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Investments for Development: Derailed to Tax Havens

A report on the use of tax havens by
Development Finance Institutions

Prepared for IBIS, NCA, CRBM, Eurodad, Forum Syd and the Tax Justice Network

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Foreword

Development Finance Institutions (DFI) are state owned companies located in European countries that invest their capital in developing countries for the express purpose of advancing development in those places by promoting investment in local business. In this respect their activities can be compared to that of the European Investment Bank (EIB) and International Finance Corporation (IFC) – a part of the World Bank.

At the end of 2008 the DFIs that were members of the European Development Finance Institutions network (EDFI) had combined funds invested of about €16.7 billion.

In our opinion DFIs have a very special and very particular role in development. As state owned enterprises it is their job to encourage three things.

The first is business activity in developing countries. However, this is not an unencumbered invitation to participate at will. It is quite clear that the requirement is that the DFIs act to provide capital, loans and guarantees that complement the existing capital markets for businesses in developing countries. This requires DFIs to encourage private capital from pension funds, insurance companies, endowments, foundations and high net worth individuals to co-invest with them in developing countries either directly or via investment funds. But it also implies that in doing so DFIs have a different role from a strict investment fund with the purpose of yielding a maximum economic return for investors on the invested funds. The complementary role does imply that the level on the rate of return for the fund is subsidiary to the enabling role a DFI has in starting up sound businesses in developing countries. It also implies that local viability is the focus: a DFI should not invest in business proposals which show no prospects of sustaining themselves by being profitable. And all this has to be in the context of 'development effectiveness', or the DFI fails to deliver on its objectives.

This leads to the second role of DFIs, which is the dissemination of the benefit of that

business activity within those countries, or their development objective is not fulfilled. We believe that this objective is best fulfilled by the DFIs ensuring that they and the funds and companies in which they invest pay their taxes that are due in developing countries. This accords with the United Nations consensus reached in Monterrey in 2002 when developing countries committed to delivering effective and efficient, transparent and accountable tax systems in exchange for increased international development assistance. The Doha Declaration in 2008, a follow-up of the Monterrey consensus, confirmed the continued support to carry on with tax reforms in order to strengthen macro-economic policies and mobilize domestic public revenues.

Thirdly, as publicly funded agents for change they have to be transparent and accountable about all they do and be seen to promote the highest standards of social, environmental and governance policy compliance. We define transparency in an appendix to this report.

There is, of course, potential conflict in these objectives. It is well known that profit can sometimes be made from ignoring or abusing those standards that we think DFIs should be promoting. In our opinion DFIs must promote the highest standards of conduct, if necessary at cost to the profit they can make. When it is known that regulatory abuse, corruption, tax evasion and illicit financial flows cost the developing world many hundreds of billions of dollars a year, and very much more than the amount of aid they receive, then we think that a part of "catalysing role" that the DFIs have is to promote better standards of business conduct. DFIs say they are committed to doing so: our argument in this paper is that we wish to see the evidence of that commitment and that at present this is not possible.

This report argues that one way in which the DFIs can do that is to stop using tax havens as places through which they invest. Tax havens have a significant and, in our opinion, harmful effect on developing countries. Tax havens are the conduit through which money illicitly flows out of developing countries. The secrecy tax

havens provide facilitates a plethora of crimes like terrorist financing, trafficking, narcotics trade, weapons smuggling, corruption and illicit capital flight, money laundering, organized crime and hides the proceeds of crime. Lately, the indictments of Goldman Sachs have revealed the need to expose and limit conflicts of interest in order to maintain financial risks at sound levels. Again, secrecy is the vehicle which provides fertile ground for all sorts of unwanted behaviour. That same secrecy means that businesses located in tax havens are almost entirely unaccountable for their actions. As a result tax havens are associated with very low standards of social, environmental and governance policy compliance.

In fairness, DFIs argue that this is not the case with regard to the activities in which they are involved, and we accept that this is possible. It is, however, our argument that only openness and transparency can avoid the risk from association that arises from using tax havens.

DFIs say that this will prevent them from securing partners for many of the investments they wish to make. We note this risk but reiterate that the goals DFIs have been given encompass conflicting objectives. If an investment opportunity has to be forgone because a potential partner insist on use of an offshore structure then we would argue that to forego that opportunity is appropriate: the commitment to development effectiveness that should ensure a commitment to invest in viable businesses is coupled with a commitment to transparency, paying tax and avoiding harmful association with tax havens have to take first priority in a publicly funded agency whose commitment is to effect change in the process of investment in developing countries. In saying this we also note that offshore structures are mostly associated with fund investment and that fund investment also tends to be associated with the more developed countries in which DFIs invest: the countries with greatest need tend to receive direct investment from DFIs. If that is so then our suggestion may also be closely aligned with the likely development effectiveness of DFI activity.

Most especially we suggest that it has been convincingly argued that tax havens undermine the tax systems of governments of many large and populous states, including those of developing countries. We think that by paying tax those companies and businesses in which DFIs invest located in developing countries provide the essential means to the governments of those places that those governments need to build their own national infrastructure, whether that be physical infrastructure or the education, healthcare and other services that these countries must have if they are to develop as independent nations, able to survive without aid. For this reason we believe that DFI use of tax havens is incompatible with their development objectives and incompatible with their duty to promote the highest standards of business conduct.

