



Tax-motivated illicit financial flows A guide for development practitioners

Martin Hearson

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Abstract

Tax revenue can help governments finance development and decrease reliance on foreign aid. But tax-motivated illicit financial flows – tax evasion, tax avoidance and aggressive tax planning – undermine these efforts. Non-specialists may find that the complex discussion on taxation and IFFs is further complicated by the lack of clear definitions of relevant concepts, and by the often polarized nature of policy debates. This issue paper explains the terms and helps development practitioners and policy makers navigate the tax and illicit financial flow debates. It also gives an overview of donors' interventions in this area. There is a growing recognition that tax-motivated illicit financial flows are facilitated in part by the policies of donor countries, hence policy coherence emerges as an important goal for the future.

About the author

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Abbreviations

ATAF	African Tax Administration Forum
BEPS	base erosion and profit shifting
CDC	Commonwealth Development Corporation
CIAT	Inter-American Center of Tax Administrations
CUP	comparable uncontrolled price
DFID	United Kingdom Department for International Development
ECOSOC	United Nations Economic and Social Council
EITI	Extractive Industries Transparency Initiative
EU	European Union
FATCA	Foreign Account Tax Compliance Act
GAAR	general anti-avoidance rule
GDP	gross domestic product
GIZ	German Society for International Cooperation
HMRC	Her Majesty's Revenue and Customs
IFC	International Finance Corporation of the World Bank Group
IFF	illicit financial flow
IMF	International Monetary Fund
IT	information technology
LTU	large taxpayer unit
MAP	mutual agreement procedure
NGO	nongovernmental organisation
Norad	Norwegian Agency for Development Cooperation
OECD	Organisation for Economic Co-operation and Development
PE	permanent establishment
SAAR	specific anti-avoidance rule
TIN	Taxpayer Identification Number
TP	transfer pricing
UK	United Kingdom
UN	United Nations
US	United States
VAT	value-added tax
WHT	withholding tax
ZDA	Zambia Development Agency
ZRA	Zambia Revenue Authority

Glossary

Arm's length principle. Tax treaties and transfer pricing regulations generally state that transfer pricing transactions within a group of companies will only be recognised for tax purposes to the extent that they observe this principle. It requires that the terms of these transactions be consistent with those that would have been arrived at by independent companies. This is intended to prevent companies from manipulating their transfer pricing transactions to reduce their tax bills. (Sections 2.8, 3.5)

Base erosion and profit shifting (BEPS). According to the OECD (2013c), this refers to “tax planning strategies that exploit gaps and mismatches in tax rules to make profits ‘disappear’ for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low resulting in little or no overall corporate tax being paid.” The BEPS project coordinated by the OECD, also involving G20 countries, seeks to reform international tax standards that have become open to exploitation by multinational firms. (Section 2.10)

Double taxation, single taxation, and double non-taxation. Where a company or individual incurs a tax liability in more than one country, international tax instruments strive to ensure that any given transaction is taxed once and only once by the different countries with a claim on it (single taxation). If two countries' claims on the taxing rights overlap, this creates double taxation; if neither country claims the taxing rights, this creates double non-taxation. Some tax avoidance strategies exploit international tax instruments in ways that were not intended, for example by ensuring that the right to tax a transaction is allocated to a country that levies no or low taxation on it. Others take advantage of inconsistencies in tax systems to engineer double non-taxation. (Section 2.6)

False invoicing. This is the practice of falsely declaring the value of goods imported or exported to evade customs duties and taxes, circumvent quotas, or launder money. The value of goods exported is overstated, or the value of goods imported is understated, and the proceeds are held illicitly overseas. Most estimates of trade-based illicit financial flows focus on this mechanism. (Sections 2.8, 3.1)

Inward investment. In this report we refer to the pursuit of inward investment by developing countries, meaning actions designed to encourage investment in their economies by companies based overseas, predominantly in more developed economies. In large part the investment under consideration is foreign direct investment, where the overseas company owns a large enough stake in the local company (10% in the OECD definition) to exercise a significant degree of influence over it. This stake may be acquired by purchasing an interest in an existing local company or by establishing a new business.

Mutual assistance. This refers to cooperation between the tax authorities of two or more countries, which usually requires the legal mandate of a treaty. It is an essential component of the toolbox for tax authorities to counter tax-motivated IFFs. OECD conventions provide the framework for three types of cooperation: exchange of information and cooperation between authorities of different countries in investigations, collection of taxes owed to one country by the administration of the other, and service of official documents issued by one country in the other. (Section 2.5)

Permanent establishment (PE). This concept in international tax standards defines when a country is entitled to tax a foreign resident company that is earning income within its borders. Because the PE definition limits a developing country's capacity to tax overseas investors, it is a key area of disagreement in tax treaty negotiations. The OECD's analysis of BEPS highlights certain areas in which the PE rules within its model treaty are vulnerable to tax planning by multinational firms. (Section 2.6)

Round-tripping. Domestic investors sometimes obtain benefits intended for overseas investors by channelling their investment through an offshore jurisdiction. A widely cited example is Indian investors' use of Mauritius to avoid capital gains tax: the terms of the India-Mauritius treaty prevent India from taxing capital gains by a resident of Mauritius, even if this is a shell company set up by an Indian national. (Section 2.7)

Secrecy jurisdiction. A jurisdiction may create a legal environment specifically for the use of non-residents, one aspect of which is financial secrecy. The originators of illicit financial flows may need to prevent the authorities in the country of origin from identifying them (for example, if the money is the proceeds of tax evasion), in which case the flow will be directed to a secrecy jurisdiction. Because IFFs seek out low taxes and secrecy, many tax havens are also secrecy jurisdictions, but the concepts are not identical. (Section 2.4)

Tax avoidance. According to a common formal definition, tax avoidance practices are those designed to gain a tax advantage by contravening the intention of legislation, but not its letter. Such practices can be prevented through statutory anti-avoidance rules; where such rules do not exist or are not effective, tax avoidance can be a major component of IFFs. (Sections 2.2, 2.3)

Tax evasion. This refers to actions by a taxpayer to escape a tax liability that has arisen under the law of a country. Doing so generally involves concealing from the revenue authority the income on which the tax liability has arisen. Tax evasion can be a major component of IFFs. (Section 2.2)

Tax exemption. An exception to the statutory tax rate may be provided for certain activities or to groups of taxpayers. Governments use these to incentivise certain behaviour as well as to shield poorer parts of the population from an otherwise regressive tax. Tax exemptions for investors ("tax incentives") cover various corporate taxes and are intended to stimulate domestic and foreign investment in certain sectors or geographic areas, although competition between developing countries through tax incentives appears to have had a limited impact on actual levels of investment. Where tax exemptions are granted to companies on a discretionary basis, especially where there is a lack of transparency and scrutiny, there is a significant risk of corruption and IFFs. (Sections 2.11, 3.3)

Tax haven. This is a jurisdiction whose legal regime is exploited by non-residents to avoid or evade taxes. The most authoritative definition was formulated by the OECD in 1998. It states that a tax haven has no or nominal tax rates, in combination with one or more other factors including lack of effective exchange of tax information with other countries, lack of transparency in the tax system, and no requirement to have substantial activities in the jurisdiction to qualify for tax residence. Tax havens are the main channel for laundering the proceeds of tax evasion and routing tax avoidance. (Sections 2.4, 3.9)

Tax information exchange. In this form of mutual assistance, one jurisdiction shares information on its taxpayers with other jurisdictions that are signatory to a treaty. The exchange can be spontaneous, on demand, or automatic. Information exchange allows tax authorities to detect and combat tax-motivated IFFs. (Section 2.5)

Tax planning. This refers to tax strategies designed to prevent a tax liability from arising. Unlike tax evasion and tax avoidance, tax planning does not contravene either the letter or the spirit of the law. We have used the term to refer to a range of activities, from those explicitly intended or condoned by the government (for example, taking advantage of a tax incentive) to more "aggressive" activities that nonetheless do not meet the technical definition of tax avoidance (for example, tailoring a business's presence in a country to push the limits of the definition of permanent establishment). In this paper we have included more aggressive tax planning schemes within the purview of a discussion of IFFs. (Section 2.2)

Tax treaty. Formally known as tax conventions on income and capital, bilateral tax treaties between countries were originally referred to as double taxation treaties. By concluding them, countries reach a negotiated settlement that restricts their source and residence taxation rights in a compatible manner, which alleviates double taxation and allocates taxing rights between them. Treaties also harmonise the definitions in countries' tax codes, provide mutual agreement procedures that can be invoked if there are outstanding instances of double taxation, and establish a framework for mutual assistance in enforcement. A treaty between a developing country and a country from which it receives investment will shift the balance of taxing rights away from the developing country. This creates opportunities for treaty shopping by foreign investors. (Sections 2.7, 3.4)

Thin capitalisation. This is a tax planning scheme under which a parent company uses debt to invest in a subsidiary and then strips out its profits through interest payments on the loan, rather than repatriating them through dividends. The loan is commonly made from a group financing subsidiary located in a low-tax jurisdiction. This practice is often used to strip developing countries of taxable profit by shifting it to other jurisdictions. (Section 2.9)

Trade mispricing. This umbrella term covers both transfer mispricing and false invoicing, two of the main components of tax-motivated IFFs. (Sections 2.8, 3.1)

Transfer mispricing. A transfer price may be manipulated to shift profits from one jurisdiction to another, usually from a higher-tax to a lower-tax jurisdiction. This is a well-known source of IFFs, although not all forms of transfer pricing abuse that result in IFFs rely on manipulating the price of the transaction. (Sections 2.8, 3.1, 3.5)

Transfer pricing. This refers to the price of transactions occurring between related companies, in particular companies within the same multinational group. Governments set rules to determine how transfer pricing should be undertaken for tax purposes, predominantly based on the arm's length principle. Much of the debate on tax-motivated IFFs revolves around the formulation and enforcement of transfer pricing regulations, their shortcomings, and the way in which they are abused for tax evasion and avoidance purposes. (Sections 2.8, 3.5)

Treaty shopping. A taxpayer can obtain a tax advantage in a cross-border transaction by seeking out one or more jurisdictions whose tax treaties give more favourable treatment and routing transactions through them. A treaty shopping structure may take advantage of the allocation of taxing rights to a jurisdiction – frequently a tax haven – that chooses not to tax, or to tax very lightly. (Sections 2.7, 3.4)

Unitary taxation. This is an alternative approach to dividing the tax base of a multinational company between countries. While transfer pricing treats the company as a collection of separate entities that transact with each other, unitary taxation considers it as one global entity and apportions its profits according to a formula, taking into account, for example, fixed assets, staffing, and sales. Such formulaic apportionments are used by some federal countries such as the United States to apportion corporate profits between states. Unitary taxation advocates regard it as a system less vulnerable to tax avoidance and evasion, and hence less friendly to tax-motivated IFFs. (Section 3.5).

1. Introduction

Helping developing countries mobilise more domestic resources through taxation is a growing area of development practice. Many developing countries have begun to devote more resources and attention to this topic, which is also emerging as an important space for donor intervention. Tax-motivated illicit financial flows (IFFs) can seriously undermine these efforts, and therefore it is not surprising that the link between tax and IFFs is generating increasing interest among development practitioners.

The actual volume of IFFs and of their different components is extremely hard to measure, and estimates vary widely. Nonetheless, there is a consensus that the outflow of IFFs from developing countries is substantial, that it has a significant negative impact on development, and that overall it contributes to making developing countries net creditors to the rest of the world. A substantial portion of these outflows relates to tax avoidance and evasion.

While the interest in tax-related IFFs among development practitioners dates back at least 15 years, the 2008 financial crisis has undoubtedly elevated the profile of this issue outside the development sector. For governments of developed countries, this was a consequence of the need to prevent tax leakages as they faced sudden fiscal deficits. These same deficits led to a downturn in aid flows to developing countries, which may have caused developing countries, too, to look at other options for increasing their public revenue. As the crisis fades from immediate memory, it is perhaps civil society organisations and the media that have done the most to raise the issue's profile, highlighting the apparent injustice of tax avoidance and evasion by wealthy individuals and multinational companies in a time of public spending cuts.

This issue paper is designed as a guide for development practitioners who wish to better understand the links between development, taxation, and illicit financial flows. Policy making in the area of taxation and IFFs is complicated by a number of factors, including the complexity of the issues, the lack of clear definitions of key concepts, and the often polarized nature of policy debates. The area has links with a broad range of different areas of development practice, including governance, anti-corruption, public financial management, and the private sector.

1.1 Tax and IFFs: Definitions

The term “illicit financial flows” is understood differently by different stakeholders. At one end of the spectrum, IFFs are defined strictly as capital flows that are illegal in the way they are created, transferred, or utilized. But the word “illicit” is different from, and more subjective than, the term “illegal,” and so at the other end of the spectrum IFFs have been defined as all flows that have a “negative impact on an economy if all direct and indirect effects in the context of the specific political economy of the society are taken into account” (Blankenburg and Khan 2012).

While this broader definition is controversial, the narrower extreme is also inadequate for a discussion of tax-motivated IFFs. Is a flow “illicit” if it breaches the spirit, but not the letter, of the law? If political influence is used to obtain a tax concession that it is within a politician's powers to give, is this “licit”? If the state itself is seen as illicit or illegitimate, could financial flows to avoid or evade tax be considered “licit”?

As we will see in section 2.2, the legal/illegal distinction in taxation can be defined in more than one way. For practical purposes, refining this distinction, while important, is not the only priority in defining the issues at stake. As Blankenburg and Khan (2012) note, in developing countries the legal framework for taxes may not be an adequate guide for identifying illicit capital flows. It may be poorly drafted, and its application could be subject to discretionary settlements which are not incorporated in legal codes.

There may be some value for policymakers in formulating a more precise definition of IFFs that draws a line between these two extremes. In the meantime, for the purposes of this paper we have adopted a broad definition of “tax-motivated illicit financial flows” that incorporates practices such as lobbying for tax incentives, transfer mispricing, trade mispricing, and exploiting tax treaties for tax avoidance. This is simply so that we can familiarise the reader with tax concepts and debates that could be useful to development practitioners.

It is worth noting that the boundaries between tax practices that are legal or illegal, licit or illicit, are constantly shifting and may be defined differently by different stakeholders. An active public debate is taking place in many countries as to what level of tax minimisation it is legitimate for businesses and wealthy individuals to undertake. It is worth keeping this debate in mind when reading the following sections.

1.2 Implications for development

Why should development practitioners be interested in the connection between taxes and IFFs? Taxes clearly have enormous development significance. The most obvious reason is that while taxation is potentially the largest source of public revenue to spend on development projects, this potential is only partly exploited: most developing countries generate tax revenues equivalent to 15% of gross domestic product (GDP) or less, compared with two or three times this in other countries. Revenue from taxation is arguably more stable and reliable than that from other sources – and less vulnerable to the shifting agendas of aid donors, in particular.

Tax also has a number of non-revenue benefits. As a means of income redistribution, it ensures that the benefits of economic growth are shared more fairly across the population. This is an important development objective, especially when the impressive growth rates achieved in some developing countries have failed to translate into a reduction of poverty and inequality. Tax reform can also be used as a tool to promote economic development: taxation can shape incentives and change behaviour, while changes in tax policy and administration can create a better business environment. Finally, tax is seen as a means of building the state, increasing government accountability to citizen-taxpayers, and strengthening the social contract (Bräutigam, Fjelstad, and Moore 2008).

The revenue and non-revenue benefits of tax have led to its inclusion in the United Nations’ ongoing deliberations on financing for development. In 2002, the Monterrey Consensus signed by heads of state recognised the need for “equitable and efficient tax systems and administration” (International Conference on Financing for Development 2002).

The decade that followed that agreement witnessed an explosion of interest in the topic from international organisations, civil society groups, and governments, including, crucially, developing countries themselves. In 2008, senior tax policy and administration officials from 39 African countries met in Pretoria. “One of the most pressing issues facing our continent is to embark on a path to free African countries from their dependence on foreign assistance and indebtedness,” they concluded. “An indispensable condition of this is the strengthening of our capacity to mobilize domestic resources” (International Conference on Taxation, State Building and Capacity Development in Africa 2008, 2).

As that conference recognised, tax-motivated illicit financial flows are a major obstacle to achieving these objectives. They reduce revenue, make the tax system less fair, and in so doing reduce public confidence in the system. This can create a vicious circle, if by undermining “tax morale” IFFs reduce tax compliance in the wider population. They also facilitate corruption and undermine good governance. Finally, these flows have negative economic effects, as they direct private capital away from productive activity and out of the national economy.

Estimating the revenue forgone by developing countries through tax-motivated illicit financial flows is a difficult and controversial affair, but most estimates are staggeringly large. The Secretary General of the Organisation for Economic Co-operation and Development (OECD), writing in 2008, cited research indicating that developing countries lose three times more to tax havens than they receive in aid (Gurría 2008). One of the most conservative estimates suggests that illicit financial flows from Africa amount to 3.8% of GDP per year, and that the accumulated illicit capital flight makes the continent a net creditor to the rest of the world. One of the tax-motivated components of this particular estimate, trade mispricing, constituted almost a fifth of the total (Boyce and Ndikumana 2001).

In summary, while taxes are potentially a key development tool, tax-motivated IFFs undermine efforts to realize this potential.

1.3 Differences and points of contact between the tax and development and tax and IFF agendas

As noted above, there is a strong connection between the “tax and development” and “tax and IFFs” agendas, and many issues are common to both. What is different, however, is the approach.

Donors generally place tax issues within a box labelled “tax and development” or “domestic resource mobilisation,” which implies that the primary objective is to maximise public revenue. In contrast, looking at tax issues from an IFF perspective, as this paper does, implies an anti-corruption lens, with a greater focus on building the integrity and transparency of governance institutions, increasing financial transparency, and enhancing international cooperation in the area of enforcement (Fontana and Hearson 2012).

In other words, by combining the IFF perspective with the domestic resource mobilisation perspective we can arrive at a more holistic perspective on the issues concerned. These include, among others, corporate transparency and lobbying, financial integrity, the influence of multinationals in developing countries, the interaction between the tax systems of developing and developed countries, and the role of tax havens.

