governments that created it, DFIs feel they should respect it.⁵⁹ More generally, DFIs argue that if their shareholders want to effect change in the arena of international taxation, then they should do so through their legislation and through the choices they make multilaterally, which they can then require DFIs to comply with. International investors operate in a landscape that is sculpted by governments. Asking DFIs to try and 'push water uphill' will not be effective – the solution is for governments to reshape the landscape.

Nonetheless, signalling can sometimes be important in international affairs. Accusations of hypocrisy can undermine international cooperation, particularly when one group of countries is perceived as trying to persuade another group to stop doing something they themselves are guilty of. In this context, the fact that many OECD countries, or their territories, have opaque financial centres with favourable tax regimes certainly gives non-OECD OFCs reason to complain about hypocrisy. But symbolism aside, it is hard to see why the actions of DFIs are important here.

All DFIs said that they would welcome new legislation on public disclosure of beneficial ownership, or progress implementing the automatic exchange of tax information between countries. If these standards were applied to all investors, then DFIs' attempts to demand public disclosure from their co-investors would not be at variance with normal market practice.

While there is undoubtedly merit to the argument that the ultimate solutions to these problems are out of DFIs' hands, it does not mean that DFIs should leave trying to change the system entirely to others. If DFIs have opportunities to make a material contribution to improving the international tax system in favour of developing countries, without (overly) reducing their

⁵⁸ These figures include estimated undeclared assets held in international financial centres that are not regarded as OFCs in this paper (such as the UK, USA and Switzerland). Africans and Latin Americans may well keep money offshore for non-tax reasons – the extent to which these figures are indicative of tax evasion is unclear, which is why the harm done by tax havens is contested.

⁵⁹ DFIs feel they should also consider their home countries' blacklists, and the forthcoming EU blacklist that looks at a wider set of characteristics than the Global Forum, including BEPS compliance and 'fair taxation'.

ability to attract capital to the poorest countries, they should take them.

7.2. Taking the world as they find it or building capacity?

DFIs see their role as working within existing constraints to encourage capital to flow into countries and sectors that it would otherwise avoid (or to change the nature of investments so that they have a greater positive impact on development). They do not see their role as trying to change these constraints. They regard tasks such as trying to improve legislation and the functioning of the judiciary, building the capacity of tax administrations and setting the rules regarding transparency, as jobs for other arms of the development body politic, such as the World Bank.

NGOs and tax campaigners, however, argue that this attitude perpetuates the status quo, and that DFIs should help developing countries acquire the institutional capacity and legal systems they need by using these systems and driving the process of change. Vervynckt (2014) argues that ‘a key part of the role of DFIs is to promote private sector development at the local level ... this implies helping create structures that allow for direct investments’.

However, the argument that DFIs should only invest directly, to build local capacity, is almost certainly wrong. Imagine a simple dynamic model in which DFIs want to maximise long-run investment in developing countries, and can divide their efforts between making immediate investments within existing constraints and spending their resources on trying to relax those constraints to lower the cost of future investments. The optimal strategy will almost certainly be to do both.⁶⁰ So the argument that DFIs should stop using OFCs because they should be trying to build capacity in the countries where they invest is misguided.

Nonetheless, DFIs could perhaps do more to push back the frontier of jurisdictions considered suitable for direct investment, in partnership with other development actors. This does not mean that they ought to simply start trying to invest directly in countries that investors currently regard as unsuitable. Making investments that no private investors would touch, and then encountering problems that would validate private investors’ decisions to steer clear, would not help. Many DFIs already seem to have adopted a cautious attitude, after having difficult experiences trying to invest directly or support funds in certain countries. However, there may sometimes be

circumstances where countries have introduced new legislation or have taken actions to build capacity in the judiciary, perhaps with the support of bilateral donors or organisations such as the IMF or World Bank, and have reached a point where pioneering investors are needed to demonstrate that the investment environment has improved. Kenya, for example, recently introduced the Nairobi International Financial Centre Act, and new laws are matched by substantive reforms. DFIs could consider taking a risk in the hope of demonstrating to other investors that Kenyan institutions have improved. Using local systems does not necessarily improve them, but when efforts are being made to improve local systems then learning-by-doing and demonstration effects are valuable.