DFIs disagree. It is their argument that there is no reason why a fund manager or project sponsor should not create an investment vehicle in a tax haven if it believes (and is advised) that a tax haven domiciled vehicle is best suited to attract DFI and private sector capital (given the legal and tax requirements of prospective investors) and thereafter to invest in portfolio companies in developing countries.

We do not agree. Whilst we accept that all companies in which DFIs invest will, whether invested in through a tax haven intermediate holding company or fund will pay taxes under relevant local laws of the country in which they operate, we suggest that there would be no reason for incurring the cost of a tax haven intermediary for investment purposes if there was no tax saving as a result. As such we think it a tautology that tax is not paid somewhere whenever such structures are used and question in this report the appropriateness of that as business conduct that DFIs should promote or be associated with.

We deal with these issues in this report, and having identified the problems created by DFI use of tax havens suggest that the new code of conduct for the use of tax havens that the EDFI is promoting is inappropriate and offer in its place an alternative code of conduct for DFI activity. This promotes:

1. Transparency, accountability and openness by DFIs;
2. The application of the accounting disclosure standards of the DFIs sponsoring state to all companies in which the DFI invests, irrespective of the requirements of the local jurisdiction in which the company in which it has invested operates;
3. DFIs positively seeking the companies in which they invest to pay the right amount of tax in the developing countries in which they are located;
4. DFIs being open and explicit about their reasons for using a tax haven if that is required to avoid double taxation;
5. DFIs seeking to promote change in developing country tax laws to prevent the risk of double taxation occurring when investment is made in those locations;
6. DFIs seeking to remove the obstacles to direct investment in developing countries by offering training, legislative support and technical advice to the governments of the jurisdictions in question to overcome the obstacles to inward investment within their domain that they have identified to exist.
7. DFIs reporting their own activities on a country-by-country basis so that the full impact of their work and the full scale of their contribution to the economies in which they invest can be appraised, including by disclosure of the tax they pay.
8. DFIs reporting on their role in achieving their development objectives as complementary investors in developing countries.

1. Development Finance Institutions and tax havens

Development Finance Institutions have been defined as :

State-owned risk capital investment funds. Their role in development cooperation is to invest in sustainable and profitable businesses in developing countries.

There are sixteen of these funds in Europe, ranging in size from CDC Group plc in the UK, with total assets of €3,190 million at the end of 2008 to SOFID in Portugal with just €4 million of assets. The sixteen European funds are all members of the European Development Finance Institutions (EDFI).

The average size of an EDFI member investment is €4 million.

Within the EDFI Equity & Quasi-Equity in shares accounts for 53% of investments, loans comprise 40% of funds invested and guarantees comprise the final 7% of the portfolios.

EDFI members have 54% of their funds invested in the finance sector, industry and manufacturing makes up 21% on average of portfolios, infrastructure 18%, agribusiness 6% and other sectors 2%. The percentage of financial sector investments increased from 33% in year 2000 to 54% at the end of 2007. These investments are in local financial services industries and institutions, including banks.

The proportion of investments in the poorest countries in Africa, the Caribbean and Pacific areas varies from 100% in the case of SOFID from Portugal to under 1% in the case of Austria's two funds. The EDFI average is 26% .

The DFI business model

The DFI business model comprises two distinct parts. Many DFIs use both. The first strategy is to invest directly in commercial companies located in developing states. The second alternative is to invest in funds that in turn invest in activities located in developing countries. The split between these activities varies. For example, at 31 December 2008, Norfund (The Norwegian DFI) had invested or committed itself to invest just under NOK 1.7 billion in fund holdings. These interests totalled almost half its total investments and commitments . The United Kingdom's DFI, CDC Group plc, in contrast has made it established policy to only invest through funds since 2004. It had committed over US\$5

billion to 65 fund managers managing 134 funds as at 31 December 2009. This is now more than half its total investment portfolio and this will, inevitably increase over time.

It is the use of tax havens / secrecy jurisdictions by the funds in which DFIs invest that is the main focus of the concern referred to in this paper.

To give some indication of the importance of secrecy jurisdiction locations in the placement of funds by DFIs, CDC Group plc has investments in companies, funds and subsidiaries in the following locations at 31 December 2009 :

	Fund	Subsidiary	Total
Mauritius *	56	12	68
United Kingdom	26	8	34
Cayman Islands *	26	1	27
Tanzania	2	8	10
Singapore *		4	4
South Africa	5		5
Uganda		5	5
Canada	4		4
Zambia		1	1
Barbados *		3	3
Luxembourg *	2		2
Sri Lanka	2		2
Vanuatu *	2		2
Guernsey *	1		1
Jersey *	1		1
BVI *			0
Delaware *	1		1
Bermuda *		1	1
Cameroon			0
Cyprus *	1		1
Egypt			0
Germany	1		1
India		1	1
Indonesia		1	1
Kenya	1		1
Malaysia *			0
Malta *			0
Netherlands *			0
Netherlands Antilles *		1	1
Pakistan			0
Various	3		3
	134	46	180

Those locations marked * are secrecy jurisdictions as defined by the Tax Justice Network . The UK has been excluded for these purposes from being considered a secrecy jurisdiction even though the Tax Justice Network defines it as such as it is the place of ultimate control, and there is economic substance to its use as a consequence. This analysis suggests that twenty two (or 48%) of CDC's subsidiaries are in secrecy jurisdictions.

It is apparent that secrecy jurisdictions are integral to the DFI business model. Cayman was ranked fourth in the Tax Justice Network's Financial Secrecy Index and Mauritius thirty second .