1.4 Organisation of the report

Based on these reflections, what is the content of the tax and IFF agenda? And why are certain tax issues relevant and connected to the IFF agenda? To analyse tax-motivated IFFs, we first have to understand the basic principles underlying national and international taxation. Section 2 begins with a discussion of the key principles of efficiency, equity, and administrability, as well as terminology relating to the different strategies that generate tax-motivated IFFs. It then analyses different tax strategies. Some are clearly illegal (tax evasion), while others breach only the intention of the legislation (tax avoidance). Still others take advantage of legal instruments in ways that have been called into question by campaigners and media reports – a category that we refer to as aggressive tax planning, and one that the OECD says it is addressing through its project on base erosion and profit shifting.

Section 2 then runs through the contours of the international tax system, considering how the system is exploited to generate tax-motivated IFFs, as well as the strategies that have been developed to deal with these flows. The manipulation of “transfer pricing” transactions between entities that are part of the same multinational group has emerged as one of the most controversial aspects of international tax and as the highest-profile type of tax-motivated IFF. It is also a major challenge for tax authorities in developed and developing countries alike. Other important areas include the exploitation of bilateral tax treaties between countries, stripping of profits through “thin capitalisation” of company subsidiaries, and the role of tax incentives in creating tax-motivated IFFs. Finally, mutual assistance

and information exchange allow tax authorities to collaborate in investigating tax-motivated IFFs and break open the financial secrecy that underlies the key role of tax havens and secrecy jurisdictions as facilitators of tax-motivated IFFs. Section 2 concludes by looking at some institutional issues in national and international tax and administration.

Section 3 considers some significant debates around tax-motivated IFFs. Studies attempting to quantify the magnitude of IFFs always need to overcome the lack of data on an area of the economy that is founded on secrecy; nonetheless, there is widespread agreement that the amounts are large. There is also some discussion about the impact of tax-motivated IFFs on the progressivity of tax systems, and about how particular taxes affect different sections of the population. Almost every major policy instrument that is vulnerable to tax-related IFFs is the subject of debate about its efficacy, independent of the issue of leakages due to IFFs. Section 3 considers some of these debates and examines the ways in which the design of these instruments may contribute to IFFs. In particular, it looks at tax incentives for multinational investors, tax treaties, and transfer pricing.

The final parts of section 3 discuss a number of policy instruments that might help developing countries combat tax-motivated IFFs, but which are partly in the hands of developed countries. Discussed in detail are transparency requirements for multinational companies, the “spillover” effects of developed countries’ tax policies on developed countries, and the ways in which development policy can help or hinder developing countries’ efforts to mobilise domestic resources.

Building on the latter point, section 4 examines the work on tax-related IFFs that is being undertaken by donors and other actors engaged in tax and development. It considers capacity-building work on the ground in developing countries, but sets it alongside efforts that can be undertaken by developed countries themselves to improve transparency and international cooperation in tax matters.

The international nature of the tax-motivated IFFs problem means that reforms in developing countries, while necessary, are not sufficient to resolve it. Section 5 expands on this point with some concluding thoughts on the political nature of tax policy and the need for consistency between donor governments’ international development objectives and their own tax policies.

2. Key concepts in tax-motivated illicit financial flows

This section offers an overview of some of the most significant concepts and policy and administrative instruments related to tax-motivated illicit financial flows in developing countries. Some of these concepts are discussed further in section 3, which focuses on current debates.

2.1 Principles of tax policymaking

Tax policy has traditionally been evaluated against three criteria: efficiency, equity, and administrability. The challenge in policymaking is often to chart a course through the conflicting priorities created by these principles. While these criteria are more usually applied to the development of domestic tax policy, there are good reasons to apply them to issues concerning illicit financial flows as well.

Efficiency

A tax is said to be efficient in an economic sense if it minimises the extent to which it influences the economic decisions taxpayers make. If certain types of income are taxed at a higher rate than others, for example, this creates a disincentive for taxpayers to earn these types of income, as opposed to other types. A tax can also be considered inefficient if it encourages planning whereby taxpayers obtain a lower rate simply by structuring the way in which their income is earned: this would result in different tax treatment based not on a taxpayer's choice of income-generating activity, but on her willingness or ability to engage in tax planning.

Of course, tax policy is often used deliberately to shape behaviours. Good examples of this are “sin taxes” on tobacco and alcohol, which are designed to reduce consumption, and “green taxes” designed to shift behaviour towards more environmentally friendly activities. The concept of efficiency, by contrast, refers to the unintended effects of tax policy.

Tax policies that facilitate illicit financial flows can be seen as inefficient, since they generally encourage unproductive behaviour. For example, a fixed-term tax holiday may have the desired effect of attracting an inward investor, but it may also have undesired, distorting effects. It may encourage that investor to plan around a short-term, rather than a more permanent, investment. It may also affect domestic businesses that do not qualify for the tax holiday, making it harder for them to compete.

International tax rules that allow base erosion and profit shifting may be inefficient if they encourage businesses to concentrate high-value-added group services such as marketing and accountancy, as well as patents, trademarks, and other intellectual property, in low-tax jurisdictions. More generally, capital flight through international tax avoidance and evasion leads to the concentration of capital in low-tax jurisdictions rather than in the economies from which the capital originates.

Equity

The principle of equity is that tax obligations should be fair. The predominant perspective in tax policymaking is the ability-to-pay principle, under which a taxpayer's relative wealth defines his or her obligations. This underpins the principle of residence taxation, on the grounds that the state in which a taxpayer resides is best placed to take into account his or her total wealth and total tax liability in other states, if any, to determine overall ability to pay.

An alternative to the ability-to-pay principle is the benefits principle, under which tax obligations are linked to the tax-funded public services provided to a taxpayer. Although this is rarely the predominant tax equity perspective, one instance in which it may seem attractive to developing countries is as a justification for the taxation of foreign investment at the source. In this case the tax

obligation of a foreign investor can be conceptually linked to the public services from which it benefits in the source country – the education and health care of the company's workforce, transport infrastructure, security, and so on.

Taking ability to pay as the generally accepted yardstick, states must determine what they consider to be fair. This can operate in two directions. Horizontal equity concerns the equal treatment of taxpayers in the same position: that is, taxpayers with the same ability to pay should incur the same tax liability. Vertical equity considers how the tax burden varies with income. Taxes can be progressive, regressive, or flat. In the first case, tax liability as a proportion of income increases with ability to pay, while in the second it is reduced; under a flat tax the rate remains the same regardless of income. Progressivity is commonly regarded as the desirable outcome, to be balanced against the potential inefficiencies of a high marginal rate, although in recent years a number of countries in Central and Eastern Europe have adopted flat income taxes.

Illicit financial flows can undermine both horizontal and vertical equity. They allow some taxpayers to reduce their tax liability relative to others with the same income, and they also take advantage of opportunities that are only available to wealthy individuals and larger companies. One particular situation that breaches the principles of both equity and efficiency is the use of base erosion and profit-shifting techniques available to multinational companies but not to their domestic competitors. Another is the provision of discretionary tax incentives to politically influential firms.

What about the treatment of taxpayers with interests in more than one country? The notion of inter-nation equity was first considered by economists Richard and Peggy Musgrave (1972). They argued that the allocation of taxing rights should be considered in terms of the gains and losses to each country; whether those gains and losses accrued to the treasury or to the private sector was to be treated as a separate question. The Musgraves also suggested that the international tax system could be used for redistribution at an international level:

With a highly unequal distribution of resource endowments and per capita income among countries and in the absence of an adequate method for dealing with the problem, an appropriate pattern of tax-imposed national gains and losses might be used to secure some degree of adjustment. (74)

Inter-nation equity provides a further lens through which to examine the impact of illicit financial flows. These flows represent a loss to developing countries, but they may not always represent a corresponding gain to developed countries, at least not to their treasuries. The gain may instead accrue to the tax havens that are net recipients of illicit flows. This needs to be considered carefully, however, keeping in mind that many of these countries are small island states with few resource endowments and a low per capita income among the general population – although the gain to that population from financial services may be minimal.

Administrability

It is commonly argued that tax policies should not be overly complex and costly to administer, either for revenue authorities or for taxpayers. Sometimes complexity is necessary in order to produce a more efficient or equitable result. An example is the implementation of a progressive income tax, with different rates for different income bands. This increases the administrative cost but is considered to be justified by the outcome.

Complexity in tax policy is often a product of efforts to close tax avoidance loopholes. However, where tax policies are too complex and hard to administer, revenue authorities may struggle to prevent their abuse. Therefore, administrability is an important factor in preventing illicit financial flows. Administrability is also a function of a country's technical capacity, which is why tax policy

development and the development of the tax administration must be considered together in developing countries.

2.2 Tax evasion, tax avoidance, and other tax minimisation categories

Practices designed to reduce a tax liability are arrayed along a legal spectrum. At one end is illegal tax evasion, which consists of actions by a taxpayer (an individual or an organisation) to escape a tax liability that has arisen under a country's law. This typically involves concealing from the revenue authority the income on which the tax liability has arisen. If the taxpayer falsifies paperwork, for example by knowingly making false statements in a tax return or engaging in false invoicing, then this is tax fraud. The distinction is important, because tax evasion, unlike tax fraud, is not a criminal offence in every country.

At the other end of the spectrum is tax planning, which is designed to prevent a tax liability from arising in the first place. The least controversial tax planning activities are those explicitly intended or condoned by government, such as taking advantage of a tax incentive by engaging in the behaviour it is designed to encourage.

Between tax planning and tax evasion lies tax avoidance, which has come to be understood in many countries as practices designed to gain a tax advantage by contravening the intention but not the letter of the legislation. This draws a boundary with tax planning, which is consistent with – or at least neutral with respect to – the intention of the legislation. Anti-avoidance rules, discussed in the next section, can be based on this distinction.

This technical definition of the term “tax avoidance” has become confused by its frequent use in public discourse to refer to practices that are not illegal but are perceived to be unethical. Many of the examples that have generated debate around the tax practices of multinational companies may not have been “tax avoidance” in the technical sense.

Finding a suitable categorisation and terminology for such activities is important to an informed political debate. Devereux, Freedman, and Vella (2012) suggest three such categories:

1. Ineffective avoidance, which can be prevented through the courts, provided it is discovered and action is taken.
2. Effective avoidance, which cannot be prevented in this way because it results from “a defect in the legislation or other failure in the way the legislation is written.”
3. Using legislation or the international tax system to one's advantage in a manner which may result in a very low tax bill, but is not tax avoidance as such.

The last category includes aggressive tax planning, a term that is often used to express the sense that an activity pushes an ethical boundary and should be addressed through changes to legislation.

Concepts in international tax related to tax avoidance and aggressive tax planning include tax arbitrage and treaty shopping. Tax arbitrage refers to practices that exploit the differences between two countries' tax systems: a taxpayer uses the different tax treatments of a transaction or entity by the two jurisdictions to obtain advantages in both jurisdictions. In treaty shopping, the taxpayer obtains a tax advantage in a cross-border transaction by routing the transactions through one or more jurisdictions whose tax treaties have more favourable characteristics.

BOX 1. GOOGLE'S TAX PLANNING

In 2010, Bloomberg Media published a report describing how Google used two well-known schemes, the "Double Irish" and the "Dutch Sandwich," to book the profits from its search engine business in Bermuda even though its staff were based in Ireland:

In Google's case, it generally works like this: When a company in Europe, the Middle East or Africa purchases a search ad through Google, it sends the money to Google Ireland. The Irish government taxes corporate profits at 12.5 percent, but Google mostly escapes that tax because its earnings don't stay in the Dublin office, which reported a pretax profit of less than 1 percent of revenues in 2008.

Irish law makes it difficult for Google to send the money directly to Bermuda without incurring a large tax hit, so the payment makes a brief detour through the Netherlands, since Ireland doesn't tax certain payments to companies in other European Union states. Once the money is in the Netherlands, Google can take advantage of generous Dutch tax laws. Its subsidiary there, Google Netherlands Holdings, is just a shell (it has no employees) and passes on about 99.8 percent of what it collects to Bermuda. (The subsidiary managed in Bermuda is technically an Irish company, hence the "Double Irish" nickname.)

A parliamentary committee in the United Kingdom took evidence from Google executives, who admitted that this structure had been put in place for tax planning purposes, including avoiding withholding taxes. In 2013, a whistleblower told the *Guardian* newspaper that Google had a large sales team in the UK, contradicting the company's statements that the Irish company in the structure described above was in charge of sales. In fact, Google had taken advantage of the way international tax rules define a taxable entity (a "permanent establishment") by vesting the authority to conclude contracts with the Irish staff, and not in the UK.

Sources: Drucker 2010 and transcript of UK Parliament's Public Accounts Committee evidence sessions, 12 November 2012 and 16 May 2013.

2.3 General anti-avoidance rules (GAARs)

One way of preventing tax avoidance is through legislative instruments known as specific anti-avoidance rules (SAARs) and general anti-avoidance rules (GAARs). SAARs are tailored to specific types of abuse and may include anti-avoidance clauses in tax treaties or controlled foreign company rules that prevent simple profit shifting into tax havens (see sections 2.7, 3.4, and 3.8).

GAARs provide a more generalised definition of the kinds of tax avoidance arrangements whose effect the tax authority may disregard when assessing a taxpayer's affairs. A weaker version of the general anti-avoidance rule is the general anti-abuse rule, which sets a higher bar before it is invoked, usually based on the artificiality of arrangements. For example, the United Kingdom's Finance Act 2013 (part 5, sec. 207) sets forth a new GAAR:

Tax arrangements are "abusive" if they are arrangements the entering into or carrying out of which cannot reasonably be regarded as a reasonable course of action in relation to the relevant tax provisions.

The GAAR proposed by the European Commission in December 2012 uses the following definition:

An artificial arrangement or an artificial series of arrangements which has been put into place for the essential purpose of avoiding taxation and leads to a tax benefit. (EC 2012a)

2.4 Tax havens, secrecy jurisdictions, and harmful tax practices

There is probably no more vexed definitional issue in international tax than that of tax havens. This is because any definition is generally associated with a list of jurisdictions that meet the criteria, which can expect to face unilateral or multilateral sanctions as well as the reputation damage associated with the label. Examples of such controversies include the inclusion of Hong Kong and Macau on a list of “noncompliant jurisdictions” at a G20 summit in 2008, which provoked a diplomatic row that threatened to derail negotiations (Dyer 2009). The following year the Netherlands government reacted with outrage to the Obama administration’s suggestion that it was a tax haven (Javers 2009).

The most authoritative starting point when seeking to define a tax haven is a 1998 OECD report, *Harmful Tax Competition: An Emerging Global Issue*. This report defined tax havens as “countries that are able to finance their public services with no or nominal income taxes and that offer themselves as places to be used by non-residents to escape tax in their country of residence.” Four criteria for the identification of tax havens were identified (box 2). The report argued that the first criterion, no or nominal taxes, was a necessary but not sufficient condition, and that the identification of a tax haven required a detailed study of each jurisdiction rather than a tick-box exercise against the criteria.

Two years later, a follow-up OECD report identified 38 jurisdictions that met its tax haven definition (OECD 2000). By 2002, all but seven of these jurisdictions had made commitments to meet the OECD’s standards on transparency and exchange of information. The seven holdouts were publicly labelled as “uncooperative tax havens” (BBC News 2002). The paring back of the assessment criteria from the OECD’s more comprehensive list to just one, transparency and exchange of information, can be traced to a change of position by the United States government, which has in turn been attributed to the combined lobbying efforts of the offshore sector and the Caribbean community inside the United States, many of the listed jurisdictions being Caribbean states (Sharman 2006).

BOX 2. KEY FACTORS FOR IDENTIFYING TAX HAVENS ACCORDING TO THE 1998 OECD REPORT

No or only nominal taxes: No or only nominal taxation on the relevant income is the starting point to classify a jurisdiction as a tax haven.

Lack of effective exchange of information: Tax havens typically have in place laws or administrative practices under which businesses and individuals can benefit from strict secrecy rules and other protections against scrutiny by tax authorities thereby preventing the effective exchange of information on taxpayers benefiting from the low tax jurisdiction.

Lack of transparency: A lack of transparency in the operation of the legislative, legal or administrative provisions is another factor in identifying tax havens.

No substantial activities: The absence of a requirement that the activity be substantial is important since it would suggest that a jurisdiction may be attempting to attract investment or transactions that are purely tax driven.

Source: OECD 1998, 23.

In 2008, the OECD and G20 began to reinvigorate global efforts against tax havens. A new standard was formulated: in order to be labelled “compliant,” a jurisdiction needed to agree to exchange tax information with a minimum of 12 others. For its May 2009 Heads of State summit in London, the OECD prepared a progress report stating which countries had achieved this standard, which had committed to achieve it, and which had done neither. The G20 declared that it stood “ready to take agreed action” against jurisdictions that did not comply (OECD 2010).

Since then, two major developments have occurred. First, the Global Forum on Transparency and Exchange of Information for Tax Purposes has begun working through a phased peer review programme. This looks beyond the agreements signed on paper to assess jurisdictions' legal and administrative frameworks and their demonstrated willingness to comply with information requests.¹ At the end of 2013, the ratings from some 50 such reviews were published, with jurisdictions rated on a scale from compliant to noncompliant (OECD 2013f).² Second, the threat of unilateral sanctions by the United States has dramatically accelerated progress towards an automatic information exchange standard (see section 2.5).

Although the "starting point" for its tax haven definition is tax rates, the OECD's programme is entirely focused on a jurisdiction's cooperation on tax information exchange. This is consistent with the alternative term advanced by some commentators, who argue that "secrecy jurisdiction" is a more apt description than "tax haven." Tax Justice Network, which prepares a biannual Financial Secrecy Index, ranking jurisdictions on transparency and information exchange, advances the following definition:

Loosely speaking, a secrecy jurisdiction provides facilities that enable people or entities [to] escape (and frequently undermine) the laws, rules and regulations of other jurisdictions elsewhere, using secrecy as a prime tool. (Tax Justice Network 2013)

In fact, the original OECD report (1998) drew a distinction between its definition of tax havens and a separate definition of harmful preferential tax regimes. The OECD subsequently identified some 60 harmful regimes in OECD countries themselves, which members agreed to eliminate (OECD 2000). The European Commission similarly identified, through its Code of Conduct for Business Taxation, 66 tax measures in European Union (EU) members or their dependencies that it regarded as "harmful tax measures." A recent proposal from the Commission suggests blacklisting jurisdictions either because that they do not comply with the OECD standards on information exchange or because they operate harmful tax measures in the area of business taxation (EC 2012b).