DFIs could also use their market power in more positive ways by publicising what developing countries need to do to ensure investors feel comfortable investing directly.⁶¹ DFIs may only account for a tiny share of global investment and offshore assets but in some developing countries they account for a significant share of inward investment.

7.3. Going onshore in Africa

DFIs argue that using OFCs does not typically deprive developing countries of tax because the alternative is using onshore OECD financial centres with equally advantageous tax treaties. But that may change.

Some NGOs argue that DFIs should make more use of onshore African financial centres today (as opposed to Mauritius, which is African but offshore) and some DFI shareholders share that objective. South Africa is the leading onshore African financial centre but Kenya, Botswana, Nigeria, Morocco, Ghana and Rwanda are also seen as potential financial centres.⁶²

Setting aside the question of whether these jurisdictions currently have the non-tax attributes investors seek, if onshore African financial centres were a viable alternative, should DFIs stop using OFCs? The growth of local capital markets would undoubtedly benefit the region – DFIs consider developing local capital markets as part of their role – but in terms of the taxes paid in the countries where the underlying investments are located, the impact would again come down to treaty networks. If the main objection to OFCs is that they reduce source country taxing rights, onshore African financial centres will not necessarily be any better.

60 The same result arises in models where aid can either be used to fund contemporary consumption or invested to raise future consumption (Carter et al., 2015).

61 EMPEA (2015a) was written by private equity investors in developing countries. It contains guidelines for policy-makers and regulators wishing to attract private equity capital, which have been translated into eight languages and widely distributed.

62 EMPEA (2015b) was written in response to the desire of DFIs and their shareholders to make more use of onshore financial centres. It includes a useful survey of fund managers regarding their use of onshore jurisdictions and what reforms would increase their usage.

South Africa has an extensive and advantageous treaty network with other African countries; this is partially why it is considered Africa's most appealing onshore jurisdiction by a wide margin (EMPEA, 2015b). Kenya, Rwanda and other possible candidates, as yet, do not. Kenya and Rwanda (along with Uganda, Burundi and Tanzania) are signatories to the East African Community Double Taxation Agreement (EAC DTA), a multilateral treaty that limits withholding taxes on interest and dividends to 10% and 5% respectively. So far, only Rwanda has ratified the treaty.

If viable onshore African financial centres were to emerge, offering the legal certainty investors require and catering for the tax transparency needs of pooling vehicles, but with treaty networks that grant source countries greater taxing rights than existing treaty networks tend to, there would be a strong case for DFIs to use them. The emergence of viable onshore African financial centres with less advantageous treaty networks would test the claim that OFCs are not used to reduce taxes payable at source. Of course, it may turn out that emerging African financial centres seek to establish tax treaty networks that are equally attractive as those available elsewhere.

7.4. A collective action problem

Potential solutions to the problems of using OFCs suffer from a collective action problem: they would only work (or work best) if all DFIs and multilateral development banks acted together, but there is no mechanism to ensure this.

Seen in game theory terms, the problem has a 'prisoner's dilemma' structure. The logic of this simple model applies to any actions that might cause a DFI to lose business if introduced unilaterally (such as requiring higher standards of transparency). For the sake of illustration, the decision is simply whether to use OFCs or not. Suppose that a DFI's 'payoff' is the product of the quantity of investment it conducts and its quality. Further suppose that the quality of an investment is higher when an OFC is not used (because it is better from a developmental perspective). If all DFIs use OFCs, or if all DFIs refuse to use them, then each DFIs' market share (quantity) is a given.⁶³ But if some DFIs refuse to use OFCs, while others continue to do so, then the latter will gain market share from the former. Following this model, payoffs may take the following form (higher is better):

Table 3: An OFCs dilemma

	Single DFI / All other DFIs	Use OFCs	Refuse
Refuse		(1,4)	(3,3)
Use OFCs		(2,2)	(4,1)

This table shows illustrative payoffs for a single DFI and a combination of all other DFIs. The first figure in brackets gives the payoff for the single DFI and the second for all the rest. The best overall outcome is if everybody refuses to use OFCs: the payoffs are 3 for all DFIs (the upper right quadrant). If everybody uses OFCs, the payoffs are 2 (bottom left). But if one DFI refuses to use OFCs, while all others continue to do so, it only gets 1 and they get 4 (upper left); whereas if all other DFIs refuse to use OFCs while one DFI continues to do so, it gets 4 and they get 1 (bottom right).