It should be stressed that useful as this data is it gives no firm indication of the actual funds that flow through those havens as a result of the direct investment activities of DFIs and the investment activities of DFI investee funds. For example, the Norwegian Commission on Capital Flight from Developing Countries did not determine this figure for Norfund, Norway's DFI.

What use do DFIs make of tax havens, and why?

DFIs use secrecy jurisdictions for two key purposes:

1. As the location intermediate holding company locations, even when they make direct investments in developing countries.
2. To either create funds in which they invest, or to be active participants in third party funds domiciled in those locations.

It is stressed that little actual DFI activity will take place in any of the secrecy jurisdiction locations in which they are nominally present. As has been argued :

Tax havens ... are largely repositories of contractual relationships and serve almost entirely as booking devices. It is rarely the case that the substance of the transactions

booked in a tax haven actually takes place there. Hence, there is very little actual activity in tax havens, and they are often described as "virtual" centres. We may define tax havens, therefore, as "legislative spaces." They are jurisdictions that deliberately create legislation to ease transactions undertaken by people who are not resident in their domain. Those international transactions are subject to little or no regulation, and the havens usually offer considerable, legally protected secrecy to ensure that they are not linked to those who are undertaking them. Such transactions are "offshore" - that is, they take place in legal spaces that decouple the real location from the legal location. We should note that, defined in this context, "offshore" has little to do with geography, let alone small islands, but rather with legislative spaces.

It is important to appreciate this in the context of DFI's use of secrecy jurisdiction. CDC has advised us, for example, that it has committed capital to a private equity fund, I&P Capital, which invests in companies operating businesses in Mauritius and Madagascar and is managed by an investment team from offices in Mauritius. This, however, is almost certainly an exception to the general rule for its apparently substantial operations in Mauritius because it is rare for such funds, when administered from a secrecy jurisdiction to actually invest in the location in which they are legally domiciled. The normal practice is for DFIs (and other investors) to record their activities in secrecy jurisdictions primarily because of the legal advantages they offer to those who do not actually base their real economic activities within those places. As a result most investors otherwise have little relationship with such places.

The EDFI says that their members use what they describe as offshore financial centres and which we call secrecy jurisdictions for the following reasons:

- OFCs typically provide legal infrastructure, which is able to accommodate the requirements of institutional investors seeking to invest in the private sector in

developing countries. Most developing countries do not;

- OFCs typically accommodate a wide range of financial structures (including (combinations of) mezzanine, equity and debt) suitable for developing country private sector investments;
- OFCs generally allow the tax neutral pooling of capital, which is then used for investment in the private sector in developing countries. If such pooling were to be uneconomical or inefficient, institutional investors would be discouraged from investing in developing countries;
- The use of special purpose vehicles (“SPVs”) in OFCs permits developing countries to access international capital markets.
- Thus the use of OFCs makes it possible for EDFIs to play a catalysing role in attracting institutional capital into developing countries and to ensure that their capital and the institutional capital invested alongside it is invested in accordance with sound environmental, social and governance policies.

These arguments are discussed in depth in the report of the Norwegian Commission on Capital

Flight from Developing Countries, where it is noted that Norfund says its reasons for using tax havens are that they offer:

- Secure and cost-effective handling of transactions between the home countries of the investors and the companies in which the funds invest
- A good and stable legal framework specially tailored to the requirements of the financial sector
- Arrangements which avoid unnecessary taxation in third countries
- Political stability.

These arguments need careful consideration before they can be accepted. There are two criteria for accepting the claims made as valid. The first is that the claim can be justified by facts. The second is that the outcome is that claimed.

These claims and an assessment of them can be summarised as follows:

Claim	Justified by facts?	Justified by outcome?
<p>Secrecy jurisdictions provide appropriate legal structures for use by investment funds</p>	<ul style="list-style-type: none"> • Partly: tax haven / secrecy jurisdiction locations do make it their business to provide such structures. • However, there is no reason why developing countries could not be encouraged to emulate secrecy jurisdiction legislation. • In practice secrecy jurisdiction legislation largely copies that in the UK, USA and some other developed states where private equity funds, hedge funds and special purpose vehicles are commonplace and can be easily created using onshore , domestic legislation – and are used for the creation of pooled investment funds. More special purpose vehicles used by the banking sector were, for example, onshore than offshore pre the 2008 crash. 	<ul style="list-style-type: none"> • Given that onshore developed country private equity investment does use onshore as well as offshore pooled investment vehicles and funds, the choice seeming to be dependent, very largely, on the country of origin of the funds they are using for investment purposes with a bias towards the use of offshore funds when offshore cash is used for investment purposes, the prima facie case for use of offshore funds for developing country investment is not clear when DFI funding all comes, tax free, from developed countries. • The absence of any DFI promoting the creation of suitable structures within developing countries to allow these funds to be located in these places provides little indication of a commitment to the development of this type of investment expertise in developing countries. • The claim is predicated on the additional claim that investing through funds is the most effective mechanism for encouraging development, and the secondary claim that investing as a consortia is of greater benefit than direct investment by the DFI in the target project.