Although the OECD and EU have drawn up lists of harmful practices among their own members, neither organisation can be considered impartial. Many commentators have questioned the OECD's ability to effectively address the tax haven problem, noting that a large number of tax havens have historical and current links to OECD member states. A number of jurisdictions, including Spain and Mexico within the OECD, and Brazil outside it, apply their own tax haven "blacklists." Transactions with jurisdictions on these lists usually trigger a specific anti-avoidance provision, place the burden of proof on the taxpayer to demonstrate the transaction's legitimacy, or incur a penalty for the taxpayer.

Classifying jurisdictions as tax havens is an important tool that countries can use to protect themselves from illicit financial flows and exert economic and political pressure on labelled jurisdictions. But the politicised debate over a binary classification can sometimes obscure the different and more complex ways in which tax laws in one country can affect others. For example, while the Obama administration withdrew its suggestion that the Netherlands is a tax haven, it is nevertheless widely acknowledged that the Netherlands' tax treatment of certain types of transactions, combined with its extensive and beneficial tax treaty network, makes it a popular jurisdiction for tax planning structures (see, for example, OECD 2013b). To consider this further, section 3.1 discusses the magnitude of

¹ This is in some ways analogous to the Financial Action Task Force, whose standards assess whether each jurisdiction's domestic legislation equips public authorities with the information required for international cooperation on anti-money laundering.

² A total of 44 jurisdictions were rated compliant or largely compliant; two (Austria and Turkey) were rated partially compliant; and four (British Virgin Islands, Cyprus, Luxembourg, and the Seychelles) were rated noncompliant. Judgment was reserved on a further 14 "pending further improvements to their legal and regulatory frameworks for exchange of information in tax matters."

illicit financial flows from developing countries to tax havens and other countries, while section 3.8 discusses how tax policy in developed countries can affect developing countries.

It is also worth noting that some tax havens are themselves developing countries, for which the offshore finance industry provides significant employment and income. Small island states, especially, often rely heavily on offshore finance to sustain their economy. Additionally, a number of African countries, most notably Ghana, have considered adopting measures that meet the above definitions of harmful tax competition in their efforts to establish a financial centre (Mathiason 2009). It is therefore important that calls to “close down” tax havens be accompanied by efforts to explore alternative development pathways.

2.5 Mutual assistance and information exchange

When one country’s tax authority is investigating a possible tax-motivated illicit financial flow, it will need to trace the flow to a second country. It may also need to investigate its own taxpayers’ affairs there: for instance, when it suspects that a taxpayer is hiding profits by transferring them elsewhere. To do this, it will need to establish cooperation with that country’s tax authority. This mutual assistance usually requires a treaty between the two countries, to give tax authorities the legal mandate to share information that is usually protected by taxpayer confidentiality laws. Standards for such cooperation are embodied in model conventions maintained by the OECD.

The OECD conventions provide the framework for three types of cooperation: exchange of information and cooperation between authorities of both countries in investigations, collection of taxes owed to one country by the administration of the other, and service of official documents issued by one country in the other.

Probably the most commonly used form of mutual assistance is tax information exchange, under which information relevant to a taxpayer in one jurisdiction is made available to another. Information can be exchanged in three ways:

1. *On request*, in response to a formal request from one tax authority to another. This is the baseline for information exchange in tax treaties. The OECD standards require that the requesting authority demonstrate that the information it requests is “foreseeably relevant” to the investigation of a taxpayer, and provide certain information about the taxpayer. This is designed in part to prevent tax authorities undertaking “fishing trips” to obtain information without a case to support them.
2. *Spontaneously*, in which case a tax authority in one country uncovers information that it thinks may pertain to a taxpayer’s tax liability in another country and transfers it without receiving a request. Treaties provide a legal basis for such exchange, but no obligation to undertake it.
3. *Automatically*, meaning that bulk data are transferred, usually electronically, on a regular basis. The information transferred is of a very basic nature. Under the European Union’s savings taxation directive, for example, automatic exchange within the EU is currently limited to the interest income from a citizen’s savings held overseas and does not extend, for example, to the principal on which the interest is earned. The information gained in this way may lead to a request from the receiving authority for more detailed information. The bulk nature of the data exchange requires considerable technical cooperation to establish compatible systems and standards.

Three international instruments embody these standards: article 26 of the OECD and United Nations (UN) model tax conventions; the OECD model Tax Information Exchange Agreement, which provides for a stand-alone information exchange treaty; and the Multilateral Convention on Mutual Administrative Assistance in Tax Matters. The latter convention was originally open only to OECD

and Council of Europe members, but it has recently been revised and opened to wider membership. In addition to these instruments, a number of regional economic institutions have established multilateral cooperation, including the European Union, Southern African Development Community, and African Tax Administration Forum.

Until recently, international exchange of information in such agreements was usually limited to exchange on request, with the notable exception of the EU Savings Directive. All the OECD models offer the possibility of automatic exchange, but do not require it – in the case of the Multilateral Convention it can be enacted by bilateral agreement between signatories. Exchange on request has also formed the basis of the international standard against which the Global Forum on Transparency and Exchange of Information has undertaken peer reviews.

This climate has recently changed with the passing of the Foreign Account Tax Compliance Act (FATCA) in the United States. FATCA requires financial institutions anywhere in the world to report information on US citizens automatically to the US Internal Revenue Service, with significant penalties for noncompliance. This approach poses a number of issues, including its non-reciprocal nature and its incompatibility with financial institutions' legal obligations regarding client confidentiality. In some countries, governments have responded by reaching agreements with the United States to collect the information themselves and exchange it automatically at a government-to-government level (Grinberg 2012).

For developing countries, information exchange, whether on request or automatically, poses challenges as well as opportunities. Exchange on request requires that the “foreseeable relevance” criterion be met, and it can be time-consuming with respect to filing the paperwork and waiting for a response. Automatic exchange is limited to enforcing taxpayers' obligations in their country of residence and is thus of little use in investigating multinational firms, since the information required from overseas will generally concern a parent or sister company, which is outside the scope of existing modes of automatic exchange.

It should be remembered that the reciprocal nature of information exchange places a considerable compliance burden on participating countries, regardless of the mode. Countries need to establish legal and administrative systems to enable them to gather and supply information to partners, a challenge demonstrated by the Global Forum's peer reviews, which show compliance problems even in larger developed countries. The UN model convention recognises this by providing for the requesting party to compensate the other for the cost of responding to a request. It is certain that many developing countries will need considerable technical assistance before they are able to comply with growing information exchange obligations and, perhaps more importantly, take advantage of the opportunities that they offer. If automatic information exchange is imposed, rather than driven by demand from developing countries, the opportunity costs may outweigh any benefits to them.

The focus on these forms of information exchange should not lead us to overlook the benefits of other forms of mutual assistance for developing countries. In 2012, African Tax Administration Forum members concluded a multilateral mutual assistance treaty designed to permit them to work together to investigate the tax affairs of multinational companies.

2.6 Allocation of the international tax base

When two or more countries have the possibility to tax the same transaction, international tax rules allocate or apportion the taxing rights between them. The logic behind this is to eliminate juridical double taxation, the scenario in which a taxpayer is taxed on the same income more than once,

because this is seen as a hindrance to cross-border trade and investment.³ In the converse situation, double non-taxation, neither country is able to tax cross-border income. What follows may seem a rather technical discussion, but the rules on jurisdiction to tax can dramatically affect developing countries' capacity to raise tax.

On a most basic level, the tax jurisdiction rules affect the share of the tax base attributed to developing countries, and hence the tax revenues that they can raise. But their effect may extend beyond this simple allocation function if they are exploited. A recent OECD report observes that, as controversial examples have shown, "the international common principles drawn from national experiences to share tax jurisdiction may not have kept pace with the changing business environment" (OECD 2013b, 7). Tax-motivated IFFs rely on moving income and wealth beyond the jurisdiction of the country from which they originate to the jurisdiction of another state that will not tax them, or at least will do so at a much lower rate. Where the rules are not designed well, or where developing countries don't have the appropriate safeguards, this creates opportunities for IFFs.

Several key concepts underpin the system used by most countries for allocating the tax base. A country has jurisdiction to tax a corporate or individual taxpayer under two circumstances: (a) if the taxpayer is a tax resident of that country, or (b) if the taxpayer earns income in that (source) country. If a taxpayer who is a resident of one country earns money in another, these two principles can clash, creating juridical double taxation. To minimise this, countries generally agree to restrict the circumstances in which they apply the residence and source principles, through unilateral measures in their own taxes and through bilateral and multilateral agreements.

With respect to individuals, a developing country may well have some interest in taxing non-resident workers who are employed in the country by multinational companies or nongovernmental organisations (NGOs). The main object of interest in the context of illicit financial flows, however, is wealthy individuals who are tax resident in a developing country but who earn income abroad. This income is usually the interest on savings and investments that may have been transferred out of the country illicitly.

With respect to companies, a developing country is usually in the position of taxing income at source. It can levy taxes on the profits of companies operating in its jurisdiction, but it may also tax foreign residents who earn money in the country through the proceeds of shareholdings, loans, technical services, or intellectual property licensing. Developing countries do this by withholding taxes levied on dividends, interest payments, royalties, and fees.

Countries restrict their right to tax at source unilaterally or through negotiations in two ways. First, they may limit the circumstances in which they tax a foreign-owned company's profits by restricting this right to circumstances in which a permanent establishment exists. If a multinational has not incorporated a local subsidiary in order to carry on its business, the permanent establishment test generally requires a physical presence in the country for a specified period of time, with exceptions for certain kinds of activities. One key area of tax treaty negotiations concerns the length of time required to meet this test. Second, countries restrict the right to tax at source by lowering their withholding tax rates, the most visible outcome of tax treaty negotiations. Within the European Union, some forms of withholding tax have been eliminated entirely.

The quid pro quo for restricting taxation at source is that countries on the other side of the transaction, where the taxpayer resides, agree to forfeit some of the right to tax their resident multinationals' income earned overseas. They may do this in three ways, listed here in ascending order of generosity: (a) by deducting taxes paid overseas from a company's profits and calculating its domestic tax

³ Juridical double taxation is distinct from economic double taxation, which occurs where two taxpayers are taxed with respect to the same income. This often occurs as a matter of design, for example, when a company's earnings are taxed once as its profits and a second time as dividends received by shareholders.

liability on the basis of its post-foreign tax income; (b) by giving companies a credit for taxes paid overseas against their domestic tax bill; or (c) by exempting foreign-earned income from domestic tax altogether. Table 1 shows how this works out in practice, considering only profit taxes.

Table 1. Effect of different methods to relieve double taxation

	No relief from double taxation	Deduction	Credit	Exemption
Overseas profit	100	100	100	100
Tax paid overseas @ 20%	20	20	20	20
Profit taxable at home	100	80	100	0
Home tax liability @ 30%	30	24	30	0
Less credit for foreign taxes paid	0	0	-20	0
Tax paid at home	30	24	10	0
Total tax paid	55	44	30	20

As table 1 shows, policies in a multinational's residence country can dramatically affect the post-tax return on the company's overseas investments. As we consider in section 3.8, this can in turn change the incentives for investors, including their incentives to lower their effective tax rate overseas through IFFs.

In summary, the rules on jurisdiction to tax predominantly affect developing countries' tax revenues in three ways: first, by restricting their right to tax inward investors; second, by creating possibilities for exploitation, leading to IFFs; and third, by altering the post-tax return on investment across different jurisdictions and hence the incentives for multinational investors, including the incentive to create IFFs.

2.7 Tax treaties and treaty shopping

Tax treaties are agreements between the participating countries on how income earned in one country by residents of another country will be taxed. Today there are some 3,000 bilateral tax treaties in force, including well over 1,000 with developing countries, as well as a number of multilateral conventions such as those within the European Union, the Nordic Council, and the West African Economic and Monetary Union. These treaties differ from information exchange and mutual assistance conventions in that they are agreements about the content of tax policy, not just about its enforcement.

Countries have signed treaties related to taxation for more than a hundred years, but the modern era begins with the development of international model treaties through the League of Nations in the 1920s and 1930s. At this time, the unilateral relief of double taxation by countries of residence (discussed in section 2.6) was not so common, and the growth in international trade and investment had made double taxation a significant issue. It is generally assumed that developing countries whose growth strategies are based on attracting foreign direct investment should pursue tax treaties to eliminate this barrier to investment, an assumption that we interrogate in section 3.4.

By concluding tax treaties, countries reach a negotiated settlement that restricts their source and residence taxation rights in a compatible manner. Treaties also harmonise the definitions in their tax codes, provide mutual agreement procedures (MAPs) that can be invoked if there are outstanding instances of double taxation, and establish a framework for mutual assistance in enforcement.

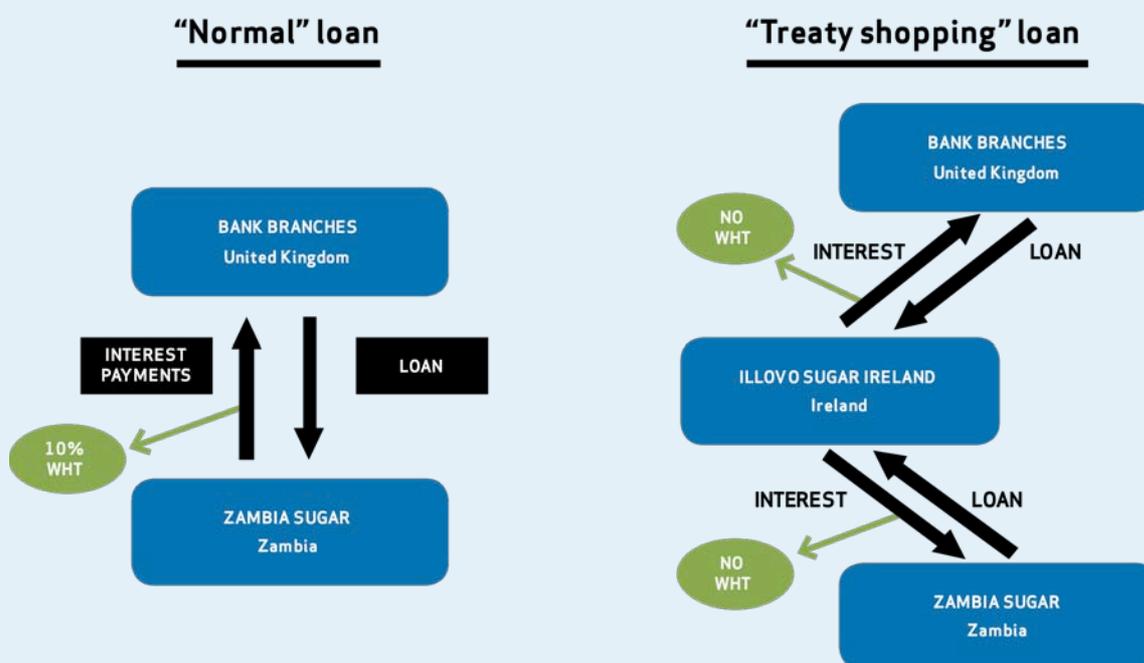
Bilateral treaties are generally based on two model conventions, maintained by the OECD's Committee on Fiscal Affairs and the UN Committee of Experts on International Cooperation in Tax

Matters, the latter of which was written with developing countries in mind. Some of the more visible differences between treaties resulting from negotiations include the maximum levels of withholding tax specified by the treaty, the number of days of presence in a country needed to qualify as a permanent establishment, and the inclusion or exclusion of clauses permitting countries to levy withholding taxes on technical services. The allocation of the right to tax capital gains to either source or residence country can also have significant implications, as the debate in India over its treaty with Mauritius demonstrates.

A number of recent developments in model treaties are worth noting. The first is the inclusion of anti-treaty shopping provisions, which are designed to challenge IFFs through treaty-based tax avoidance. Treaty shopping is the practice of structuring a cross-border transaction through a third jurisdiction in order to benefit from the favourable provisions of a tax treaty with that jurisdiction. An example of such activities is given in box 3. Tax treaties generally shift the balance of taxing rights away from developing countries and towards their treaty partners, and so a treaty shopping structure may take advantage of the allocation of taxing rights to a jurisdiction – frequently a tax haven – that chooses not to tax, or to do so very lightly.

BOX 3. ASSOCIATED BRITISH SUGAR ACCUSED OF TREATY SHOPPING

A report published in 2013 by ActionAid gave examples of what the NGO argued were treaty shopping arrangements, designed to avoid withholding tax that would have been paid to the Zambian government (Lewis 2013). In one example, a Zambian subsidiary of Associated British Foods took out a loan from a UK-based bank. Because of the terms of Zambia's tax treaty with the UK, the interest payments on this loan would have incurred a 10% withholding tax (WHT). Instead, the loan was made from the UK bank to another group company, registered in Ireland, which in turn loaned the money to the Zambian company. Zambia's tax treaty with Ireland prevented Zambia from levying any withholding tax on interest payments, and Ireland does not levy withholding tax on interest payments to EU companies.



Source: Lewis 2013.

A related practice is round-tripping, in which domestic investment is structured through an offshore jurisdiction to gain treaty benefits that are not available to domestic investors. The often-cited dominance by Mauritius of inward investment into India is likely to be a consequence of round-tripping by Indian investors seeking to avoid capital gains tax (Commission on Capital Flight from

Poor Countries 2009). Anti-treaty shopping provisions in treaties include restrictions ensuring that only investors with a real economic presence in the treaty partner are eligible for the preferential terms of the treaty.

Another recent change is the introduction of a mandatory arbitration clause into the OECD model convention. Both model treaties already include mutual agreement procedures which permit either a signatory or a taxpayer who incurs double taxation to initiate a negotiation between the two countries to resolve a dispute. Because there was no obligation to reach an agreement, a large backlog of MAP cases arose; this led to the strengthening of the clause, so that a taxpayer now can force the countries into an arbitration procedure. The new UN model does not include an arbitration clause by default, because of fears that developing countries would lack the capacity to participate fully in the arbitration process. It has been suggested that, because they are confidential negotiated settlements between governments, MAPs reduce the efficiency and democratic scrutiny of tax administration (Christians 2011). They may also disadvantage developing countries, which have less negotiating capacity.