This structure makes cooperation hard to sustain: if some DFIs agree to stop using OFCs, others may be tempted to deviate and gain market share. Moreover, it means that any DFI that unilaterally refuses to use OFCs suffers. It suggests that some sort of commitment mechanism, perhaps sustained among shareholders in a forum such as the G20, may be necessary.

It should be emphasised that while this simple model helps us think about collective action problems, the presumed payoffs in the table are question begging. Perhaps if everybody refused to use OFCs the payoffs would be worse because mobile international capital would invest less in LDCs.

⁶³ Meaning market shares are determined by other factors we do not need to concern ourselves with here.

7.5. How much influence do Development Finance Institutions have?

The DFIs interviewed argued that they can rarely dictate the structure of an investment. Most often, the project sponsor or fund manager brings them an investment proposition where the cross-border structure has already been chosen. At other times, DFIs are investing to help an already existing enterprise or fund expand. Only occasionally are DFIs involved at a sufficiently early stage that the structure is still up for discussion (unless the DFI chooses to raise the issue).

It is hard to know what to make of these arguments, because the primary rationale for DFIs is that they exist to make investments happen that private investors would otherwise not support. This would seem to put them in a strong bargaining position. Is the argument that they often lack influence, a tacit admission that they are not always confident of their own additionality?

First, it is important to remember that while DFIs might have bargaining power over project sponsors with no other options, they have no bargaining power over private investors with the whole world to choose from. When investors that DFIs want to ‘crowd in’ demand the use of an OFC, they can either accede or walk away. Whenever DFIs are attempting to attract private investors into a deal, the question of what influence DFIs have over structure is only relevant within the set of structures acceptable to co-investors.⁶⁴

Second, a DFI often makes investments where the investee has other options, but the DFI wants to take the business in other directions than a private sector investor would. For example, a private equity fund might want to buy a business, focus on its core markets, maximise cash flows and exit reasonably quickly. A DFI might bid for the same business, but require it to enter risky new markets whilst promising to be a patient investor and look at the long game. Here the imposition of extra costs (in addition to those required to meet environmental, social and governance (ESG) standards, ensure business integrity and meet other demands that DFIs make) could push the business into the hands of the private sector.

Within the tolerance of private co-investors, the impression from interviewees is that DFIs could probably collectively insist on the use of an OFC that grants source

countries more taxing rights, but have historically not seen the benefits of doing so as justifying the disruption. In some cases, restructuring would be a taxable event in itself, which investors would want to avoid. In cases where the legal structure is already established, the costs and time required to change it may be considerable, and DFIs said that a proposal to change domicile just to pay higher taxes at source would be met with hostility.

The collective action problem is also important here. When DFIs collaborate on projects, any DFI that unilaterally insists on a less attractive structure risks being excluded. DFIs and investors recognise that certain OFCs are off limits but, within the set of acceptable OFCs, the idea that they might be asked to choose one that grants source countries more taxing rights may be regarded as unacceptable.

That could change, and greater transparency would help make the case either way. If DFI shareholders saw that certain jurisdictions generate more tax for developing country governments, while still being acceptable to private investors, identifying and choosing such places could become a routine expectation. But we do not know how often such situations arise. In practice, DFIs are probably reluctant to test these limits. For investment teams who face the incentives to get developmental deals done (within accepted constraints such as higher ESG standards), source capital income taxes are regarded as only a minor element of the total development impact of investment.

Shareholders could also consider asking DFIs to increase the ‘concessionality’ of their finance, to induce private investors to use structures under which source countries are better able to tax capital income. This would require adjusting the targets they set DFIs for financial returns and may even require the injection of grant funds (or equivalents). This would not necessarily be a good use of public money, especially if it amounts to paying investors’ tax bills for them; but, in principle, higher source taxes on capital income could become something that DFIs ‘buy’, like other developmental goods. There is, however, the difficulty of knowing when private investors genuinely need an extra inducement to use certain structures (or when they are merely pretending to). But if we want DFIs to stop using OFCs without sacrificing the level of investment in LDCs, this is one way of doing it.