Claim	Justified by facts?	Justified by outcome?
<p>'Efficient' tax pooling is a condition of investing in developing countries</p>	<ul style="list-style-type: none"> • This can only be justified if 'efficient' means low or no tax, as is a tax haven characteristic. • The argument can also be justified if it could be shown that double taxation is avoided as a result – because it is agreed that double taxation is undesirable. This is acknowledged in the proposed Code of Conduct for DFIs, noted below, where it is suggested that explicit explanation of the tax issues addressed by use of a tax haven should be given to ensure that a full understanding of the tax problems requiring remedy in the developing countries in which investment occurs are made available so that a basis for reform can be suggested. • As the Norwegian Commission on Capital Flight from Developing Countries showed, just two of the 35 funds in which Norfund was invested in 2008 paid any tax at all, and then in modest amount. Admittedly, some funds made losses. Non-payment of tax does however seem to result from the use of fund structures. • The same Commission reported that of the eight companies that made a profit in the year in which Norfund held direct investments six paid tax. 	<ul style="list-style-type: none"> • The claim is predicated on the additional claims that investing through funds is a) the most effective mechanism for encouraging development country investment and b) that tax is a significant factor in determining the rate of return on investments. • 23 of the funds in which Norfund invested in 2008 lost money, totalling NOK 698 million. • 8 funds in which Norfund invested made a profit in 2008, totalling NOK 282 million. The other funds did not report. • 26% of reporting funds made a profit. 25% of these paid tax. • 8 of the 14 companies for which direct investment data was available made a profit, a ratio of 57%. 75% of these paid tax. • The ratios are not conclusive, but fund management appears a) to carry increased risk compared to direct investment but b) pays lower tax, maybe because of poorer investment performance. • An outcome of 'pooling' is that some investments, whilst appearing to have a minority interest from each DFI, are actually DFI controlled when the impact of pooling is considered and this is not clear at present. This matter is referred to again in the proposed Code of Conduct noted below.

Claim	Justified by facts?	Justified by outcome?
Political stability	<ul style="list-style-type: none"> The assets in which funds ultimately invest are not located in the secrecy jurisdictions in which funds and intermediate holding companies are located. Those "end use" assets are located in the countries in which the companies invested in are actually located. As such the political risk of investing is unavoidably located in the country of end investment. To argue that many developing countries of substantial size face significant political risk is wrong: many are long established democracies and are likely to remain so. 	<ul style="list-style-type: none"> There is no evidence that the geo-political risk of investing in a developing country can be seriously mitigated by investing in that location through an intermediate, tax haven state. The risk of the underlying investment is not altered by the legal form given to the transaction that records its existence. It is true that risk may be higher in some developing countries, so reducing their attraction to private capital. But the role of the DFIs is to overcome that barrier to investment, not to reinforce it, and in refusing to invest directly instead of through intermediate states the DFIs are reinforcing existing prejudice instead of breaking them down.
The use of tax haven locations enables DFIs to catalyse institutional capital investment into developing countries and ensures that those funds are invested in accordance with sound environmental, social and governance policies.	<ul style="list-style-type: none"> This cannot be proven unless the funds in which the DFIs are transparent and the source of other funds provided are known. Minority investment in a fund is very unlikely to create any significant control over the fund, its environmental, social or governance policies as minority fund holders have no control of such issues which are decided upon by the fund's management independent of the investors. 	<ul style="list-style-type: none"> Although DFIs can have a positive impact on private funds and their standards of conduct (and evidence provided during the course of writing this report suggests that they seek to have that impact) there is no evidence that DFIs actually have the capacity to follow up on the implementation of the required standards in the funds in which they invest, whatever is written in the contract Repeated requests for data on the funds in which DFIs invest do not result in disclosure of information, and in many cases suggest that the DFIs do not hold the information to appraise performance against these objectives.

In summary, of the four broad claims made, that regarding political stability has little substance that proves the need to invest via tax havens in either fact or proven outcome, and the same can be concluded for the claim that use of tax havens catalyses other investment, for which the evidence is simply not available due to the opacity that the chosen structures create.

The claim that tax efficiency is important suggests what may be an inappropriate emphasis upon engineering financial returns rather than concern about the developmental impacts of the underlying investments. It may, or may not be coincidence that in the period for which Norfund's performance was assessed direct investment appeared to significantly outperform fund investment, but the additional cost of running a fund would seem to create this possibility, whilst the lack of control over actual investment will encourage attention to be placed on wholly artificial factors affecting investment return, such as tax paid, which run counter to the fourth claim on catalysing effective investment. It is also possible that many of the funds were at a relatively early stage in their investment cycle, but this is not clear from the information available, in itself emphasising the importance of transparency for appraising performance.

Finally, it may be true that developing countries

do not have the appropriate legislation to allow pooled investment funds to exist within their domains but if this is true then it gives rise to a series of additional questions which need to be answered before this argument can be used to justify investment via tax havens. First of all, it must be shown that developing countries wish to receive investment through pooled funds which make it hard to identify the source of funding for projects in their domain and to establish lines of accountability. Developing countries may, for the good reason that it might enhance governance, accountability and transparency, prefer that direct investment be made in companies operating in their jurisdictions. Second, developing countries may consider that the tax neutrality of these funds may not be to their advantage, and there is ample evidence that India, for example, thinks investment through Mauritius is harmful to its well being. Thirdly, if this is an issue then the DFIs should be working with at least some of the most stable developing countries to develop the necessary legislation and expertise to shift these operations into their domains, but there is no evidence that they are doing this.

As importantly, the arguments presented by the DFIs fail to mention issues of greater concern about their use of tax havens / secrecy jurisdictions.