2.8 Transfer pricing and mispricing

In the previous sections we discussed the principles that countries have adopted to define their jurisdiction to tax income in a bilateral setting. The next consideration is how to distribute the tax base of a multinational firm operating across many tax jurisdictions. This generally affects developing countries because many of their largest businesses are part of multinational firms, although a growing number of firms based in developing countries are beginning to invest abroad.

There are two possibilities: a unitary approach, which considers the multinational as a whole and apportions its collective profits between countries based on a formula, and the separate entity approach, which begins by breaking the multinational group down into its constituent companies and taxing each independently on the basis of its profits.

Since the work of the League of Nations in the 1920s and 1930s, when the growth of multinational firms created a desire to address this question at international level, the separate entity approach has been the dominant model. But it is challenging to implement. Since under the separate entity approach, the companies within a multinational group trade with each other, the group can easily manipulate these internal transactions to allocate as much profit as possible to companies that incur lower tax rates. In response to this, a regulatory regime for these transfer pricing transactions developed, based on the principle that the commercial and financial relations between related companies should allocate profits between them in the same way as transactions between independent companies transacting at “arm’s length.”

All OECD countries and most developing countries that have adopted transfer pricing regulations follow guidelines maintained by the OECD. These guidelines set out five methods through which the arm’s length price can be determined, as well as a methodology for applying them. The starting point for the OECD’s methods is the identification of “comparables,” real-life arm’s length transactions that can be used as the basis to determine the appropriate transfer price between related parties. As we will consider later, this starting point is increasingly challenged by the proliferation of situations for which no comparable can be found, either because the transaction is of a nature that would not occur between independent companies, or because it occurs in a developing country or region where few comparables exist. This has created considerable scope for illicit financial flows from developing countries that take advantage of the challenges faced by tax authorities in enforcing transfer pricing rules.

Discussion of illicit financial flows from developing countries often focuses on “transfer mispricing,” narrowly understood as the use of a false transfer price when products are imported or exported in order to shift profits. Transfer mispricing should not be confused with trade mispricing, which is an

umbrella term incorporating both transfer mispricing and false invoicing. False invoicing refers to the practice of falsely declaring the value of goods imported or exported to evade customs duties or circumvent quotas. It has the effect of reducing a company's taxable income by manipulating the import or export price, but it usually takes place between independent companies and is a matter of outright fraud.

The application of transfer pricing methodologies is, however, usually a more complex affair than this simple description of transfer mispricing. The first stage in determining a transfer price is to conduct a functional analysis, that is, an assessment of the functions, assets, and risks pertaining to the companies involved in the transaction. This is important because all three can affect the price, and they also determine the suitability of a particular comparable.

For example, consider a local company in a developing country that imports and distributes manufactured products under the brand name of a multinational firm. Such a company may have taken on considerable risks – in initial marketing, infrastructure development, and importing a certain amount of goods – and may have had to borrow money to fund this. Alternatively, it might be a “limited risk distributor,” which means that it has an arrangement under which the brand name manufacturer takes on some of these risks – for example by agreeing to buy back any unsold stock. Clearly the price at which the goods were imported would be higher in the second scenario, in recognition of the risks taken on by the manufacturer.

Once the functional analysis has been undertaken, it's time to find a comparable arm's length transaction. In the simplest case, “comparable uncontrolled price” (CUP), a transaction is found that is similar enough that the price can be used as a reference, possibly with some subsequent adjustments. Since in many instances it's not possible to find an appropriate comparable for the CUP method, the OECD guidelines provide for four other methods (box 4).

BOX 4. TRANSFER PRICING METHODS IN THE OECD GUIDELINES

Traditional methods: Focus on the gross profit margin

Comparable uncontrolled price. The transfer price used is the price of a comparable transaction taking place at arm's length, possibly subject to some adjustments.

Resale minus. This method is used when the company being tested purchases a product from within the same multinational group and resells it to independent customers. The transfer price is the actual price at which the end product is sold, less the gross profit margin made on the resale. The profit margin is determined using a comparable.

Cost plus. When a good or service is sold to another company within a multinational group, the transfer price is the total cost incurred to produce the product plus an appropriate markup. The markup is determined by using a comparable – preferably the margin earned by the same company when it sells on to an independent party (an “internal” comparable) or, failing that, one earned by a comparable company in an equivalent transaction (an “external” comparable).

Transactional profit methods: Focus on the net profit margin

Profit split. For more complicated transactions, this method takes profit earned by the related companies involved in a transaction and divides the total between them based on the functions they perform and other factors such as bargaining power and intangible assets. It requires the use of “allocation keys,” which may include the number of employees, value of sales, etc. Although this is similar to a formulary apportionment, it differs from unitary taxation in that it relates only to the profits from a particular transaction, and the allocation keys used are bespoke to that transaction.

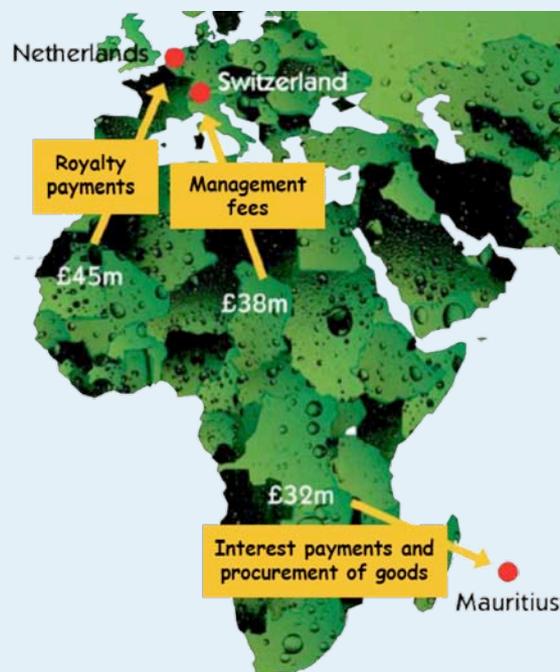
Transactional net margin method. This method uses the ratio of operating profits made from a particular transaction to a particular base relevant to that transaction (such as assets, sales, or costs). The ratio is compared that from a comparable transaction, preferably an internal one.

In later sections we will discuss some of the challenges posed by these methods and the alternatives that have been advanced by some developing countries. The reader should also note that illicit financial flows do not necessarily depend on the use of a false transfer price. They can also be facilitated by manipulating the location of functions, assets (particularly intangible assets), and risks, so that the transfer price, although properly determined using the methods listed above, nonetheless results in capital flight.

BOX 5. SABMILLER'S TAX PLANNING

In 2010, the development NGO ActionAid published a report suggesting that multinational brewing firm SABMiller had avoided £20 million of tax liability in Africa and India (Hearson and Brooks 2010). This was done through transfer pricing arrangements that ActionAid said shifted over £100 million of taxable profits to Mauritius, Switzerland, and the Netherlands. Four types of transactions were described:

1. Royalty payments for the use of trademarks registered in the Netherlands, including the Castle brand that had been developed in South Africa. The Dutch company concerned paid almost no tax on its profits.
2. Management fee payments to a company in Switzerland, where the tax rate was around 6%. The company said that these payments covered "financial consulting," "personnel strategy," "business advisory services," "marketing," and "technical services," but conceded that they had been "routed" through the Swiss company, which did not itself provide the services.
3. An arrangement through which raw materials used by some of the operating companies were procured via an office in Mauritius, where the effective tax rate is 3%. The goods did not appear to physically pass through Mauritius during the procurement process.
4. Interest payments on a loan from the same Mauritius company to one in Ghana, which ActionAid argued constituted thin capitalisation.



Source: Hearson and Brooks 2010.

SABMiller denied that these transactions were motivated by a desire to minimise tax payments. A subsequent analysis by a former OECD tax official argued that, on the basis of the evidence presented by ActionAid, the financial flows could have been prevented through proper enforcement of the arm's length principle (Schatan 2012).

2.9 Thin capitalisation

A form of tax planning related to those based on transfer pricing, in that it also shifts taxable profits through intragroup transactions, is thin capitalisation. Under this technique, a parent company uses debt to invest in a subsidiary and then strips out its profits through interest payments on the loan, rather than repatriating them through dividends. The loan is commonly made from a group financing subsidiary located in a low-tax jurisdiction.

This technique exploits the different treatment of debt and equity income in tax systems and tax treaties. Because the interest payments reduce the operating company's taxable profits, they reduce its corporation tax bill.⁴ If the loan is made from a tax haven, there may be little or no further tax to pay once the interest payments reach their destination.

A relatively simple legislative device can be used to counter thin capitalisation. This specifies that the interest payments on related-party loans above a certain multiple of the company's equity capital are not tax-deductible. If the threshold is 2:1, for example, the cost of interest payments can only be subtracted when calculating the company's taxable profit up to a loan value of twice its total share capital.

Thin capitalisation can also be challenged using transfer pricing rules if it concerns a loan that is not arm's length, for example, because the size of the principal or the interest rate differ from what would have been negotiated between unrelated companies.

2.10 Base erosion and profit shifting

The term "base erosion and profit shifting" (BEPS) originated from the OECD during 2012, as the organising principle for a G20-endorsed work plan to reform international corporate tax rules. According to the OECD (2013c), BEPS refers to "tax planning strategies that exploit gaps and mismatches in tax rules to make profits 'disappear' for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low resulting in little or no overall corporate tax being paid."

A recent OECD report discussing BEPS states:

Their overall effect is a tendency to associate more profit with legal constructs and intangible rights and obligations, and to legally shift risk intra-group, with the result of reducing the share of profits associated with substantive operations. These tendencies become more pronounced over time as the economy evolves from bricks and mortar based businesses to more mobile information technology and intangibles based businesses.

While these corporate tax planning strategies may be technically legal and rely on carefully planned interactions of a variety of tax rules and principles, the overall effect of this type of tax planning is to erode the corporate tax base of many countries in a manner that is not intended by domestic policy. This reflects the fact that BEPS takes advantage of a combination of features of tax systems which have been put in place by home and host countries. This implies that it may be very difficult for any single country, acting alone, to effectively combat BEPS behaviours. (OECD 2013b, 45)

"BEPS" has been quickly adopted by governments, businesses, civil society groups as a catch-all term for the flaws they see in the international tax system, but in practice it refers to six specific areas:

⁴ While corporation tax would be avoided in this example, there may still be a withholding tax to pay on the interest payments, just as there would have been on dividend payments.

1. The existence of “hybrid entities” that exploit mismatches between tax definitions in different countries
2. The taxation of e-commerce, and in particular the balance of source and residence taxation that results in companies with large customer bases in some countries paying little tax there
3. The use of intragroup financing to shift profits through interest payments
4. Ongoing issues in transfer pricing
5. Anti-avoidance rules, including GAARs and controlled foreign company rules
6. Harmful preferential tax regimes

The BEPS project is taken forward by the OECD secretariat and three working groups: a group on transfer pricing, chaired by the United Kingdom; a second on e-commerce, chaired by the United States and France; a third on other base erosion issues, chaired by Germany. The outcomes at each stage are agreed first by the OECD’s Committee on Fiscal Affairs, made up of finance ministers, and then forwarded to the G20. Some larger developing countries are involved in the process at the OECD and G20, while input has also been solicited from developing countries (OECD 2013a).

The OECD’s action plan on BEPS proposes to conclude the project by 2015, but many commentators have expressed scepticism that such an ambitious timeline can be adhered to without compromising on the depth of reform.

2.11 Tax competition and tax incentives

Governments in developed and developing countries often use the tax system to try to attract foreign capital, or to retain domestic capital. Insofar as tax policy affects investment decisions made in isolation, this is the use of tax by the government to direct the economy.⁵ But these decisions are not made in isolation; they are made by mobile taxpayers who take into account the tax systems of a range of possible investment destinations. The result is that governments may feel the need to offer favourable tax treatment to investors not simply as a matter of national economic policy, but rather in order to offer a more beneficial environment than competing countries. This is tax competition.

Tax competition is sometimes referred to as “harmful.” The OECD’s 1998 report *Harmful Tax Competition: An Emerging Global Issue* defines tax competition as harmful if it is undertaken by a tax haven or through a harmful preferential tax regime. According to that report, if a country derives “significant” revenue from taxes on corporate income, albeit at a lower rate than another country, this may be considered “undesirable,” but it is not “harmful” (OECD 1998, 15–16).

Perhaps the most visible form of tax competition is in headline tax rates. The effective corporate tax rate has declined on every continent since the 1970s, and it shows no sign of levelling off (Kumar and Quinn 2012). Interestingly, however, falling rates have often coincided with rising total revenue. There are a number of explanations for this observation, including the suggestion that ending some corporate tax exemptions and bringing more informal businesses into the formal sector has broadened the tax base.

Aside from the headline rates, however, tax competition can also take the form of other measures to reduce certain companies’ effective tax rates. Tax incentives typically include reductions or exemptions on corporate income tax, import and export duties, and other forms of tax on activities by companies in sectors or geographic areas that the government wishes to promote. They can also

⁵ Tax competition over individuals can also take place, but for practical purposes this section focuses on corporate tax competition.

include special treatments such as accelerated depreciation, under which companies can offset the cost of capital investment against their taxable profits more quickly than they would normally be able to.

Tax incentives are the subject of some controversy in developing countries, as will be discussed in section 3.3. Questions have been raised about whether the benefits outweigh the costs in lost revenue, as well as about the manner in which they are granted – sometimes on the basis of personal discretion, with little transparency.

A term related to tax incentives is tax expenditures. This constitutes the cost to government of any concessions granted for particular groups of taxpayers or particular behaviours. Tax expenditures include incentives granted to businesses as well as to the general population, such as reduced sales taxes on environmentally friendly goods. Another category of tax expenditures is not granted to incentivise behaviour change but to assist people in particular need; an example is exemptions on value-added tax (VAT) for certain products.

Incentives for investors may be outlined through a formalised investment code. Certain tax concessions may only be available as part of a broader package of incentives for companies established in certain “free zones.” In some cases incentives last indefinitely, while in others companies are offered tax holidays which last for a fixed period of time after the investment is made.

Like competition over headline rates, there has been considerable competition over tax incentives. Table 2, based on an International Monetary Fund (IMF) study, shows that many types of tax incentives have become much more common across sub-Saharan countries.

Table 2. The proliferation of tax incentives in sub-Saharan Africa

Type of investment tax incentive	Proportion of countries offering incentive	
	1980	2005
Tax holidays	45%	69%
Reduced corporate income tax rates	10%	51%
Investment allowances	59%	56%
Incentives for exports	10%	28%
Free zones	3%	46%
Investment code	31%	74%

Source: Based on Keen and Mansour 2009, table 2.

The incentives outlined above are all statutory, set out in the law and available automatically or on application to a government authority. Sometimes tax incentives are discretionary, granted personally by a minister or official with the authority to do so. Incentives may also be built into the terms of larger investments, if there is a contract between the investor and the government. It is common for such contracts to include fiscal stability clauses, which insulate the investor from changes to the fiscal code for a certain period of time; in some cases, companies have negotiated stand-alone fiscal stability agreements for this purpose.

2.12 Entities of national government relevant to taxation

In most countries, the competence for tax policy sits with the finance ministry, while tax administration sits with the revenue authority. In practice, collaboration between the two functions is

important in the design of tax policy and administration, and in certain areas the finance ministry may rely on the revenue authority's advice. "In developing countries," so the aphorism goes, "tax administration is tax policy" (Casanegra De Jantscher 1990, 179).

In most developed countries and a growing number of developing countries, the revenue authority is a semi-autonomous entity, with some limited independence from political interference and the ability to set its own financing and salary arrangements. In others, the revenue authority is a part of the finance ministry, without this autonomy. Customs and excise may be a separate authority or integrated with the revenue authority.

Many tax authorities have established large taxpayer units (LTUs) to focus on big businesses such as multinational companies. Among the services offered by these units may be enhanced relationships, a formal model of cooperation between LTU and taxpayer, and advance pricing agreements, a form of transfer pricing settlement that is negotiated before, rather than after, a transaction. Revenue authorities may also have a designated competent authority to handle transfer pricing disputes; this is a requirement of the mutual assistance procedure contained in tax treaties.

In general terms, there is a high degree of parliamentary scrutiny of tax legislation, because it is at the core of the social contract with citizens and can have major electoral implications. One major exception is the negotiation of discretionary tax incentives, a process that often takes place in secret. The effectiveness of scrutiny may also be limited by the technical complexity of some tax reforms. In some developing countries, tax treaties need parliamentary ratification, while in others this authority is vested in the executive.

In most countries local authorities have some responsibility for tax policy and administration within a framework set by central government, a common example being property taxes. In federal countries, state governments also have taxing competence. Fiscal decentralisation is an ongoing trend in developing countries as part of efforts to strengthen local government and its accountability.

2.13 International institutions relevant to taxation

The highest-profile international tax institution is the OECD, which acts as a standard setter and think tank and increasingly as a provider of technical assistance. Its three most significant products are its model tax convention, transfer pricing standards, and tax information exchange treaties and standards. The OECD's membership includes 34 countries, with a number of larger developing countries enjoying observer status to different bodies.

Associated with the OECD is the Global Forum on Transparency and Exchange of Information for Tax Purposes, a body that facilitates the peer review assessments of its members' compliance with OECD tax information exchange standards. The Global Forum has over 100 member jurisdictions.

In recent years the G20 has taken an increasing interest in international tax issues. In 2009 it provided the mandate and threat of sanctions that led to the creation of the Global Forum, and it is currently the organisation mandating the OECD to undertake its work on base erosion and profit shifting.

The United Nations has a long history of work on international taxation and a mandate to consider the special needs of developing countries. Its Committee of Experts on International Cooperation in Tax Matters maintains its own model tax convention, which is based on the OECD model but adjusted with the UN mandate in mind. The UN also recently published a first edition of its *Practical Manual on Transfer Pricing for Developing Countries* (UN 2013).

Regional cooperation between tax authorities provides an important tool for mutual assistance and capacity building. The Inter-American Center of Tax Administrations (CIAT) provides this function

in Latin America, although it has associate members in other regions. In Africa, its equivalent is the recently created African Tax Administration Forum (ATAF).