⁶⁴ Sometimes a project is regarded as so unappealing to private investors that DFIs and other public bodies are the only sources of finance. In such cases, they should be able to overrule the project sponsors’ preferences over legal structure. In theory, there could also be some deals where private investors demand an unacceptable OFC structure and DFIs ought to respond by taking on the whole deal themselves.

8. Conclusion

This section presents the views of the author.

Elsewhere in development, we are constantly reminded that development actors should not impose simplistic blueprints, and should recognise the imperfections of real world markets and fit practice around these realities. Ideas such as ‘working with the grain’ (Levy, 2014) and ‘good enough governance’ (Grindle, 2004) are met with widespread approval from practitioners. Maxims that look good in principle (such as the ‘results agenda’) can be counterproductive if applied overzealously when they encounter messy reality. The same could be said about a puritanical approach to international taxation.

The use of OFCs should be seen in this way: it might be better if OFCs were not necessary, but they often are. Rather than prohibiting the use of OFCs, the focus should be on moving things in a better direction.

If DFIs stopped routing their investments through OFCs two things would happen, both uncertain. First, the ability of developing countries to tax capital income from those investments that take place in their territory would rise, to some degree. But the arguments presented here suggest that the impact on taxing rights would be minor, either because DFIs and their co-investors would route their investments through onshore OECD financial centres with equally advantageous tax arrangements, or because overseas investors would be offered tax incentives regardless of domicile. Second, the quantity of investment that DFIs can conduct in developing countries would fall, to some degree. This would come at the cost of lower taxes in developing countries from profits and wages, a fall in investment would result in fewer jobs created and a decrease in the production of goods and services (such as renewable energy). Furthermore, it would be the LDCs, where investors are more likely to want to use an OFC and where capital is most scarce, that would be most affected.

The magnitudes of these effects are unknowable. DFIs say that whenever an OFC is used, a non-tax case must be made for its inclusion, but they rarely test whether it is truly necessary or specify precisely what the counterfactual is. In some cases, the project would doubtless go ahead even if the use of OFCs were proscribed. But DFIs are supposed to focus on projects that are on the cusp of commercial viability and interviewees claimed that they often encounter individual projects that, without an OFC, would not go ahead or where the ability of a fund to

attract investors and the set of viable investments would be much reduced.

How should policy be made in the presence of uncertainty? One established approach to decision-making under uncertainty is to determine the least regrettable option: banning the use of OFCs and investment flows to LDCs drying up, or continuing to use OFCs and depriving these countries of some taxes on capital income.⁶⁵ In the opinion of the author the balance of risk and reward is decidedly one-sided, and the potential magnitude of what could be gained in tax does not justify risking what could be lost through a reduction in investments. On that basis, blanket criticism of DFIs for the use of OFCs is misguided. Instead, the use of OFCs should (probably) be recognised as sometimes necessary for DFIs to achieve their development objectives. Imposing a rule that would probably make minimal difference to the amount of capital income taxes paid by foreign investors, while potentially resulting in a net loss in terms of the other taxes and attendant benefits of investment in less developed countries, would be a major error. All DFIs believe that anything resembling a blanket ban on OFCs would do just that.

This is a conclusion based on an assessment of the development impact of banning OFCs, not a judgement on the advocacy positions of campaigners who have called for DFIs to stop using OFCs. Campaigning strategy is beyond the scope of this paper. It may be that to secure reforms, campaigners must ‘overshoot’ in terms of their demands. Many interviewees expressed appreciation for the constructive role that NGOs and other tax campaigners have played by drawing attention to a set of issues that, until recently, had received insufficient attention from DFIs and their shareholders.

8.1. What needs to change?

But concluding that DFIs should not stop using OFCs does not amount to concluding that the status quo is acceptable. The question is what should DFIs do differently? Little would be gained, from a development perspective, by pushing DFIs away from OFCs towards investment from OECD capitals – although it would doubtless be more palatable politically in developed countries if DFIs did more business via their domestic financial systems. This

65 See Manski (2013) for analysis of decision-making under uncertainty, including decision rules based on minimising regret.

view is shared by some civil society tax campaigners, who argue that the objective is not to ban certain jurisdictions but to raise the standards of transparency wherever investments are housed.