2. Why is DFI use of tax havens a problem?

There are a number of reasons why DFI use of tax havens / secrecy jurisdictions is considered a problem by development agencies. The Norwegian Commission on Capital Flight from Developing Countries suggests three such reasons, which are that this activity:

1. **Contributes to the loss of tax revenues by developing countries.**

It is hard to estimate the amount lost because the information available on DFI investments is so limited. A proxy measure has therefore been prepared for the purposes of this study.

EDFI suggests that its members managed total investment portfolios of about €16.7 billion at the end of 2008. The average rate of return on the benchmark MSCI Barra Emerging Markets investment index over the five years to March 2010 was about 19.3%. This would suggest overall after tax returns of about €3.2 billion a year would have been earned on the DFI portfolios on average if they had matched market expectations over this period, as would be likely if independent investment rather than tracker fund investment was to be justified.

In this context it is important to note that it is normal for venture capital investors to seek significantly higher rates of return in the markets in which they invest.

With regard to tax, according to Keen and Mansour (2009), suggest the effective corporate tax rate in Africa in 2006 was less than 18%. Using this 18% rate as a proxy for taxes due the tax revenue expected on a portfolio €16.7 billion with an after tax return of 19.3% would be approximately €0.7 billion.

The same methodology would suggest Norfund should have paid tax in 2008 of approximately €21 million.

According to the Norwegian Commission on Capital Flight from Developing Countries the maximum amount of tax paid by Norfund in the year was NOK66 million, or €8 million. This implies an underpayment of tax against reasonable expectation of some €13 million in a year. It seems highly likely as a result that either significant tax has been avoided within the Norfund portfolio or that the portfolio in question is underperforming expectation.

This may be because it has only recently been invested, but without transparency so that this possibility can be assessed it is hard to draw firm conclusions. What is clear is that if this loss were replicated across the EDFI portfolio the loss would be in excess of €430 million a year on average over the last five years. It should however be noted that EDFI reports on recent profits suggest they have not matched the rates noted above. Again, this may be because of the deferred nature of many DFI returns, which rely heavily on capital gains as investments are disposed of. But this cannot be assessed because the lack of available information on which to base form an opinion.

This extrapolation, which suggests actual corporate taxes paid on the EDFI portfolio might be as low as €270 million per annum is in direct conflict with the EDFI claim that their investments generated approximately €2 billion of tax revenues per annum for developing countries unless a) the sum in question is the gross contribution from the companies invested in and does not represent the EDFI share, which would be wholly misleading or b) it represents the total tax collected and paid by EDFI's share of each of the companies in the portfolio including payroll and employee taxes, sales taxes and other taxes collected and paid over as agent and not as principle, in which case the claim is also very misleading and technically inaccurate.

Based on commentary received from Norfund in response to a draft of his paper it would seem that the first of these assumptions is correct – that is, the claimed tax payment is not the part attributable to the DFI investment but the whole tax due by the companies in which the DFIs have a stake. To claim this is the result of DFI activity is only tenable if it can really be claimed that the DFIs were pivotal and essential to ensuring that the investments occurred. Without there being any published evidence to prove this it seems that the EDFI claim on tax paid is based on an incorrect assumption and is therefore misleading.

As a result specific reference is made to this issue in the proposed Code of Conduct for DFIs, noted below, where the point is also made that in the interests of their

development objectives DFIs should seek to make payment of any tax due as a result of their investment activities or as a result of the activities of the companies in which they invest is made in the countries in which those investments are made. The current culture of avoiding tax which appears to pervade DFI activity has to be explicitly replaced by a culture of paying tax where tax is due.

2. Contributes to maintaining tax havens by providing them with income and legitimacy which, in turn, contributes to lower growth in poor countries. Numerous estimates have been made of the cost of tax havens to developing countries each year as a result of illicit financial flows, much of it relating to transfer mispricing. The precise quantum of the sum in question is disputed by those in the business community, but a recent report by Global Financial Integrity suggested the sum may be approximately \$1000 billion per annum, all of facilitated by the same type of opaque structures that DFIs are using in locations like Mauritius and Cayman.

3. Contribute to money laundering and tax evasion, as noted above.

To this may be added the following:

4. Contributes to the misallocation of investment funds.

This is because the opacity of the investment structures may in itself result in the misallocation of investment funds. This will happen because opacity creates risk, which in turn increases the cost of capital required of an investment project; As a result the rate of return required for any project rises and the resulting higher rates of return usually preclude investment in projects in smaller enterprises and local communities that tend to produce lower rates of return but have greatest impact in terms

of local wealth creation. This means there is a resulting bias towards capital intensive, low employment generating projects and the development, employment, environmental, stakeholder and community benefits of inward investment tend to fall as a result. As a result the opacity of the fund structures may result in a loss of development effectiveness.

5. Contributes to the risk that investments fail to meet governance criteria.

The minority stakes taken in investment funds may mean that there is no ability to ensure that investments meet sound environmental, social and governance standards. A minority cannot influence these issues after contracts have been signed and therefore measurements and reporting on these parameters are likely to be limited.

6. Contributes to the risk that DFIs are not democratically accountable.

The opacity of the investment processes and investment returns, including the development effects expected, may be so great that democratic accountability of the DFIs to the countries that sponsor them may be lost.