The International Monetary Fund is an important provider of research and technical assistance on tax policy and administration, frequently publishing working papers on tax and development subjects. It has tended to focus on domestic tax policy, while the OECD focuses on international tax matters, although that distinction has blurred as both organisations engage in the tax and development agenda. The World Bank and development agencies such as Germany's GIZ and the Norwegian Agency for Development Cooperation (Norad) also provide technical assistance to developing countries.

3. Current tax debates relevant to illicit financial flows

This section considers some of the areas of policy and research in which there are ongoing debates. The aim is not to reach a conclusion as to which side is right, but rather to offer insights into the different perspectives for the benefit of development and anti-corruption practitioners .

3.1 Magnitude of illicit financial flows

Several academics and civil society organisations have tried to estimate the cost to developing countries of tax-related illicit financial flows (for a survey, see Fontana 2010). The methodology and conclusions of many of these studies have often been challenged, and understandably so: the data with which to formulate estimates are often hard to obtain, because of taxpayer confidentiality and tax haven secrecy, and consequently an element of guesswork is inevitable.

It should also be noted, of course, that advocacy organisations often put forward magnitude figures as a means of drawing attention to the scale of a problem, rather than providing an academically robust analysis. Pascal Saint-Amans, director of the OECD's Centre for Tax Policy and Administration, stated recently that "plenty of people are very good at coming up with figures which are all fake, so we don't do that. But we say there is an issue" (Goodall 2013).

Key estimates of illicit financial flows

Given this polemical remark, it is ironic that one of the most widely quoted statistics originates from OECD Secretary General Angel Gurría (2008), writing in the *Guardian* newspaper:

Developing countries are estimated to lose to tax havens almost three times what they get from developed countries in aid. If taxes on assets hidden by tax dodgers were collected in their owners' jurisdictions, billions of dollars could become available for financing development.

The article doesn't give a source for this estimate, but it places the total at around US\$300 billion per year. It's important to ensure that like is compared with like: aid inflows represent public revenue, so the correct comparator is not the magnitude of illicit financial flows out of developing countries, but the tax revenue that would have been raised from this sum.

Aggregate figures for illicit financial flows tend to be estimated by comparing the sources of revenue entering a country with the amount of revenue used, and assuming the difference to be flight capital. These may be illicit financial flows that cause developing countries to lose tax revenue, but they are primarily composed of the proceeds of corruption, not tax-related IFFs. We limit the discussion here to a couple of examples.

A widely publicised Tax Justice Network study in 2012 estimated that assets worth US\$21–\$30 trillion were held illicitly offshore, of which US\$7.3–\$9.3 trillion originated in developing countries (Henry 2012). The paper uses a simple methodology to estimate the tax that is lost because the earnings from these assets are not taxed, arriving at a result of US\$66–\$84 billion per year. Boyce and Ndikumana (2001) apply a similar approach to a panel of 25 low-income sub-Saharan countries between 1970 and 1996. They find that the annual capital flight through corruption from these countries amounts to US\$270 million per year.

Turning to tax-motivated IFFs, the most commonly cited estimate of the cost to developing countries of trade mispricing is Christian Aid's estimate that developing countries lose US\$160 billion each year (Hogg et al. 2008). This figure is based on the estimate made by former businessman Raymond

Baker (2005) in his book *Capitalism's Achilles Heel*, using a qualitative interview methodology, that 7% of global trade involves the illicit movement of capital to evade taxes.

Most other estimates of illicit financial flows through trade mispricing (or its components, transfer mispricing and false invoicing) are obtained by looking for discrepancies in trade data. False invoicing is measured as the difference between country A's reported exports to country B and country B's reported imports from country A, adjusting for factors such as shipping costs. For example, Boyce and Ndikumana (2001) estimate an annual loss to their sample of 25 sub-Saharan countries of US\$60 million per year. A study commissioned by the United Nations Development Programme (UNDP) from the NGO Global Financial Integrity, meanwhile, covering 1980–2008, gives a substantially higher estimate for a sample of 48 least developed countries of US\$6.6 billion per year (Kar 2011).

Estimates of transfer mispricing use a "price filter" to identify discrepancies between the average price of an import or export in trade data and the price of particular transactions. They assume that transactions where the price deviates substantially (typically outside of the interquartile range) represent transfer mispricing. Such estimates rely on fine-grained trade data to obtain accurate price segmentation, which can generally only be obtained from developed countries. According to one study published by Christian Aid, which uses this method, low-income countries alone lost an average of US\$5 billion per year through transfer mispricing transactions with the United States and European Union (Hogg and McNair 2009).

Criticisms of this work

A study commissioned by the UK Department for International Development (DFID) in 2009 examined some of the papers cited above, and others (Fuest and Riedel 2009). It raised a number of methodological criticisms. In particular, it suggested that the "price filter" method may produce false positive results due to glitches in the data and variations in product quality that would give the appearance of manipulated prices. It also questioned the conceptual underpinning of studies that assume the shifting of profits from developing to developed countries for tax reasons. The authors suggest that estimates of capital flight should not be converted to revenue loss figures simply by multiplying by average corporate income tax rates, given the extent to which the counterfactual tax payment would have been reduced by tax incentives. The paper concludes:

Most existing estimates of tax revenue losses in developing countries due to evasion and avoidance are not based on reliable methods and data. Moreover, it seems that too much emphasis is put on producing aggregate estimates of tax revenue losses for the developing world as a whole. (Fuest and Riedel 2009, vi)

Interestingly, both the Global Financial Integrity and Tax Justice Network papers cited above include methodological discussions that note these and other issues. For example, the estimates of trade mispricing imply illicit flows in both directions, and one question debated in these papers is whether to "net out" the difference. Boyce and Ndikumana (2001) do so, which may explain why their estimates are much lower than those of Global Financial Integrity/UNDP.

In sum, then, it is clear that most of the large figures cited in association with illicit financial flows should be treated with caution, as they generally are by their original authors. That said, policymakers and tax officials appear to harbour no doubt that tax-motivated illicit flows are a significant problem for developing countries and that the sums involved are large. As GIZ (2010, 12) concludes:

These studies certainly reveal the importance of the issue and might even provide a rough indication of the size of the problem. However, it should be noted that underlying definitions and assumptions differ widely and the estimates are, therefore, neither comparable nor reliable.

3.2 Progressivity and tax incidence

As discussed in section 2.1, it is generally accepted that tax policy should aim for progressivity, though the principle of equity must be balanced against economic efficiency and the practicalities of administration. Tax-motivated illicit financial flows, and measures to prevent them, can have implications for tax equity as much as they may complicate administration and distort economic efficiency.

Consider the likely beneficiaries of IFFs designed to avoid or evade personal income tax. In developing countries, this tax is often only levied on a minority of individuals whose income exceeds a certain amount, so they are the ones with the potential to benefit from avoiding or evading it; access to the types of financial advice and overseas connections needed to avoid or evade income tax is probably restricted still further to the most wealthy within the population.⁶ Tax Justice Network argued in a 2012 report that official estimates of inequality underestimate the gap between rich and poor because they do not take account of illicit wealth held offshore (Henry 2012).

The situation is more complicated with respect to corporate income tax. Where a company owned by a wealthy businessperson evades tax or uses political influence to obtain a tax incentive, it follows that the owner, who took the risk, would expect to retain the benefits. But what about the proceeds of tax avoidance or tax incentives exploited by a publicly owned multinational firm, with many shareholders around the world?

In fact, the incidence of a tax levied on a business can fall on three groups of people: shareholders, through dividends; employees, through wages; and customers, through prices. Depending on how tax-related changes in the business's profitability affect dividends, wages, and prices, the beneficiaries of some tax-motivated IFFs may be external to the country from which the flows originate.

A government crackdown on IFFs by one group of taxpayers may also have unintended effects on other parts of the population if it causes a change in behaviour. For example, when some authors found a reduction in investment flows into developing countries following the conclusion of a tax treaty, they attributed it to the discouraging effect on unscrupulous investors of the treaty's mutual assistance provisions, which would make tax evasion more difficult (Sauvant and Sachs 2009).

Finally, a further equity impact of IFFs may occur if the government responds by levying higher taxes on those (less wealthy) taxpayers that it is able to tax. For example, civil society organisations have opposed the widespread adoption of value-added tax by developing countries over the last two decades, arguing that VAT is regressive and that its incidence falls more heavily on women. These organisations want governments to focus more heavily on tackling IFFs, especially tax incentives and corporate tax evasion and avoidance.⁷

3.3 Tax incentives

As section 2.11 established, there has been a proliferation of tax incentives across many developing countries. A survey of tax officials undertaken by ATAF, summarised in box 6, underscores the problematic nature of this increase.

⁶ Of course, nonpayment of personal and corporate tax is also widespread within the informal sector, where it occurs among poorer as well as wealthier people.

⁷ The IMF, however, argues that VAT is more progressive than the tariffs it replaced, and that there are few alternatives for developing countries. It also states that regressive taxation can be compensated by progressive spending: "What ultimately matters is not the impact of any tax instrument in isolation, but the combined impact of all such measures—and of the spending they finance" (IMF 2011; see also Keen 2012).

BOX 6. ATAF SUMMARY OF TAX OFFICIALS' VIEWS ON TAX INCENTIVES**Traditional methods: Focus on the gross profit margin**

The African Tax Administration Forum commissioned a series of workshops with African tax officials. Some key findings:

- Participants from across the continent observed that “there is a proliferation of tax incentives and exemptions across the regions and they are often not evaluated in terms of cost-benefit analysis.” They placed particular emphasis on VAT exemptions.
- Participants cited the “abuse of the incentives system,” which is “particularly prevalent in the extractive industry (mining, oil and gas),” and the “lack of coordination between the various government agencies that grant the incentives and the revenue authorities that are required to administer the incentives.”
- The officials “underscored that tax incentives and exemptions have been over-emphasized as investment promotion tools” and “have not necessarily delivered in terms of attracting huge investments.”
- Tax holidays, rebates, allowances, credits, and tax rate deductions “create an administrative burden,” and the challenge is “rationalizing, managing, and monitoring” them.
- There is a “great lacuna in the quantification and analysis of tax expenditures” through which to ascertain “the extent to which tax expenditures erode tax collections in different African countries.”

Source: Monkam 2012, 7.

Some governments include figures for the revenue forgone because of tax incentives in detailed tax expenditure reports, while others release such data sporadically. A recent study published by ActionAid took the amount forgone in statutory corporate tax incentives from 16 such reports (table 3).

Table 3. Revenue forgone through corporate tax incentives in selected countries

Country	Year	Corporate income tax forgone through incentives		
		In US dollars	As a share of GDP	As a share of corporate income tax raised
16-country average			0.60%	24%
Bangladesh	2005	113,162,000	0.19%	30%
Costa Rica	2010	296,232,800	0.82%	28%
Kenya	2008	158,461,600	0.52%	21%
Mozambique	2007	154,720,800	1.93%	77%

Source: ActionAid 2013, 8.

An interesting aspect of the debate is that this proliferation of tax incentives occurs despite a nearly universal view among academic economists and providers of technical assistance such as the IMF that incentives are not effective at attracting investment – or at least do not attract the right kind of investment. A report prepared for the G20 in 2011 by the IMF, OECD, United Nations, and World Bank – organisations that have in the past encouraged countries to adopt tax incentives – concluded:

Incentives, including corporate income tax (CIT) exemptions in free trade zones, continue to undermine revenue from the CIT; where governance is poor, they may do little to attract investment – and when they do attract foreign direct investment (FDI), this may well be at the expense of domestic investment or FDI into some other country. Tax-driven investment may also prove transitory. (IMF et al. 2011, 19)

BOX 7. TWO TAX INCENTIVES WON BY ZAMBIA SUGAR

A report published by ActionAid estimated that a British-owned company, Zambia Sugar, saved over US\$3 million per year in tax payments to the Zambian government because of a tax incentive it obtained through the courts (Lewis 2013).

Agricultural companies can qualify for a tax incentive granting them a reduction in the corporation tax rate, from 35% to 10%. Because most of Zambia Sugar's profits come from sugar processing, not growing, the Zambia Revenue Authority (ZRA) concluded that the company was only eligible for the reduced rate on the minority of its profits that came from its agricultural activities. Zambia Sugar took the case to the tax tribunal, where it succeeded in winning the reduced tax rate across all of its profits. ActionAid reported:

Lusaka-based tax experts we spoke to were surprised by Zambia Sugar's successful suit, since the 15% farming rate was originally introduced to help domestic farmers, and has previously been denied to commercial farms seeking a similar blanket low rate on their profits [...] One ZRA advisor blamed tax incentives drawn too widely in outdated Zambian tax law: "This is bad design: we could have a revenue threshold on the rate so that massive companies can't qualify for it." (Lewis 2013, 28)

Zambia Sugar also obtained a second tax incentive from the Zambia Development Agency (ZDA) in return for investment to expand its mill and estate. Despite a legal obligation to do so, ZDA declined to disclose the terms of this tax incentive. "Troublingly," ActionAid wrote, "we do not know the precise terms of this second tax break, or what investments and jobs Zambia Sugar has promised to deliver in return" (28).

So why do tax incentives – and in particular discretionary, opaque ones – persist, despite this advice? An answer may lie in the political-economic conceptualisation of tax policy formation in developing countries, which sees it as emerging from, and dependent on, bargaining among different elite groups within a country. Tax academic Richard Bird (2012) explains the issue as follows:

[Tax exemptions] are overwhelmingly political, shaped not only – or even primarily – by the efficiency concerns of economists, but by the desire to deliver important benefits to key political constituencies. This line of reasoning signifies that tax exemptions will persist, despite economists' equally persistent demonstrations of exemptions' distortionary economic effects.

In recognition that the persistence of tax incentives has its roots in political bargaining, many campaigners and development agencies have focused on arguing for greater transparency and democratic scrutiny of tax exemptions. Box 8 sets out 10 principles for tax incentives developed by the OECD under the auspices of its tax and development task force.

It is widely agreed that discretionary tax incentives, which are often negotiated in secret by politicians or officials, are most undesirable because they are economically inefficient, pose a corruption risk, and are the result of agreements made outside the process of democratic scrutiny that is important for the fiscal policymaking process. GIZ (2010, 24) states that "under certain circumstances – nepotism, corruption, and low transparency – they may just appear to be 'tax evasion with an official stamp on it.'"

Multinational investors lobby for tax incentives in developing and developed countries alike, with varying degrees of “licitness.” Some guidance is offered in the OECD Guidelines for Multinational Enterprises, which state that enterprises should “refrain from seeking or accepting exemptions not contemplated in the statutory or regulatory framework related to human rights, environmental, health, safety, labour, taxation, financial incentives, or other issues.” The commentary notes that “the words ‘or accepting’ also draw attention to the role of the State in offering these exemptions” (OECD 2011, 19, 21).

It should be noted that, while there is quite a consistent lobby against corporate tax incentives, few organisations support the elimination of all tax exemptions. Civil society groups often argue in favour of some tax exemptions, such as from VAT on basic foodstuffs, while opposing corporate tax incentives.

Donor agencies are often themselves beneficiaries of tax exemptions in developing countries – sometimes offered by host countries, but at other times demanded by funders – which somewhat undermines the credibility of any work they undertake to help improve the integrity of tax systems. This issue has been debated for some time: in 2005, the IMF’s Victor Thuronyi prepared a paper for the United Nations tax committee arguing that “tax exemption undermines the budgets of aid recipients, increases the transaction costs relating to international assistance, facilitates tax fraud, and leads to economic distortions” (Thuronyi 2005, 5).

BOX 8. OECD DRAFT PRINCIPLES TO ENHANCE THE TRANSPARENCY AND GOVERNANCE OF TAX INCENTIVES FOR INVESTMENT IN DEVELOPING COUNTRIES

1. Make public a statement of all tax incentives for investment and their objectives within a governing framework.
2. Provide tax incentives for investment through tax laws only.
3. Consolidate all tax incentives for investment under the authority of one government body, where possible.
4. Ensure tax incentives for investment are ratified through the law making body or parliament.
5. Administer tax incentives for investment in a transparent manner.
6. Calculate the amount of revenue forgone attributable to tax incentives for investment and publicly release a statement of tax expenditures.
7. Carry out periodic review of the continuance of existing tax incentives by assessing the extent to which they meet the stated objectives.
8. Highlight the largest beneficiaries of tax incentives for investment by specific tax provision in a regular statement of tax expenditures, where possible.
9. Collect data systematically to underpin the statement of tax expenditures for investment and to monitor the overall effects and effectiveness of individual tax incentives.
10. Enhance regional cooperation to avoid harmful tax competition.

Source: OECD 2013e.

3.4 Tax treaties

As section 2.7 explained, tax treaties between countries have their origins in efforts to resolve the problem of juridical double taxation, which can be a barrier to cross-border trade and investment. Critical scholars have noted for some time that modern tax systems in the home countries of multinational companies provide unilateral double taxation relief through credit or exemption mechanisms, so tax treaties are unnecessary to achieve this on a grand scale (Dagan 2000; Thuronyi 2010). Indeed, empirical studies are divided on whether tax treaties encourage, discourage, or have no impact on foreign direct investment in developing countries (Sauvant and Sachs 2009; Barthel, Busse, and Neumayer 2009; Christians 2005).

Despite this, developing countries still view treaties as an important investment promotion tool. One explanation for this is the signalling effect of a treaty: it may contribute, along with other factors, to creating the impression that a country has a favourable regulatory environment for investors. A related suggestion is that treaties act as a form of “credible commitment,” which is to say that they allow countries whose fiscal regime is seen as unstable to make a visible and binding long-term commitment to the treaty partner, which constrains their ability to increase or levy certain taxes.

In addition, tax treaties undoubtedly confer some administrative benefits. The harmonisation of definitions between signatories, and the institution of a mutual agreement procedure to resolve disputes, reduces the likelihood that companies will incur double taxation. Mutual assistance provisions, while not requiring a full-blown tax treaty, are an additional benefit. Tax-sparing clauses may be thought to increase the effectiveness tax incentives – a benefit to be viewed with some caution, as noted above.