There is no decisive refutation of the view that some DFIs expressed: that everything legal is acceptable because legislation reflects the decisions of sovereign nations. But everybody, from the Tax Justice Network to the IMF, seems to accept that all is not right in the world of international taxation when seen from the perspective of developing countries (primarily because of the global network of bilateral tax treaties and the widespread use of tax incentives). On that basis, it would seem desirable that DFIs try to push beyond the current combination of laws and accepted market practices to do more for development. But exactly what that would mean is unclear. Many DFIs said they would welcome a set of actionable guidelines in this area because this issue is a constant source of angst for them.

Nobody interviewed for this paper could see a way of defining when the choice of jurisdictions confers an unacceptable tax advantage, in a way that would not have an unacceptable impact on their ability to attract investors to the poorest, most capital-scarce countries.

8.2. Solutions

The next section will consider actions that DFIs might take themselves to minimise the potential harm of using OFCs, without unduly harming their ability to attract investors to less developed countries. This section briefly considers long-run solutions that would require multilateral action at the inter-governmental level. DFIs all stated that they cannot solve the problems of cross-border investment by themselves.

The best solution would be for all countries to review and, where necessary, renegotiate their bilateral tax treaties, and their domestic legislation governing the taxation of foreign investors, so that legal compliance becomes a sufficient test of developmentally desirable behaviour. DFI shareholders have a role to play here, through the technical assistance that their bilateral aid agencies provide, as do the major multilateral institutions such as the IMF and World Bank. DFI shareholders must also adopt a more developmental attitude towards treaty renegotiation – there will be no progress if ministries of finance resist ceding taxing rights to developing countries. We need developmental policy coherence across government. The recent OECD Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS shows that multilateral progress towards closing the gaps in international tax rules and establishing some minimum standards is feasible.

Some DFIs believe minimum rates of withholding taxes and capital gains taxes charged by source countries would be the best way forward. The basic idea is to shift

the balance of taxing rights back towards developing countries, ending tax competition and creating a standard that DFIs would find easy to implement. However, DFIs felt this was not something they could establish unilaterally – at least, not where it matters: the taxes paid by private sector investors. For example, if capital gains taxes are waived under treaty when an investor invests directly from their country of residence, DFIs could not require them to pay more tax than is legally due.

Another option would be to tighten multilateral blacklist criteria over time. If done judiciously, this could shift activity away from the worst OFCs without significantly harming the quantity of investment. DFIs said they would prefer to support the Global Forum on Transparency and Exchange of Information for Tax Purposes, rather than a parallel system.

Blacklists based on transparency standards are already problematic; a blacklist based on how jurisdictions affect the ability of developing countries to tax foreign investors would probably be impossible to construct. Mauritius is one of the few OFCs with a significant tax treaty network, and it would be hard to create objective taxation criteria that would blacklist Mauritius without also blacklisting most major onshore international financial centres.

8.3. Recommendations

DFIs should not merely wait for the international community to reform the taxation of cross-border investments. They should collaborate to find marginal improvements to the status quo, which they can implement themselves. The association of European DFIs has recently agreed some new tax guidelines (unpublished at time of writing). Ideally, further improvements would also be agreed by the multilateral development banks. It would also be helpful if the public debate with civil society moved on from whether OFCs should be used at all, and focused on where to find improvements.

The argument that DFIs use OFCs for legal and other pragmatic reasons, unrelated to tax, suggests that DFIs should ideally use OFCs that do not also bring tax advantages (over and above tax neutrality). If this is the destination we wish to arrive at, it is not obvious how to get there. The first step is to get a clearer idea of where we currently stand.

8.3.1. Tax transparency

Movement towards greater transparency – legislated and voluntary – seems unstoppable. DFIs have made important strides, but there is much more that could be done: DFIs should aim to make basic information about each investment – such as the case for additionality and expected development outcomes – readily available online. DFIs should include the non-tax rationale for using an OFC and basic information about any tax advantages conveyed by the structures they have invested through.⁶⁶

International taxation is complicated, and opaque to many stakeholders, including the staff of OECD development agencies (except for the few directly involved), government officials and citizens in developing countries. DFIs would create a public good by promoting an understanding of these issues throughout the ‘development community’. Although DFIs would resist taking on an advocacy role, their combined knowledge of international capital markets and development could be useful if, for example, ministries of finance are taking decisions about tax treaties.