7. Contributes to development ineffectiveness.

Investment by DFIs through third party funds via a structure nominally located in a jurisdiction that may be remote from the place in which the funds might actually be invested might eventually create a disconnect between the management of the DFI and the developing world which will mean that the only available investment criteria the DFI will eventually use to assess investments will be financial and this will, by default, mean that the development, social, environmental, stakeholder, capacity and state-building opportunities that an effective development investment fund should also prioritise will be foregone.

3. What can be done?

It is apparent that there are significant problems that arise from the use of tax havens / secrecy jurisdictions by DFIs. The EDFI has suggested that these problems can be overcome through use of a new Code of Conduct on investment through such locations. This Code says that EDFI members:

“should not be associated with harmful practices, such as tax avoidance, money laundering and non-transparency. By following the activities and reports of supervisory institutions such as the Organisation for Economic Co-operation and Development and the Financial Action Task Force closely, EDFI applies the following set of criteria based on the bullet points below to determine what is an acceptable OFC for EDFI investment purposes:

- *Committed Jurisdiction: the OFC should have (i) formally committed to implementing and enforcing the OECD tax standards (the “White List”) and the FATF 40+9 recommendations; and (ii) complied with or demonstrated clear progress towards satisfying OECD and FATF values in respect of the matters below;*
- *Transparency: the OFC should be transparent in relation to the formation and beneficial ownership of SPVs. Each EDFI will check transparency as part of its own investment due diligence;*
- *Exchange of information: the OFC should have expressed a willingness to enter into bilateral tax information exchange agreements or double tax conventions consistent with OECD standards;*
- *Financial sector integrity: the OFCs’ implementation and enforcement of regulations to prevent fiscal and financial abuses should be checked as part of each EDFI’s own investment due diligence; and*
- *Capital flight: if an OFC is found to be involved in illicit capital flight from developing countries (notwithstanding*

its presence on any published list), EDFIs will consider whether it is appropriate to continue recognising such OFC as an acceptable OFC for EDFI investment purposes.”

There are a considerable range of issues and concerns arising from this proposed Code, including the following:

1. Commitment is not the same as action. For example, for many years after 2001 many of the world’s major tax havens / secrecy jurisdictions committed to cooperation with the OECD on bases that ensured they had to take no actual action to comply with any recognised standard.
2. Commitment to the FATF standards is not enough: very few secrecy jurisdictions come close to implementing sufficient of these standards as has been noted by the review of compliance with these standards undertaken on a jurisdiction by jurisdiction basis by the Tax Justice Network .
3. The OECD “white list” referred to requires a jurisdiction to sign just twelve Tax Information Exchange Agreements (TIEAs). There are no criteria set on who those TIEAs need be with. As a result many secrecy jurisdictions have signed TIEAs with each other. In addition TIEAs with the Faroe Islands, Greenland and Iceland have become very popular – these three tiny jurisdictions providing a quarter of the required quota to meet the required international standard, with no prospect of real information exchange arising as a result.
4. There is no evidence that TIEAs will give rise to meaningful information exchange and to date almost no TIEAs have been signed with developing countries, leaving them almost wholly excluded from the information exchange process promoted by the OECD, which does seem to make it an inappropriate yardstick for measurement when investment in developing countries is the real issue of concern for the DFIs .

5. By definition tax havens / secrecy jurisdictions do not require that the beneficial ownership of special purpose vehicles (SPVs) be recorded in open or transparent fashion and in the vast majority of cases do not provide a mechanism that ensures that this information is available on public record. As a survey by the Tax Justice Network has shown, just one of the sixty secrecy jurisdictions that they assess requires that the beneficial ownership of any corporate entity within that jurisdiction be placed on public record. That exception to the general rule is Monaco, which is exceptionally unlikely to be used as allocation for investment activities by any DFI. DFIs cannot, as a consequence, possibly achieve the second criteria noted by the EDFI.
6. Transparency is required on more issues than beneficial ownership. Information on the constitution of the entity invested in, those who manage it and its financial performance is also essential if adequate transparency standards are to be met but the EDFI makes no reference to these issues.
7. Willingness to enter into Tax Information Exchange Agreements and Double Tax Agreements cannot be guaranteed to translate into effective information exchange. Jersey and the USA had one of the first ever TIEAs signed but in a period of more than 5 years to 2008, for which data is available, less than ten successful exchanges of information arise whilst Cayman budgeted in 2009 to receive no more than 120 requests for information under its TIEA network – including that with the USA. This is a long way short of effective information exchange.
8. A DFIs assessment of financial sector integrity is not open to public inspection.
9. Such is the scale of capital flight that it is hard to imagine any tax haven / secrecy jurisdiction does not have involvement in the activity, rendering any standard precluding investment in a tax haven / secrecy jurisdiction on this basis akin to an effective ban on their use.

What is obvious is that use of these external standards is inadequate in the case of DFIs where, because of the nature of their ownership and the goals they have been established to promote; much higher standards of conduct are expected than would be the case generally.

Having noted their own concerns about the opacity of Norfund's activities the Norwegian Commission on Capital Flight from Developing Countries suggested its own Code of Conduct for Norfund. This would require that Norfund have:

1. Guidelines on reporting requiring (in summary) that:
 - a) In dialogue with its owner, Norfund should develop and publish ethical guidelines for its choice of investment location.
 - b) Norfund should report
 - the proportion of its capital invested in funds and direct investments respectively, and the return on these two categories as well as on the subcategories of loans and shares before and after tax
 - where the funds are registered
 - who the co-owners of all funds and investments are
 - for fund investments, Norfund's share of tax paid as a proportion of its share of the capital in the fund.
 - c) Norfund should work to ensure that the funds in which it invests have publicly accessible accounts.
- As the Commission noted, it felt that all this data should be readily accessible to Norfund.
2. Norfund should seek to find African states that could act as investment hubs without the problems associated with tax haven locations.
 3. Norfund should seek to ensure that funds in which it invests are in future located in the countries in which the resulting investments are made to avoid risk of tax leakage from that state which the investment is meant to benefit.