But treaties also come with significant costs. The most obvious is the reduction in tax revenue as a result of lower withholding taxes and a more restrictive definition of permanent establishment: tax treaties always result in a transfer of taxing rights from source to residence, which generally means from a less developed to a more developed country. “The low withholding taxes common in double tax treaties . . . can weaken a last line of protection for weak administrations,” notes the IMF (2011, 36).

Treaties also lock countries which have not adopted international standards on, for example, transfer pricing into the standards required by the treaty. This may have the beneficial effect of stimulating legislative and capacity development in these areas, but it may also be premature.

Some authors suggest that tax treaties are best seen as a matter of tax competition (Baistrocchi 2008). In this understanding, it would be preferable for developing countries collectively not to sign treaties, but they are in a prisoner’s dilemma: once one country signs a tax treaty, others are better off following suit. Indeed, the reduction in source taxation rights may act as a tax incentive by reducing the overall tax liability of investors from the partner jurisdiction, if that jurisdiction exempts the foreign income concerned.

If they do not include anti-treaty shopping clauses, treaties with certain jurisdictions can create opportunities for base erosion and profit shifting. Multinational companies commonly structure their investments in developing countries to take advantage of the most favourable tax treaty available, namely one that allocates taxing rights to a treaty partner that does not exercise them.

As an example, many developing countries’ tax treaties with Mauritius allocate the right to tax capital gains to the country of residence. Because Mauritius does not exercise its right to tax capital gains, investments into other countries via Mauritius are effectively free from this kind of tax. Furthermore, a large share of inward investment benefiting from these treaties is in fact domestic investment that has been “round-tripped” via Mauritius. On this basis, the Norwegian Commission on Capital Flight

from Poor Countries (2009, 75) concluded that “tax treaties help to make tax havens a more favourable location than if such agreements did not exist.”

The Netherlands is another common conduit country, used in tax planning structures because of its wide treaty network and favourable treatment of some kinds of foreign income. This was highlighted in the OECD’s initial report on BEPS (OECD 2013b). Two recent studies of the impact on developing countries of treaty shopping via Dutch tax treaties estimated the cost in reduced withholding tax revenue to be on the order of hundreds of millions of euros per year (DutchNews 2013). In response, the Dutch government has announced a review of its tax treaties with developing countries, and training for their tax treaty negotiators, with a view to renegotiating these treaties and including greater protection against treaty shopping (Government of the Netherlands 2013).

Weighing the potential costs and benefits of a particular tax treaty is challenging for developing countries. Negotiating a favourable outcome with a more powerful and experienced country is inevitably difficult. And on top of investment and tax considerations, treaties are made in the context of political, economic, and diplomatic relationships between countries, which may limit the room for manoeuvre.

For donor countries, tax treaty negotiations with developing countries present challenges for policy coherence. Should negotiators be more generous in negotiations with aid recipients, to allow them to maintain tax revenues? Some donors have historically included provisions in tax treaties exempting aid projects from tax in the developing country: in the short term this means that aid money goes further, but in the long term it may undermine domestic resource mobilisation.

At present, there is little debate in developing countries about the costs and benefits of tax treaties, but there are signs that this may change. In 2012 Mongolia, acting on IMF advice, cancelled several tax treaties, including those with the Netherlands and Luxembourg (Ernst & Young 2012b). An official statement indicated that an assessment had led the government to conclude that the treaties did not produce sufficient benefits to offset the costs. Argentina also cancelled a number of treaties, including its treaty with Spain, which was quickly renegotiated on more advantageous terms, and its treaty with Switzerland, which was not (Tax Treaties Analysis 2013; Ernst & Young 2012a).

3.5 Transfer pricing and models of corporate taxation

Although the consensus among OECD countries appears to have settled on the approach to corporate taxation embodied by the OECD’s transfer pricing guidelines, a more detailed look reveals a complex patchwork of national legislation, both outside and inside the OECD. There is a vocal community of campaigners and academics who argue for sweeping reform of international tax, and a broader constituency who find the OECD approach unsuitable for developing countries.

In this section we briefly consider the strengths and weaknesses of the OECD guidelines and their alternatives in the context of illicit financial flows from developing countries. The reader should keep in mind the considerations of efficiency, equity, and administrability. We have classified alternatives into two categories: transfer pricing methods that differ from the five specified by the OECD, and alternatives to transfer pricing.

Most developing countries have yet to make a concerted effort to implement transfer pricing rules, although capacity building in this area is gathering pace. Where countries have moved forward, few have deviated dramatically from the OECD guidelines. Although the guidelines have only the status of soft law, legal scholars have debated the extent to which they are binding on countries. Reuven Avi-Yonah (2007), for example, argues that transfer pricing, along with other elements of the international tax regime, has become an aspect of customary international law.

Alternatives to the five methods specified by the OECD

The chief difficulty presented by the OECD transfer pricing methods is their administrative complexity. This is a challenge even for developed countries, in particular for transactions involving intangibles and technical services, which may be of a nature that would never occur outside of a multinational firm. It is hoped that this issue can be addressed through the OECD's BEPS project.

Probably the most obvious difficulty with the methods set out in the OECD guidelines is that they rely on obtaining comparables. In developed countries, businesses and tax authorities use commercially compiled databases to obtain data for applying the guidelines, but these databases have relatively little coverage in developing countries. There are a number of reasons for this, including the low demand for such data, the lack of publicly available company accounts from which the databases are compiled, and in many cases the sheer absence of local comparables because of the small number of companies in developing countries and the dominance of many sectors by multinational firms.

The OECD guidelines do allow the use of comparables from other countries or even continents, provided suitable adjustments can be made, but as the comparables become more different and the adjustments more significant, transfer pricing assessment becomes much harder. One result of this situation has been the growing use of "location-specific advantages" by revenue authorities in India and China. This concept is premised on the idea that, when one is using comparables from other countries, adjustment should be made for local advantages in these countries such as lax environmental regulation, cheap labour, and large, unexploited markets.

Aside from the difficulties with comparables, the technical capacity required in a tax authority to prevent illicit financial flows through transfer pricing is significant. Tax officials need not only transfer pricing knowledge, but also expertise in the sector they are assessing in order to understand the business models and to effectively scrutinise the transfer pricing practices of companies under assessment. Some countries have developed simplifications to help correct for this:⁸

- *Safe harbours.* Companies meeting certain criteria may be exempted from transfer pricing assessment to reduce compliance costs and allow tax administrations to focus on higher-risk transactions.
- *Sector-specific regimes.* The Dominican Republic, for example, developed bespoke transfer pricing rules for its hotel sector, where it had identified widespread exploitation of tax havens (Montero 2012).
- *The "sixth method."* Developed originally in Argentina but now used widely across Latin America, this prevents multinational firms from shifting profits into low-tax jurisdictions by taking advantage of fluctuating commodity prices. The transfer price must be the market price of the commodity on the day that it is physically shipped.
- *Fixed margins.* Instead of seeking a bespoke comparable to identify the margin on a transaction, Brazilian legislation specifies the profit margin to be used in particular sectors.

Alternatives to transfer pricing

Despite the original decision in the 1930s to adopt transfer pricing as the international standard for corporate taxation, the alternative of unitary taxation through formulary apportionment continues to be discussed. Under this approach, a multinational is treated as one global entity, and its global profits are apportioned among the countries where it operates using a formula based on allocation keys such as fixed assets, staff costs and numbers, and sales. Clearly, the choice of formula would have a

⁸ For a good summary of the different approaches to transfer pricing in Latin America, see Arias Esteban et al. (2012).

tremendous impact on the distribution of taxing rights among countries, which is said to be the reason why it would be politically impossible to reach global agreement on the use of a formulary approach.

No country has yet adopted formulary apportionment as the means of determining its allocation of companies' taxable profits relative to other countries, but this is not to say that there is no practical implementation of this approach. Some countries, including the United States and Switzerland, use the formulary approach to allocate taxing rights among states. When the state of California adopted this approach it created considerable international controversy, and so the "water's edge" principle now applied requires that the formulary approach be used to allocate profits within the United States, but that the total to be allocated is still determined using transfer pricing (Picciotto 1992, 235–45). The European Union is considering proposals to introduce formulary apportionment among a group of its member states, although it would be optional for companies to do so.

Unitary taxation is unlikely to be a realistic option for developing countries in the near term, because it would be difficult to deviate dramatically and unilaterally from the international consensus. But some academics and civil society groups argue that in the long term, a global shift in international tax rules would be beneficial in that it would significantly reduce the capacity for illicit financial flows through base erosion and profit shifting (Picciotto 2012). This is because profits are allocated through a formula that uses indicators of real economic activity.

The outstanding question is of course how particular formulas would allocate the tax base to different types of countries. Formulas based on the traditional "three factor" combination of sales, physical assets, and employees would yield mixed results, but would have a detrimental impact in extractive industries because the sales generally take place outside the country of extraction. In any case, it is unlikely that a global negotiation would arrive at a formula that allocated more income to developing countries relative to the status quo.

That said, formulary apportionments at the level of individual transactions are already in use through the OECD transfer pricing guidelines. The profit split method allocates the profits generated by a transaction using allocation keys in a way similar to that proposed under global formulary apportionment.

3.6 Financial transparency and country-by-country reporting

Many civil society organisations have focused their campaigning energy on calling for improved transparency around multinational companies. Corporate transparency, and the lack of it, has repercussions for illicit financial flows. Given that some of these flows occur within multinational companies, requiring transparency from them would shed some light on the patterns of IFFs, circumventing secrecy in those jurisdictions – including most developing countries as well as tax havens – where corporate accounts are not publicly available. The Publish What You Pay civil society campaign, for example, seeks corporate transparency both to ensure companies' fair tax contributions and to minimise corruption. They call for

full financial transparency from companies, to ensure the availability of quality data that is regular, credible, comprehensive, comparable and accessible/open. This will provide women, men and youth in resource-rich countries with the information to demand accountability from both industry and government. (Publish What You Pay 2013)

A paper written by a multi-stakeholder group for the OECD tax and development task force (Devereux et al. 2011, 7) identified the aims advanced by advocates of greater financial transparency as follows:

- a. *To hold governments to account with regard to:*
 - i. *Integrity of administration of tax collection;*
 - ii. *Efficient administration of tax collection;*
 - iii. *Appropriate domestic tax policies; and*
 - iv. *Adoption of appropriate international taxation standards.*
- b. *To hold companies to account with regard to:*
 - v. *Paying the amount of tax due in each country in which they operate; and*
 - vi. *The tax planning strategies of companies even where the amount of tax due has been paid.*

That report's focus is on the proposal for country-by-country reporting advocated by a number of campaign groups, under which summary financial data (taxes paid, profits, turnover, etc.) from a multinational company's financial report would be broken down for each country in which it operates. This, they argue, would facilitate public scrutiny of companies' tax behaviour, exerting a deterrent effect on many forms of tax planning. It would also be the easiest way of ensuring that tax authorities in developing countries have access to the information.

Opponents of country-by-country reporting argue that the cost to businesses of providing the information would not be justified by the potential benefits. The cost relates not only to the administrative burden, but also to the additional communications costs associated with managing reputational risk, and to the potential (unfair) reputation damage that might result.

Despite these objections, the United States passed legislation requiring a limited form of country-by-country reporting by US-listed companies operating in the extractives sector in 2010, although this has yet to be implemented and has been challenged in court. The European Union decided in 2013 to implement similar requirements for companies in the extractive and forestry sectors, while the banking industry will be required to disclose a broader range of information to the European Commission at first, with a view to public disclosure from 2015 onward.

Public country-by-country reporting is one option available. It has also been suggested that a country-by-country breakdown could be made available privately to tax authorities. The OECD's action plan on BEPS notes that "in many countries, tax administrations have little capability of developing a 'big picture' view of a taxpayer's global value chain." It goes on to propose that multinational enterprises "provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template" (OECD 2013a, 22–23). A subsequent OECD memorandum proposes a range of options, predominantly based on the disclosure to all tax authorities of financial information for each legal entity within a multinational group, grouped by country (OECD 2013h).

A variation on these approaches is the Extractive Industries Transparency Initiative (EITI). Under this mechanism, to which individual countries may opt in, companies in the extractive sector disclose the payments they make to the government, by type and by project, and the government discloses the amounts it receives in the same way. A comparison of the two allows investigators to focus on any discrepancies, which may be the result of corrupt activities. A side benefit of the EITI is the public availability of tax payment information. This is of limited use in terms of the aims set out earlier, however, because it's hard to evaluate the magnitude of a tax payment without a base – most likely the company's profits - with which to compare it.

Another reform that has perhaps not been given enough consideration is the creation of public registers of company accounts in developing countries – something that exists as a matter of course in developed countries. Tax authorities have access to financial information through companies' tax returns, and treaties permitting information exchange allow them to access information on other group companies overseas when undertaking investigations. But the latter process is time-consuming and, of course, limited to a country's treaty partners.

From an enforcement perspective, increasing the number of countries with public registries could have the significant benefit of making it easier to obtain comparables for transfer pricing assessments (Bowler 2012). International guidance discourages tax authorities from using "secret" comparables taken from other companies' tax return data and hence known only to the tax authority, because they are harder for a taxpayer to challenge. Furthermore, commercial comparables databases, which save time for the tax authority and make it easy to obtain comparables from similar countries, can only be compiled if accounts are publicly available. If company accounts were to be made available across a whole region or subregion, this might permit their aggregation into a comparables database for use in transfer pricing assessment.

The potential benefit from the registers of accounts is the increased accountability of government and taxpayers. Most cases in which companies and revenue authorities have been subject to public criticism have their origins in studies of companies' accounts. Although it is sometimes argued that such studies are prone to misunderstandings, it is nonetheless the case that they often spur governments to action to improve enforcement. For example, an ActionAid study of one company was the trigger for the creation of a new mutual assistance treaty between members of the African Tax Administration Forum (Crotty 2013). The OECD's (2013b, 13) report on base erosion and profit shifting suggests that the BEPS project is a response to a series of media reports in the UK and elsewhere.

A final element of public financial transparency is the proposal that each country should create a public registry showing the beneficial ownership – that is, the ultimate owner – of all registered companies and trusts. Such registries would be designed to help prevent tax evaders and money launderers from concealing assets in secrecy jurisdictions, often behind layers of corporate ownership that make tracing the ultimate ownership difficult or even impossible. At the G8 summit in 2013, civil society organisations proposed an international convention that would bind signatories to create such registries (IF 2013). The summit concluded instead with a nonspecific statement of principle that trust and company ownership information should be accessible to authorities and that some information should be made public (G8 2013).

3.7 The international governance of tax standards

As previous sections have illustrated, policymaking in many areas of international tax is strongly influenced by international standards. The preeminent standard setter in the areas of transfer pricing and tax information exchange is the OECD, which, along with the United Nations, also maintains a model tax treaty. The OECD is made up of 34 countries, predominantly the world's wealthiest democracies, which have economic structures and governmental capacities very different from those of developing countries. Because these standards are adopted by a much wider group of countries than the core OECD membership, arguably with little choice, this poses challenges for their applicability and legitimacy.

The OECD has responded by reaching out to a wider constituency. Several larger developing countries have formal observer status in the organisation, allowing them to participate in meetings and enter formal positions in official documents. Still wider constituencies are involved in bodies such as the OECD Task Force on Tax and Development, the Global Forum on Transparency and Exchange of Information, and additional global forums on transfer pricing and tax treaties. The OECD's work on base erosion and profit shifting is also mandated by the G20, whose membership includes several

non-OECD emerging economies, all of which have taken up an invitation to participate in the OECD's deliberations on an "equal footing."

These efforts have not been enough to satisfy developing countries, which have repeatedly sought through international processes to improve the status of the United Nations Committee of Experts on International Cooperation in Tax Matters. A motion tabled on behalf of the G77 group of developing countries at the 2011 session of the United Nations Economic and Social Council (ECOSOC) called for increased funding for the committee, which has only a handful of secretariat staff and struggles to fund participation in its working groups. It also called for the creation of an intergovernmental committee to accompany the expert group, responding to a fear voiced by developed countries that upgrading the current committee would considerably slow down its work. Discussions on this resolution ended in stalemate. A consultation on the committee's role exposed a significant divide between developing and developed countries, with the latter group favouring a rationalisation of the UN committee's work, citing duplication with the OECD (UN 2011).

Larger emerging economies have been especially vocal. During the most recent update to the UN model convention, the Indian, Chinese, and Brazilian committee members expressed reservations regarding the convention's endorsement of the OECD transfer pricing guidelines.⁹ At a special ECOSOC meeting in 2012, India was outspoken, writing to the UN secretariat in advance to say that the OECD guidelines "only represent the interests of developed countries" and calling for the UN model convention to be endorsed as an intergovernmental document by ECOSOC (Mishra 2012). The UN tax committee's recent *Practical Manual on Transfer Pricing for Developing Countries* includes a chapter setting out how transfer pricing methodologies in these countries differ from the OECD guidelines (UN 2013).

It remains to be seen whether these debates will lead to a substantial shift in the international governance of tax standards, or whether the OECD will be successful in satisfying the demands for greater participation and more appropriate standards for developing countries.

3.8 Policy coherence and spillover analysis

Tax-motivated illicit financial flows through multinational firms may involve several different countries: source, conduit(s), destination, and home country of the multinational. While the conduit and destination countries are likely to be tax haven jurisdictions best dealt with through international cooperation, the home country is quite likely to be an aid donor country with some level of commitment to policy coherence for development. Policy coherence implies that governments consider how areas of policy outside of their development-specific aid work may affect developing countries.

In their report to the G20, the IMF, OECD, UN, and World Bank suggested that these countries undertake a "spillover analysis" when making changes to their tax systems with the potential to have an impact on developing countries.

While such analyses will of course not necessarily alter the course adopted, they may point to remedial measures to be incorporated into the reform and should be published for the international community to reflect upon – at a minimum, to enable developing countries to respond with parallel changes to their own systems if that would be helpful in protecting their revenue bases. Ideally, a "baseline analysis" along these lines would be undertaken immediately. (IMF et al. 2011, 27–28)

⁹ It should be remembered that committee members participate in a personal capacity, and so these reservations are not official country positions.

An example is given in an IMF paper discussing proposed changes to the United States' system of international taxation (Mullins 2006, 16). It suggested four levels of such analysis:

1. Will it change the level and/or location of outward investment from the US?
2. Will it encourage other countries to more aggressively pursue tax competition to attract that investment?
3. Will other countries follow the United States' lead?
4. Will there be an impact on the tax revenues of other countries?