The concept of ‘tax advantage’ is also complicated. DFIs should invest some effort in clarifying the concept, accepting that a pragmatic compromise between ease of understanding and accuracy will be necessary. Greater clarity may benefit both internal decision-making and external communication. To simplify the problem somewhat, rather than try to present a complete tax analysis, DFIs should focus on the implications for developing countries, using a partial definition that defines ‘tax advantage’ in terms of a reduction in taxes payable at source.⁶⁷ They could perhaps start by stating whether they regard the structure as having no impact on source taxing rights, relative to a benchmark, or whether it reduces source taxing rights – perhaps using a traffic light rating system.

Tax advantage is hard to define because it requires a benchmark, and when investors from many countries are involved in a project, there is no single benchmark that applies to all. The non-treaty statutory rates are not a useful benchmark because, in the absence of a pooling vehicle in an OFC, investment is unlikely to come from a country with no tax treaty with the developing country in question. The concept is also complicated because a structure may include investors who were present before the DFI, and others who arrive afterwards.

DFIs most commonly use OFCs for private equity funds. DFIs could disclose those countries where tax benefits are claimed by the fund under a tax treaty, and whether that reflects the funds’ choices of domicile or the location of intermediary holding companies. Such disclosure would need the consent of fund managers and other investors.

In other cases, where DFIs use pooling vehicles in intermediary jurisdictions to invest ‘directly’ in companies, they could consider using the country of residence of the largest investor in the pooling vehicle as a benchmark to define tax advantage, or a weighted average.⁶⁸ When DFIs and private co-investors invest in the same project

via separate structures, it would be more challenging to provide information about the tax advantages of structures DFIs are not themselves using, particularly if these structures are established either before or after the involvement of the DFI. DFIs should actively investigate whether (and when) they could persuade other investors, who did not enter as part of a deal brokered by DFIs, to divulge some basic tax analysis.

DFIs invest through a bewildering array of instruments and structures, and the recommendations above may not suit all of them. Because DFIs often collaborate, the definition of tax advantage for different instruments and types of structure would need to be standardised to ensure consistency across each DFI’s public reporting.

The DFIs interviewed for this paper were not thrilled at the prospect of having to invest scarce staff time in operationalising a standard for defining and disclosing the tax advantages conveyed by OFCs. They emphasised the limited number of tax experts they employ (some employ none and rely on advisors), and how overheads and expenditure on external advice eat into the money they have for reinvestment. The idea that all this expense and effort would ultimately have little tangible impact makes it even less appealing. But DFIs are public servants and the fact is that – rightly or wrongly – there is a good deal of public interest in tax practices, so it may be reasonable to accommodate that interest. This is ultimately a question for DFI shareholders. If governments value greater transparency, they must mandate it and adjust DFIs’ funding and financial targets to make room for the additional overheads and expenses.

8.3.2. Transparency of beneficial ownership

There is a strong case to be made for publicising information on beneficial ownership, particularly when prominent individuals from the country or region where DFIs invest are involved in a deal. When it was suggested to DFIs that they should require the identity of such investors to be made public, they were immediately able to provide examples where doing so would have caused a deal to collapse, to no obvious end (the individual demanding anonymity appears innocuous). Such examples may be rare, but they should not be trivialised. But how many ‘deals not done’ is the price worth paying for greater transparency? Contributing towards greater public awareness of the systems of patronage that pervade many developing countries should also not be trivialised. In the opinion of the author, DFIs should start experimenting

66 Under the MLI, tax authorities may apply a ‘principal purpose test’ for eligibility for tax treaty benefits; structures deemed to exist solely to obtain tax benefits will not receive them. So DFIs will need clearly articulated non-tax rationales for using OFC structures.

67 When the project includes major investors from developing countries (perhaps the project sponsor), taxes paid at residence are also relevant; but this is a relatively minor part of the problem.