4. Norfund should work with other DFIs to achieve these goals.

These criteria are clearly a substantial improvement over those promoted by the EDFI, not least because they recognise the special and particular obligation of DFIs to be transparent about their activities – a criterion which we suggest should rank higher than the requirement to make pure financial return when assessing investment opportunities. The Commission achieves this goal by requiring Norfund to establish and publish its own criteria for assessment which necessarily exceed international baselines for acceptability, which are aligned with development goals and which ensure that the process in which it is engaged is democratically accountable, as is necessary given its ownership.

These are worthwhile goals that need to be embraced more widely. It is for that reason that we suggest that a significantly improved Code of Conduct for DFIs is required.

A new code of conduct

Any guidance for DFIs should have the following goals:

1. It should address the problems highlighted in this report related to investments through or related to tax havens;
2. It should play a positive role in changing investment patterns and promote new models of investment in developing countries that stresses the complementarity of the role DFIs must play;
3. It should promote development goals and the ability of developing countries to mobilise tax in order to finance these goals;
4. It should enhance governance, transparency and accountability to taxpayers.

In pursuit of these goals we suggest that each DFI should adopt a stakeholder focussed Code of Conduct with regard to their activity in which they accept their explicit duty to be accountable to those in the country that promotes their activity and to those in the countries in which they invest. We suggest this might read as

follows:

1. Our investment activities will be transparent and accountable;
2. We will discharge our public duty to promote investment in the interests of development on the assumption that all we do might be subject to the glare of publicity in all locations in which we operate;
3. We will ensure that all our activities, and the activities of all funds in which we invest and all companies and other entities in which we invest are disclosed in all locations in which we operate to at least the standard required in our parent jurisdiction of incorporation, without exception. If the entities in which we invest do not do so in the location in which they are incorporated we shall publish this information in our own country of incorporation instead;
4. When the funds and entities in which we invest are controlled by a combination of DFIs, whether directly or indirectly, we will make that clear so that this is known to all who engage with that entity in the interests of transparency, accountability and good governance being evidenced in practice;
5. We will seek to ensure that all entities in which we invest are tax compliant by which we mean that they will seek to pay the right amount of tax (but no more) in the right place at the right time where right means that the economic substance of the transactions undertaken coincides with the place and form in which they are reported for taxation purpose. In furtherance of this goal we shall ensure that each entity in which we invest makes full disclosure of all taxes paid on profits it makes, and to the greatest degree possible, all other revenue payments that it makes to the government of the jurisdiction in which it is incorporated whether that payment is made by it as principle or as agent for others;
6. We shall seek, quite openly, to avoid double taxation of any transaction in which we are engaged as actively and as publicly as we will seek to avoid non-taxation of any

transactions in which we engage;

7. Whenever we need to use a tax haven / secrecy jurisdiction to fulfil this objective we will be explicit about reasons for doing so, shall state what double taxation charge we are seeking to avoid and shall lend our support to reform of the taxation system of the states whose law might give rise to double taxation charge to ensure that a more open and transparent tax system arises for the benefit of all market participants, states and investors in that location;
8. We shall, wherever and whenever possible seek to ensure that the funds in which we invest are located in those places in which they in turn onward invest on our behalf. Where that is not possible we will be explicit in explaining our reasoning and will seek to remove those obstacles that exist to investing in the way we desire, including by offering training, legislative support and technical advice to the governments of the jurisdictions in question to overcome the obstacles to inward investment within their domain that we have identified to exist.
9. We shall account on a country-by-country basis for the activities that we undertake - taking into account the substance and not the form of the transactions we undertake, and shall publish reports according to the

principles of country-by-country reporting in each and every country in which we operate .

10. We shall in respect of each investment we make and in respect of each investment by each fund in which we invest in the year in which an investment is made explain why it was essential that we participate in this investment in pursuit of our development goals; shall state what those development goals were in each such case and shall state why, without our participation, those development goals would not have been achieved so that evidence of our having fulfilled our duty to be complementary shall be placed on public record. In subsequent years we shall explain why in respect of each such investment we believe that our development goals have been fulfilled and shall state our methodology used in forming that opinion.

This Code puts the obligation to be transparent at the forefront of a DFIs duty. In our opinion nothing else is possible if it is to achieve the goal of openly and accountably enhancing the investment opportunities within those jurisdictions in which it invests.

That is why we believe it should be adopted, now.

Appendix 1: A definition of transparency

Transparency is at the core of the demands we make of DFIs. But what is it? This appendix seeks to provide a concise answer to that question.

Financial transparency exists in our opinion when the following information is readily available to all who might need it to appraise transactions they or others might undertake or have undertaken with another natural or legal person:

1. Who that other person is;
2. Where the person is;
3. What right the person has to enter into a transaction;
4. What capacity the person has to enter into a transaction;
5. What the nature of the entity is;
6. On whose behalf the entity is managed;
7. Who manages the entity;
8. What transactions the entity has entered into;
9. Where it has entered into those transactions;
10. Who has actually benefited from the transactions;
11. Whether all obligations arising from the transactions have been properly fulfilled.