For the purposes of this paper, we could add an additional question:

5. Will it increase or reduce illicit financial flows?

The US tax reform under discussion in the IMF paper was a proposal to replace the credit system with an exemption from US taxes for foreign income (for an explanation, see section 2.6 of this paper). The study discusses the possibility that this change might increase tax competition, because the benefit of a tax incentive could be retained by the company, whereas under a credit system it would simply be transferred on paper to the US treasury. The same argument could apply to the savings from base erosion and profit shifting by US companies operating overseas. For example, the OECD's BEPS action plan notes that controlled foreign company (anti-avoidance) rules in the residence country of a multinational may "have positive spillover effects in source countries because taxpayers have no (or much less of an) incentive to shift profits into a third, low-tax jurisdiction" (OECD 2013a, 16).

In the United Kingdom, civil society organisations and parliamentarians asked the UK government to conduct such an analysis on some of its own controlled foreign company rule reforms, which a parliamentary committee argued "will incentivise multinational corporations to shift profits into tax havens. This is likely to have a significant detrimental impact on the tax revenues of developing countries" (International Development Committee 2012a). The government replied that "it is not feasible to produce an estimate that would be sufficiently robust or accurate to be of value" because "any assessment would need to focus on the tax regimes of other countries" (International Development Committee 2012b).

The government did, however, acknowledge its responsibility as a destination for illicit financial flows:

As a leading global centre for financial and legal services, the UK is a significant target for attempts to launder criminal proceeds obtained through corruption overseas. This can take any number of forms including acquisition of property in the UK, payment of private school fees in the UK or bank transfers via the UK to other financial centres.

There is no consensus on the size of total illicit flows from developing countries into the UK but there is little doubt that stemming such flows and tackling the underlying problems is critical for developing countries both in economic terms and the governance impact associated with the elites that benefit. (DFID 2012a)

Recent debate in the Netherlands about the impact of its tax treaty network on developing countries led two private organisations to conduct their own spillover analyses, concluding that the Netherlands gains €3 billion per year from shell companies that act as tax planning conduits, while developing countries lose €771 million (DutchNews 2013). The government subsequently committed to an analysis of its tax treaties with developing countries (Government of the Netherlands 2013).

3.9 Use of tax havens by development finance institutions

Many donor countries have established publicly owned corporations that use development cooperation funds to invest in private sector projects in developing countries. Because these funds are designed to stimulate private sector investment, not to fund projects outright, they often operate through pooled funds, many of them located in offshore jurisdictions. Development finance institutions defend the practice on the grounds that the legal environment to establish pooled investment funds does not exist in most developing countries, but civil society organisations argue that it reflects a lack of policy coherence (Murphy 2010).

The 2009 report of the Norwegian Commission on Capital Flight highlighted this issue and recommended that Norway's development finance institution, Norfund, cease to make new investments via tax havens. The Commission argued that the use of tax havens to channel investments has three negative effects: the direct loss of tax revenues by developing countries, for example through treaty shopping; "maintaining tax havens by providing them with income and legitimacy"; and potentially supporting "money laundering and tax evasion" by private investors who participate in the same offshore funds (Commission on Capital Flight from Poor Countries 2009, 114).

The UK Parliament's International Development Committee stopped short of calling for Norfund's UK equivalent, the Commonwealth Development Corporation (CDC), to cease using tax havens. It recommended instead that "the tax payments made by CDC's fund managers and investee companies should be published annually on a country-by-country basis. If certain fund managers or investee companies are unwilling to agree to this, CDC should use alternative companies which are willing to be more co-operative" (International Development Committee 2012a)

In August 2013 the UK government disclosed to the *Guardian* newspaper that half of investments made by the British government's CDC are made via six offshore jurisdictions: Mauritius, the Cayman Islands, Luxembourg, Guernsey, Jersey, and Vanuatu (Provost 2013). The government told the *Guardian* that CDC is to be prevented from establishing new investments through jurisdictions that have not substantially implemented the international standard monitored by the Global Forum. The World Bank Group's International Finance Corporation has a similar, but more explicit, policy, which rules out jurisdictions that have been rated "partially compliant" or "noncompliant" by the Global Forum (IFC 2011).¹⁰ At the date of publication, six jurisdictions meet this criterion (section 2.4).

In July 2013, the Belgian government announced that the Belgian Corporation for Investment in Developing Countries (BIO) would be prohibited from investing in states with no or low taxes, as well as in offshore jurisdictions (Government of Belgium 2013).

¹⁰ Also excluded are jurisdictions for which "a Phase 1 review has been completed and, based on a report publicly issued as part of the Peer Review Process, the Phase 2 review is deferred because the jurisdiction does not have in place crucial elements for achieving full and effective exchange of information." In all cases the exclusion can be rebutted "if the World Bank Group is satisfied that the jurisdiction is making meaningful progress."

4. Tax and IFFs: Who is doing what?

This section looks at initiatives aimed at helping developing countries tackle tax-motivated IFFs, with particular emphasis on the role that donors play in this area. To better understand such interventions, three levels of reform should be considered. These are institution-building reforms in developing countries themselves, financial transparency, and improvements in international cooperation. This section considers each in turn.

4.1 Institution-building reforms in developing countries

The list of organisations funding and conducting work at national level on tax and development is quite long. Although there is no single comprehensive source of information, a number of documents serve to highlight much of the work that is being undertaken. GIZ undertook a mapping exercise that outlined the work underway through bilateral projects by Australia, Austria, France, Germany, Japan, Spain, Sweden, Switzerland, the United Kingdom, and the United States, as well as by international organisations, regional networks, multi-stakeholder initiatives, NGOs, and research institutes (Köhne, Kundt, and Schuppert 2010).

Some organisations have published reports reflecting on their experiences to date – the IMF, for example, in a board discussion paper, and DFID, in its evidence to a parliamentary committee in the UK (IMF 2011; DFID 2012a, 2012b, 2012c). The IMF is one of the biggest providers of technical assistance. According to the board paper, in 2011 headquarters staff undertook 35 missions on tax policy issues and around 61 on tax administration; the IMF’s legal department helped draft laws in 25 countries. In addition, the IMF’s seven regional technical assistance centres provide short-term support on revenue administration.

BOX 9: COMPONENTS OF NORAD’S TAX FOR DEVELOPMENT PROGRAMME

1. Capacity building

Aim: To contribute to improving tax systems and strengthening tax authorities in partner countries.

Example: Technical assistance from the Norwegian Tax Administration to the tax authorities in Zambia, Tanzania, and Mozambique.

2. Knowledge generation and dissemination

Aim: To increase research efforts and dissemination of research findings in the areas of taxation and capital flight so that this knowledge can benefit poor countries.

Example: Funding for the International Centre for Tax and Development.

3. International cooperation

Aim: To actively participate in international cooperation efforts related to issues of taxation and capital flight.

Example: Participation in the OECD’s tax and development work.

4. Support to civil society

Aim: To strengthen popular engagement in and public debate on taxation and capital flight issues.

Example: Financial support for the Tax Justice Network.

Source: Norad 2011.

General concerns

Important lessons from technical assistance work across a wide range of public administration topics in developing countries include the need to prioritise reforms based on demand, to ensure ownership of the process and the priorities at the country level, and to tailor reforms to the specific needs and unique contexts of each country. With this in mind, the OECD proposed a series of principles for capacity-building work in taxation (box 10).

Missing from these principles is another important lesson, given the multiplicity of donors involved in this area: the importance of coordination between the many providers of technical assistance. The GIZ mapping study notes that 47 countries have more than one organisation delivering tax-related technical assistance, and eight countries have at least four organisations. Conversely, “while there is intensive donor activity in many African countries, 17 out of 53 African countries, that is 1/3 of the entire continent, still do not receive long-lasting tax-related assistance” (Köhne, Kundt, and Schuppert 2010, v).

BOX 10. OECD DRAFT PRINCIPLES FOR INTERNATIONAL ENGAGEMENT IN SUPPORTING DEVELOPING COUNTRIES IN REVENUE MATTERS

1. Follow the leadership of government and coordinate at the country level.
2. Do no harm [considering the sensitive political economy of tax issues].
3. Take a “whole of government” approach to maximize policy coherence and aid effectiveness.
4. Take account of international aspects of taxation.
5. Balance revenue collection imperatives with fairness, equity and governance considerations.
6. Encourage transparency in revenue matters.
7. Strengthen revenue and expenditure linkages.
8. Promote sustainability in revenue collection systems.
9. Encourage broad-based dialogue on revenue matters that includes civil society, business, and other stakeholders.
10. Measure progress and build the knowledge base on revenue matters.

Source: OECD 2013d.

Building institutions is not just about organisational development, but about strengthening the tax system as a whole: legislation, implementation, and enforcement, embedded within a taxpaying culture. The shopping list of reforms is well established, but it is long, and prioritisation is a challenge for developing countries. Balancing short-term revenue gains with long-term institution building, and revenue raising with equity and efficiency considerations, not to mention domestic and international political economy, is complex.

The starting point for this prioritisation should therefore be to identify the objectives of reform. Donors generally situate tax measures within a box labelled “tax and development” or “domestic resource mobilisation,” which implies that the primary objective is to maximise public revenue. In contrast, the illicit financial flows framing that is the focus of this paper tends to imply an anti-corruption lens, with a greater focus on building the integrity and transparency of governance institutions.

Tax reforms may also be instituted as economic management tools, in particular as means of improving the investment climate. The World Bank's annual *Paying Taxes* survey, part of its *Doing Business* report, assesses the cost to businesses of a range of tax policy and administration matters. The World Bank and IMF both situate their capacity building on taxation within the broader theme of public financial management, which is consistent with many civil society organisations' emphases on revenue raising and public spending as two sides of the same coin.

A long-term objective of tax reforms is to build tax morale and a taxpaying culture. DFID (2012c) notes that:

Improving compliance requires not only tackling deliberate evasion and avoidance but also ensuring that taxpayers find the process straightforward and are convinced that their taxes are well spent (i.e. "tax morale" is high). Authorities need to help those willing to pay their taxes as well as making it difficult for those that want to escape their liabilities.

Whether or not large sums are recouped by targeting wealthy tax evaders, such actions may help build a perception that the tax system is fair, improving compliance across the board. Conversely, efforts to tax the informal sector may entail high administrative costs relative to the revenue raised, but help create a taxpaying habit.

There is much discussion in tax and development policy circles about the challenges of taxing the informal sector, which in many developing countries constitutes a large share of the economy. By definition, informal sector trading and employment is not subject to income tax, and so it is often viewed as a potential source of new tax revenue. Often characterised as small traders with low incomes, the informal sector can also incorporate some medium-size businesses owned by wealthy individuals; it may therefore be linked to both tax evasion and illicit financial flows.

According to the IMF, policy efforts should focus on

understanding the nature of the taxpayer/trader population; identifying key compliance risks and how they arise (from weak laws and regulations, for instance, or administrative incapacity?); clarity on accountability for, and adequate resourcing of, compliance activities; and specifying performance indicators and potential corrective actions. . . . [However,] it is not uncommon for developing country tax administrations to devote large resources to this segment in the hope of flushing out medium or large taxpayers by blanket enforcement operations; but results have been poor and costs of implementation high. (IMF 2011, 22)

Planning a tax reform programme therefore implies drawing on input from the range of stakeholders affected within and outside of government. The other aspect that seems to be rarely considered by developing countries is a cost-benefit analysis, including a distributional analysis of the impact of reforms. International tax reforms, such as participation in information exchange conventions and adoption of transfer pricing rules, place obligations on the tax administration. They require significant upfront investment in administrative capacity, and it may be many years before they generate enough revenue to justify the costs. As a recent IMF paper argues:

Developing countries face particular challenges in dealing with sophisticated multinationals, and responding to international initiatives, in a context of limited capacity. These problems have received little systematic attention, so that it is often unclear how extensive the challenges are or how measures to address them should be designed and prioritized within wider programs of administrative reform. (IMF 2013, 13)

As the some of the examples in section 3.5 suggest, there may be more cost-efficient approaches than the wholesale adoption of international standards, at least in the short term.

Reforms to target corporate tax avoidance and evasion

Taxing multinational companies well requires capacity building at three levels: policy/legislation, administration/enforcement, and judiciary.

Policy capacity within the finance ministry enables the design and evaluation of more effective policies, as well as participation in international standards-setting processes. Cracking down on tax avoidance, after all, begins with effective legislation that minimises the gap between its letter and spirit.

Quantifying and understanding the “tax gap” that results from noncompliance is one area where there is quite a bit of assistance available. In Tanzania, for example, a multi-donor-funded Tax Modernisation Programme includes funding for the Research and Policy Department within the Tanzania Revenue Authority to analyse the likely tax gap in key sectors, such as mining and telecommunications (DFID 2012c).

Transfer pricing legislation and the accompanying regulations issued by the revenue authority require great precision. Defining terms such as “related party” in the legislation can make a big difference to a revenue authority’s success rate in disputes, and getting documentation requirements right ensures that companies cannot withhold important information from the tax authority during an audit. Many developing countries currently have a cursory reference to the arm’s length principle in their law, but without more detail this creates tremendous room for discretion on the part of the revenue authority, leading to uncertainty or lax enforcement.

BOX 11. COMPONENTS OF WORLD BANK TECHNICAL ASSISTANCE ON TRANSFER PRICING IN GEORGIA

The World Bank is providing Georgia with technical assistance on transfer pricing as part of a more comprehensive tax administration simplification program focused on small and medium enterprise tax, appeals reform, and strengthening of the audit process. The assistance includes three stages:

Stage 1: Development of primary and secondary legislation

Stage 2: Preparation of transfer pricing training manual for auditors

Stage 3: Transfer pricing training for Ministry of Finance and tax authority officials, combined with audit skills training

Source: Awasthi 2011.

When it comes to administration, specialist capacity in transfer pricing is one area that needs to be built, but this often needs to be situated within broader administrative reforms. DFID (2012b), for example, points to its funding for projects to build large taxpayer units in Bangladesh, Mozambique, Sierra Leone, and Tanzania. In Bangladesh,

[the project] will provide support to the large taxpayer unit (LTU) to increase efficiency, professionalism and effectiveness, leading to increased tax revenue. This includes provision of training on selected business sectors (e.g. banking, telecoms and insurance) as well as complex functions such as transfer pricing. There will also be mechanisms put in place to reduce LTU income tax arrears outstanding (e.g.

revision of appeal process, strengthened appeal resolution process, strengthened income tax return audits). A Central Intelligence Cell will be strengthened to support investigation of non-compliance and tax evasion.

An important component is human resources, especially in highly skilled units that can audit multinational companies and investigate tax evasion. Tax authorities often struggle to retain these skilled staff given the large “brain drain” to the private sector, where salaries are higher. This can be mitigated to some extent by increasing the pay of revenue officials; this is an important driver of the trend towards semi-autonomous revenue authorities, which are able to diverge from civil service pay scales.

Exchange programmes and secondments – both into and out of developing countries – can be a helpful way to build capacity. In the United Kingdom, Her Majesty’s Revenue and Customs (HMRC) supports various developing countries in this way, according to DFID (2012b). Two of its compliance caseworkers spent time helping Nigeria’s Federal Inland Revenue Service develop a compliance strategy, while HMRC hosted a short-term secondment from the Ugandan Revenue Authority in 2012, “focused on risk, intelligence and criminal investigation functions.” This also extends to the senior level: senior HMRC managers sit on the board of the Nigerian tax administration in an advisory capacity, and there was an “ongoing mentoring arrangement” between the previous head of HMRC and his counterpart in Rwanda.

The OECD has suggested the creation of “tax officials without borders,” an initiative that would provide developing countries with short-term assistance from experienced officials in developing countries, as a means of learning by doing.

BOX 12. EXTRACTS FROM PRICEWATERHOUSECOOPERS RECOMMENDATIONS ON TRANSFER PRICING (TP) CAPACITY BUILDING

Developing countries with no TP legislation in place

“Assistance should be provided to establish a fundamental understanding of TP principles, methods and tax treaties within the local tax administration. Assistance is also needed with respect to the drafting of TP legislation . . . A selected group of tax officials should be given the possibility of deepening their understanding of TP, e.g. by observing TP practices in other countries during secondments.”

Developing countries close to adopting TP legislation

“Local tax administrations could be assisted in drafting mandatory questionnaires to gather the most-relevant taxpayer information on inter-company transactions or to gradually implement documentation requirements. Support will be necessary to ensure that this newly available data is processed efficiently. Shortly before/after implementation of the TP legislation, funding could be provided to facilitate and improve communication between taxpayers and tax administrations.”

Countries that have TP legislation in place

“It may be important to offer technical assistance to review and revise the existing legislation. Together with this, developing countries can be supported in drafting more-sophisticated TP legislation such as advance pricing agreements (‘APA’) and simplified compliance procedures. Assistance is furthermore necessary to improve access to data on comparable transactions, e.g. by developing and administering own (regional) databases.”

Source: PwC 2011, 39–40.

As noted by GIZ (2010, 31), “tax fraud and avoidance are also a result of a weak judiciary.” Some transfer pricing disputes are resolved in court, and so an effectively functioning transfer pricing

system presupposes capacity and expertise within the judicial system. “The legal systems of developing countries will frequently encounter difficulties when enforcing [transfer pricing] standards, which presuppose a decentralized network of competent and well educated lawyers and judges,” argues Baistrocchi (2005, 955).

Transfer pricing policy and administration is a popular area of technical assistance among international organisations and donors. In 2011, the European Commission funded research into the transfer pricing needs of four developing countries (PwC 2011). This led to a joint capacity-building exercise funded by the Commission and undertaken by the OECD and World Bank, which covers “transfer pricing legal drafting (including procedures and guidelines), organizational issues, risk assessment mechanism, thin capitalisation, intangibles, secondary adjustments, simplifications measures (e.g. safe harbours), APA [Advanced Pricing Agreements], MAP [Mutual Agreement Procedures].” The work was being piloted in Ghana, Kenya, Rwanda, Vietnam, Colombia, and Honduras, with plans to scale this up to include Zambia, Ethiopia, Thailand, the East African Community, and the Economic Community of West African States (Corrick, Stern, and Montero 2013).