68 Here ‘directly’ refers to an investment that the DFI undertakes itself, rather than delegating to a third-party fund manager.

with making the disclosure of beneficial ownership information a requirement of their participation when they invest directly and when they support a new private equity fund. One drawback of experimentation is that it will create a situation where public information is available for some investments, but not others. Some interviewees felt this would unfairly cast aspersions on those cases where investors remain anonymous. A less ambitious step would be to commit to the voluntary reporting of beneficial owners to the source jurisdiction tax authority.

8.3.3. Tightening offshore financial centre blacklist criteria

DFIs all want to support the Global Forum and do not want to create their own blacklists. The forthcoming EU blacklist may be more stringent than the Global Forum, and be adopted by some European DFIs. Some DFIs regard the Global Forum as more objective and less susceptible to political influence than the EU. Global Forum peer reviews look at many indicators. DFIs could consider the

underlying indicators and select the ones that are deemed particularly relevant; and require OFCs to be largely compliant on these specific indicators (a jurisdiction may be deemed largely compliant overall, but only partially compliant on a few potentially more important indicators). Rather than attempt to specify here what indicators DFIs could use to tighten the minimum criteria they require of OFCs, this could be a fruitful area for collaboration between DFIs, tax experts and campaigners. Any proposal would have to be informed by a joint evaluation of the implications for the ability of developing countries to tax foreign investors and on the ability of DFIs to do business.

These three recommendations – greater transparency around tax advantages and beneficial ownership, and tightening blacklist criteria – would either require collective action or would be weakened in its absence. The association of European DFIs (EDFI) should collaborate with other International Financial Institutions to find improvements in how they currently use OFCs and how they report the tax implications of doing so.

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Appendix 1. The development effectiveness of Development Finance Institutions

This appendix provides a brief justification for the assumption that DFIs are effective instruments of development.

The assumption is based on a combination of theory and supportive quantitative evidence. The reasoning may fall short of the standards of rigorous evidence that are often demanded elsewhere in development policy, but the reality is that not all development interventions are amenable to the sorts of impact evaluation that meet these standards. In which case, we must resort to the best available evidence, from a variety of sources, to assess development effectiveness.

Other forms of development interventions seek to confer benefits on a well-defined treatment group, and data are often available that make it possible to compare outcomes against an estimate of what would have happened in the absence of an intervention. For example, health outcomes in an area with a recently opened health clinic can be compared against health outcomes in a similar area with no clinic. This sort of analysis is not possible in the case of DFIs because investments do not target a well-identified ‘treatment group’ but have effects that are spread across an economy and may emerge slowly and in a non-linear fashion. In theory, and with sufficiently large datasets, it may be possible to pin down the contribution of one factor among many others in a complex process (such as economic development), but such data do not exist. Even where limited data make it possible to match investments to information on poverty, standard techniques may not be capable of identifying the impact at the household level because there are too many potentially confounding factors. McLaren and Yoo (2017), for example, found that

the welfare impact of FDI in Viet Nam is swamped by large flows of internal migration into regions with more FDI.

At the country level, statistical evaluations are plagued by the problem of distinguishing between correlation and causation; there are some potential solutions to such problems but they rely on the existence of valid ‘instruments’ or natural experiments. To date, none have been discovered that would definitively identify the causal impact of DFI investments. That said, the correlations in the data are consistent with DFIs having a causal impact on macroeconomics variables such as the share of investment in GDP, the level of productivity and employment (Massa et al., 2016).

DFIs themselves gather data on jobs created, taxes paid, electricity generated and other intermediate outputs; and there is also evidence on investment, economic growth and productivity at the country level. This evidence can be set alongside evidence on the importance of the formal sector for economic growth and on the importance of economic growth for poverty reduction, to construct a case that DFIs contribute to the reduction of poverty over the long run.

In the end, the assumption that DFIs are effective is based on four elements: macroeconomic evidence about the impact of DFIs (which is consistent with effectiveness but not conclusive); plausible qualitative evidence that DFIs make investments happen that would not otherwise; the strength of cross-country empirical evidence that investment drives growth and poverty reduction (De Long and Summers, 1991); and a theoretical presumption that the development of capital markets and investments in strategic sectors such as renewable energy and agriculture are vital for development.



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