And with regard to entities that are not natural persons:

Only when these questions can be answered on timely basis and at low or no cost by anyone who wishes to make enquiry does financial transparency exist.

References

- ¹Richard Murphy is a chartered accountant and graduate economist. He was senior partner of a London firm of accountants for more than ten years. He has also been a serial entrepreneur. Since 2000 Richard has worked mainly on taxation policy. He is director Tax Research LLP and advises the Tax Justice Network (of which he was a founder), the UK Trade Union Congress and many other organisations on tax policy issues. He has been a consultant to the World Bank and a visiting fellow in tax and political economy at a number of UK universities. According to the Accountancy Age Financial Power List for 2009 Richard is the 25th most influential person in UK finance. Richard writes a daily blog at www.taxresearch.org.uk/blog. He is co-author of 'Tax Havens: How Globalization Really Works' published by Cornell University press in January 2010.
- ²Agents of change in support of achieving the MDGs include the Paris Declaration on Aid Effectiveness, the Accra Agenda for Action and generally a sustainable development agenda encompassing good governance for equitable economic growth ultimately benefiting developing countries.
- ³From The Growing Role of the Development Finance Institutions in International Development Policy, EDFI, 2009, <http://www.edfi.be/component/downloads/downloads/19.html> accessed 31-3-10
- ⁴Ibid
- ⁵All data, ibid
- ⁶Tax Havens and Development, The Norwegian Commission on Capital Flight and Developing Countries, Oslo, 2009, page 108
- ⁷Secrecy jurisdictions are places that intentionally create regulation for the primary benefit and use of those not resident in their geographical domain. That regulation is designed to undermine the legislation or regulation of another jurisdiction. To facilitate its use secrecy jurisdictions also create a deliberate, legally backed veil of secrecy that ensures that those from outside the jurisdiction making use of its regulation cannot be identified to be doing so. Quoted from Murphy, R. Defining the Secrecy World: Rethinking the language of 'offshore', The Tax Justice Network, 2009
- ⁸We are grateful to CDC supplying this data for the purposes of this paper
- ⁹Murphy R, 2009, Where are the world's secrecy jurisdictions? The Tax Justice Network http://www.secrecyjurisdictions.com/PDF/SJ_Mapping.pdf
- ¹⁰<http://www.financialsecrecyindex.com/2009results.html>. Data on Cayman can be found here <http://www.secrecyjurisdictions.com/PDF/CaymanIslands.pdf> and on Mauritius here <http://www.secrecyjurisdictions.com/PDF/Mauritius.pdf>
- ¹¹Palan, R., Murphy, R., Chavagneux, C, 2010, Tax Havens: How Globalisation Really Works, Cornell University Press, page 21
- ¹²EDFI Briefing Note On EDFI Guidelines For Offshore Financial Centres, October 2009
- ¹³The pooling of capital means that a number of investors join together to share the risk of making a single investment in a particular company or a range of investments of broadly similar type. The idea is that risk is spread and so overall capital returns should increase. The risk is that this hope is not realised because of a) extra costs b) weaker decision making c) increased opacity d) asymmetry of information supply within the new hierarchical structure.
- ¹⁴Onshore in this context means that the transactions take place and are recorded in the same place. Offshore means that either the place where the transactions are recorded and the place where they actually have economic impact are different or that none of the participants to the contracts recorded in a place are actually resident there. Both definitions of offshore apply to most activities of most DFI funds located in secrecy jurisdictions although there are bound to be exceptions.
- ¹⁵From The Growing Role of the Development Finance Institutions in International Development Policy, EDFI, 2009, <http://www.edfi.be/component/downloads/downloads/19.html> accessed 31-3-10
- ¹⁶http://www.msccibarra.com/products/indices/international_equity_indices/gimi/stdindex/performance_em.html accessed 1-4-10, the ratio suggested being the average of the BRIC, Africa, Asia, and Latin American indices.
- ¹⁷After tax returns are implicit as the index refers to stock market valuations where returns are calculated on the amount available for distribution to shareholders, meaning tax has already been accounted for at the corporate level.
- ¹⁸Keen, M and Mansour, M (2009) Revenue Mobilization in Sub-Saharan Africa: Challenges from Globalization. IMF working paper WP 09 157
- ¹⁹<http://www.financialtaskforce.org/2010/02/12/new-report-finds-100-billion-lost-each-year-from-developing-countries-due-to-trade-mispricing/> accessed 1-4-10
- ²⁰See <http://www.secrecyjurisdictions.com/PDF/FATF-Ratings.pdf>
- ²¹For a discussion of some of the issues see http://www.taxjustice.net/cms/upload/pdf/TJN_0903_Exchange_of_Info_Briefing_draft.pdf accessed 2-4-10
- ²²<http://www.secrecyjurisdictions.com/PDF/PublicCompanyOwnership.pdf> accessed 2-4-10
- ²³<http://www.taxresearch.org.uk/Blog/2009/01/07/call-that-information-exchange/> accessed 2-4-10
- ²⁴For a full description of country-by-country reporting see Murphy, R. (2009) Country-by-Country Reporting: Holding Multinational Corporations to Account Wherever They Are, Task Force on Financial Integrity and Economic Development, Washington DC