According to the IMF (2013, 11), it has delivered technical assistance on transfer pricing in Bangladesh, Burkina Faso, Cambodia, Colombia, Dominican Republic, Egypt, El Salvador, Ethiopia, Greece, Guatemala, Malawi, Mauritania, Mongolia, Nicaragua, Panama, and Ukraine.

Since its inception, transfer pricing has been a priority for the African Tax Administration Forum, which has a working group devoted to the topic. ATAF organises capacity-building workshops, arranges peer-to-peer learning, and is developing products to be used by developing countries.

Because of the attention devoted to transfer pricing and the large demand from developing countries, this is an area at high risk of duplication. For example, the OECD, World Bank, and United Nations have all developed written guides for developing countries that wish to adopt transfer pricing rules.

BOX 13. ATAF SUMMARY OF AFRICAN TAX OFFICIALS' VIEWS ON TRANSFER PRICING

The following points summarise the challenges identified by African tax officials when discussing transfer pricing in a survey conducted for the African Tax Administration Forum.

- Most countries “lack skilled and experienced staff to identify and analyze complex transfer pricing cases.”
- They “do not have effective tools used to combat transfer mispricing and protect the tax base, such as comprehensive transfer pricing rules and regulations, reference guidelines, advanced pricing agreements (APAs), formal tax treaty agreements, strong regional and international cooperation, sound information sharing, etc.”
- Specifically, “the legislative framework and guidelines for transfer pricing are either non-existent or very complex which makes it difficult to implement them.”
- Tax officials noted “the lack of a platform promoting dialogue, exchanging experiences, and especially exchanging information, with other national authorities (e.g. treasury, customs, banks, etc.), other tax administrations in the continent, and treaty partners.”

Source: Monkam 2012, 8.

Another important focus of donor assistance is the extractive industries, where targeted interventions can help deal with specific challenges, especially when significant revenue is involved. DFID (2012b) is providing Uganda with technical assistance “to purchase a new information technology system to

manage oil taxation, and to pay for training for staff involved in oil taxation, to pay for technical advisers to provide mentoring and on-the-job training for cost recovery audits, and to help update the oil tax manuals.” In Zambia, Norad, the European Commission, and DFID are jointly supporting work in the Ministry of Mines, including “strengthening the cadaster (crucial for issuing exploration licenses), review of mining legislation, piloting physical audits of export consignments and supplementary funding of EITI” (DFID 2012b).

Reforms to target tax avoidance and evasion by individuals

Although much of the emphasis in public discussions of IFFs centres on the international cooperation needed to uncover individuals’ interests in tax havens, domestic reforms are also needed, both for their own sake and so that countries can make use of the opportunities from international cooperation. “Failure of elites to pay a fair share of taxes undermines support for the wider tax system,” states the IMF (2011, 32). “Raising substantially more from such groups, often influential and intimidating, is hard.” Examples of reforms to increase taxation of elites include ending exemptions for agricultural income, taxing individuals on their worldwide income, real estate taxes, and stronger, dedicated enforcement capacity.

Accurate and systematic collection of data on taxpayers is essential if instances of noncompliance are to be detected. For this reason, many developing countries have, with donor support, invested substantially in information technology. The Canadian International Development Agency (CIDA) supported countries in the Caribbean with technical assistance for the “reform of taxation management and public expenditure,” which included “a combination of upgrading facilities, human resources development and new management and computer packages.” A CIDA article on the project noted that the programme helped increase tax revenues by 30% to 40%, introducing greater consistency (horizontal equity, in other words) in areas such as payroll taxes (Foreign Affairs, Trade and Development Canada 2011).

Crown Agents, a British agency delivering technical assistance in many developing countries, markets a system called “Trips,” which is in use in Ghana, Guyana, the Philippines, and Mongolia, among other countries. It describes Trips as “an enterprise tax solution that addresses a broad spectrum of government requirements while supporting the needs of citizens and business: from tax administration automation – to the integration of all revenue streams and processes – to full e-Government service provision” (Crown Agents 2013).

A significant component of information technology (IT) systems is the creation of unique Taxpayer Identification Numbers (TINs), which allow the tax authority to cross-reference an individual’s or company’s tax information across different types of tax. Nigeria’s Joint Tax Board includes among the expected benefits of its TIN project improved information sharing between tax authorities for assessment purposes, a widening and deepening of the tax base, and better budget forecasting.¹¹

It is worth introducing a note of caution concerning IT projects in developing countries. The IMF (2011, 21) observes:

IT systems in developing countries (whether home-grown or packages) are often inadequate, with many disappointing examples and far fewer moderately successful ones (as in Colombia, Peru, Rwanda, Tanzania). Poor results can arise from inadequate linkages with a broader reform strategy (perhaps being designed with only an isolated objective – administering the VAT, for instance – in mind, or with insufficient attention to restructuring basic processes), or conversely, from excessive ambition.

¹¹ From the Joint Tax Board’s Taxpayer’s Identification Number (TIN) Program website (no longer publicly available).

Nonetheless, technological solutions, and TINs in particular, are seen as essential for the implementation of automatic information exchange and as advisable for the effective use of information from other jurisdictions, as well as for compliance with reciprocal obligations under information exchange treaties. As many developing countries are only beginning to participate in international agreements concerning information exchange, this area of technical assistance is new. The secretariat of the Global Forum on Transparency and Exchange of Information is undertaking pilot capacity-building work in Ghana and Kenya, two of the first developing countries to join the Global Forum (DFID 2012c).

4.2 Transparency

Across many areas of policy, transparency is an important tool to help limit illicit financial flows, which rely on concealment from the public and enforcement bodies. Here we are considering transparency in the sense of public availability of information, distinct from disclosure to and exchange of information between investigating authorities. Making information publicly available, rather than available only to authorities, is not only a matter of public scrutiny. As discussed in section 3.6, it can also make investigations more efficient and assist with the production of third-party tools such as comparables databases.

Domestic transparency includes publishing full budget information showing how revenue is raised and spent, in time for scrutiny by the public and legislators. Transparency in the area of tax incentives is especially important, but the political economy of this issue makes it a difficult area for reform. Based on the principles discussed in section 3.3, the OECD secretariat has begun to conduct reviews of tax incentives in three developing countries: Tunisia, Ghana, and Senegal (OECD 2013g). After an earlier OECD review in Zambia, incoming finance minister Alexander Chikwanda made a commitment to review the “proliferation of inefficient tax incentives” as part of a “diagnostic review of the entire tax system” during 2013 (Chikwanda 2012).

In its technical and financial assistance in partner countries, GIZ is pursuing a Good Financial Governance approach, which looks at the political economy aspects of budget transparency. In doing so, it integrates the technical dimensions of public finance reforms with elements of good governance, such as transparency, participation, responsiveness, oversight, accountability, and predictability.

Transparency is also an area of considerable interest to civil society organisations. Tax Justice Network – Africa and ActionAid, for example, published a series of country analyses for East African Community countries, accompanied by a regional roundtable discussion, during 2011 (Tax Justice Network – Africa 2011). Transparency of incentives was a key recommendation.

International transparency reforms are aimed at increasing the ease of access to information for official investigators and the public in all countries, and circumventing secrecy provisions of noncompliant jurisdictions. Plans to require the country-by-country reporting of certain information by European-registered multinationals take advantage of the power that home countries have to require multinationals to report across all jurisdictions in which they operate.

These corporate financial transparency measures have been considered in several intergovernmental forums, although they have rarely been discussed by groups of developing countries themselves. The most detailed consideration has been through the OECD’s Tax and Development Task Force, which commissioned two studies, one looking at country-by-country reporting (Devereux et al. 2011) and a later one considering statutory registers of accounts (Bowler 2012). While the former report was more sceptical in its conclusions, the latter suggested that there may be some benefits, although a full cost-benefit analysis would be essential.

The UK Parliament’s International Development Committee took an interest in the topic during its 2012 enquiry into tax and development, requesting among other things that DFID test citizens’ ability

to access company accounts in Zambia. DFID was only able to obtain accounts for one of five publicly listed companies that it tested, while there was no requirement for private companies to file accounts (International Development Committee 2012b).

Although these investigations have not themselves led to practical steps to change transparency requirements and systems, developments in the United States and the European Union have in some respects overtaken them. The Dodd-Frank Wall Street Reform and Consumer Protection Act, passed in the US in 2010, required public companies listed in the United States and operating in the oil and gas industries to disclose a range of information on a country-by-country basis. At the time of writing, the legislation is yet to be enacted, as the debate between industry and the regulator has resulted in a court case.

In 2012, the European Union followed suit, in a directive that also included the forestry sector and also covered private companies. In 2013, reforms to the EU directive covering the financial sector included a wider country-by-country reporting obligation for these companies, although the financial information covered will in the first instance be reported confidentially to the European Commission.

A reform to which few countries currently subscribe, but which came to the fore during discussions at the G8 summit in 2013, is public registers of beneficial ownership, which would disclose the ultimate owners of companies and trusts. G8 members agreed to consider the creation of national registers but stopped short of enacting the civil society proposal for an international convention binding all countries to public disclosure of this information (G8 2013).

While transparency measures can play a significant role in curbing tax-related IFFs, it is important to underscore that to be effective, information not only must be made available but must also be easy to obtain, accurate, timely, and presented in a consistent and clear format. Moreover, there must be an audience (journalists, civil society organisations, government officials, politicians) that possesses the tools and skills to interpret it, use it in an efficient way, and process it for the broader public. Not all of these conditions are usually present in developing countries. Donors can play an important role in this area, for instance by supporting capacity building of journalists and civil society actors, making available outlets for the information, and providing IT technical assistance.

4.3 International cooperation

Countries need to work together in international tax for two main reasons: standardisation and collective action problems. In the former instance, coordination ensures compatible approaches that reduce compliance costs and maximise efficiency, for example through transfer pricing rules and model tax treaties. Collective action problems occur where countries have incentives to act in ways that undermine others' tax bases, for example by engaging in harmful tax competition. In some of these instances, such as codes of conduct on tax competition, cooperation is a means for countries to work together to resolve a prisoner's dilemma, but in others, such as tax information exchange, it can become a means for larger countries to coerce smaller ones into compliance.

A number of developing countries have committed to international cooperation, for example by concluding tax treaties, over 1,000 of which have been signed with developing countries. Several developing countries have adhered to the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, including Ghana, Guatemala, and Morocco, while more have joined the Global Forum on Transparency and Exchange of Information, for example Cameroon, Colombia, and the Philippines. In doing so, they may obtain explicit benefits conferred by the agreement. Such cooperation also sends positive signals to investors and donors and enables countries to learn from international dialogue.

But such participation also entails risks. On the policy side, the biggest concern is that countries may not be equipped to evaluate the costs and benefits of particular agreements, that they may lack the

negotiating experience to obtain a result that maximises the benefits, and that participation may be the result of implicit or explicit coercion. African tax officials surveyed by ATAF noted this concern:

The experts surmised that throughout the continent, there is a power imbalance when negotiating international agreements such as Double Taxation Agreements (DTAs) and Memoranda of Understanding (MoU). Additionally, they indicated that frameworks of double taxation agreements are in general characterized by a complexity of international tax laws often written in favor of developed countries and often outdated. (Monkam 2012, 9)

Participation in international organisations and particularly attendance at meetings entails a commitment of both time and financial resources, which has an opportunity cost for the tax policy unit. “The sheer transactions costs of negotiating [double tax treaties] can be a severe drain,” argues the IMF (2011, 36), suggesting that this “could perhaps be eased by developing multilateral treaties.” Without this commitment, however, there is a risk that countries may not be effectively represented when organisations make decisions affecting them.

There is no doubt that international cooperation is essential for countries wishing to target illicit financial flows. But countries should seek to make focused interventions based on cost-benefit analyses, prioritisation, and a proper sequencing of reforms. According to the ATAF survey, “tax administrations across the [African] regions are not fully utilizing instruments providing for information sharing even when they do exist” (Monkam 2012, 9).

Regional agreements provide a potential means to achieve some of the benefits of multilateral cooperation while minimising risks. On the African continent, there is a growing number of multilateral tax treaties, including those within the West African Economic and Monetary Union and the East African Community. There are also new mutual assistance treaties, including one for members of the Southern African Development Community, and another facilitated by ATAF.

South-South international tax cooperation is growing, with the establishment of entities such as ATAF and the Inter-American Center of Tax Administrations. These bodies have the advantage of focusing on the shared priorities of developing countries, both for work within their regions and also globally. ATAF’s 2013–15 strategic plan includes as one organisational objective: “Becoming the African voice on tax issues to inform and influence the global dialogue” (ATAF 2013, 13).

5. Conclusions and recommendations for practitioners

As the preceding sections have shown, there is no shortage of opportunities and means for developing countries to tackle tax-motivated illicit flows. Not all of these opportunities will be suited to a particular country's economic structure or administrative capacity. There is a risk that the enthusiasm on the part of developing countries and development agencies for progress could lead to hasty decision making or to countries adopting "off the shelf" measures without considering their implications. With this in mind, a number of recommendations for development practitioners and donors can be made.

The first is that efforts to target illicit financial flows must be situated within broader reform efforts. Developing the administrative capacity to engage in complex audits of multinational companies is undoubtedly necessary in the long term, but it needs to take place as part of a logical sequence of reforms aimed at institutional development of the revenue authority. For example, effectively legislating for and enforcing the OECD transfer pricing guidelines may be too far a stretch for a country in the early stages of developing its corporate taxation regime.

Second, reforms need to be tailored to domestic priorities and limitations. While it's well recognised that "one size fits all" approaches can be problematic and unsustainable, the challenge is to balance that recognition with the need to ensure compatibility and coordination in international tax areas such as information exchange. Countries will often be faced with a choice between adopting international standards wholesale, adopting them in simplified form, or waiting until they have the capacity to implement them well.

In this context, some of the more advanced measures to tackle tax-related illicit financial flows, such as participation in automatic information exchange, may not be the best use of limited resources at a particular time and may divert attention from the nuts and bolts of tax system development. Conversely, when factors such as taxpayer morale, investment promotion, and tax equity are taken into account, these same tax reforms may turn out to be urgent priorities for some countries, warranting greater investment than is implied by their immediate potential to raise revenue.

Building the institutions necessary to target tax-motivated IFFs is politically sensitive work, which will challenge elite interests. It is also, in many cases, technically complex, requiring significant investment to build institutional knowledge and recruit high-quality human resources. All of this points to the need for sustained, high-level political commitment, along with recognition that reforms may take several years to yield results.

The international tax "community" can work together to help challenge vested interests in individual countries while still respecting national sovereignty. Reforms that increase the integrity of tax institutions, such as the creation of autonomous revenue authorities, create a platform from which to challenge problems such as poor governance of tax incentives, which is magnified by collaboration among revenue officials across borders.

To ensure the long-term sustainability of reforms, donors and development agencies should improve coordination among themselves, encouraging countries to conduct their own needs assessments and to seek support based on priorities they have developed. Cooperation among developing countries, for example at regional level through ATAF and CIAT, should increase ownership of reform priorities and encourage countries to take responsibility for their own decision making.

Learning by doing is more effective than learning in the abstract, and so donors should place an emphasis on long-term assistance plans and secondments, as well as initiatives such as Tax Inspectors Without Borders. South-South cooperation, such as collaborative investigations of multinationals

using the new mutual assistance treaties, is an excellent way to build confidence and capacity through shared learning.

There can be no doubt that the long-term sustainability of international tax cooperation requires greater participation by developing countries, whether through a more active engagement in OECD standard setting, a stronger role for the United Nations tax committee, or the development of new, regional cooperation mechanisms. Most likely it will be a combination of all three. But at the same time it must be recognised that meaningful participation by developing countries in international institutions will need to develop, over time, in parallel with stronger policy and administrative capacity at home. Here too, donor agencies can play a role in facilitating developing countries' participation in these forums.

Developed countries' short-term tax policy priorities, meanwhile, seem to put them at odds with more participative proposals for international cooperation. This may undermine both their own international development priorities and, perhaps, the long-term sustainability of international tax governance.

Furthermore, as this exploration of illicit financial flows has demonstrated, it is not enough for donors to keep the tax and development agenda in a box marked "capacity building." While there is undoubtedly a substantial unmet need in that area, it must be recognised that fiscal policy is political and therefore capacity-building initiatives will yield limited results if they are not paired with efforts to encourage sustained political and public engagement in tax policy and administration.

Finally, there is a growing recognition that tax-motivated illicit financial flows are facilitated in part by the policies of donor countries. Tax treaties, corporate tax regimes, and financial secrecy all have potentially positive and negative spillovers for developing countries. The principle of policy coherence for development, well established in some other areas of economic policy, suggests that donors will only obtain value for money from tax assistance to developing countries if spillover analysis becomes a routine part of policymaking.

Indeed, it would be paradoxical for a donor government to devote billions of dollars each year to overseas aid when much of this aid is plugging a revenue gap that could be closed through its own tax policies. In some instances, such as the negotiation of tax treaties with developing countries, this is a matter of adopting an enlightened approach to international tax that supports development priorities. In many other cases, however, developed and developing country governments have a shared interest in tackling illicit capital flight. The challenge is to develop sustainable, multilateral solutions that allow poorer countries to use taxation to raise public revenue for investment in economic development, to direct private wealth into productive investments, and to distribute the proceeds of growth fairly.

Further reading

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INDEXING TERMS:

Illicit financial flows

Tax evasion

Transfer pricing

Treaty shopping

Tax incentives

Policy coherence

Tax avoidance

Tax havens

Trade mispricing

Tax exemptions

Tax minimisation

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Tax revenue can help governments finance development and decrease reliance on foreign aid. But tax-motivated illicit financial flows – tax evasion, tax avoidance and aggressive tax planning – undermine these efforts. Non-specialists may find that the complex discussion on taxation and IFFs is further complicated by the lack of clear definitions of relevant concepts, and by the often polarized nature of policy debates. This issue paper explains the terms and helps development practitioners and policy makers navigate the tax and illicit financial flow debates. It also gives an overview of donors' interventions in this area. There is a growing recognition that tax-motivated illicit financial flows are facilitated in part by the policies of donor countries, hence policy coherence emerges as an important goal for the future.