Report

International financial centres and development finance

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Cover photo: new building construction in Kisangani, DRC. Mauritian IFCs are important to infrastructure investment in Africa. Credit: Flickr/CIFOR.

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All views expressed are those of the author, alone, and do not reflect the views of interviewees, discussants, BVI Finance or ODI.

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Acronyms

AfDB	African Development Bank
AEOI	Automatic exchange of information
BEPS	Base erosion and profit shifting
BIS	Bank for International Settlements
BVI	British Virgin Islands
CRS	Common Reporting Standards
DFI	Development financial institution
EITI	Extractive Industries Transparency Initiative
EU	European Union
FATCA	Foreign Account Tax Compliance Act
FATF	Financial Action Task Force
FCPA	Foreign Corrupt Practices Act
FDI	Foreign direct investment
FSB	Financial Stability Board
GDP	Gross domestic product
HMRC	Her Majesty's Revenue and Customs
ICIJ	International Consortium of Investigative Journalists
IFI	International financial institution
IFC	International financial centre
IMF	International Monetary Fund
KYC	Know your customer
LIC	Low-income country
LMIC	Lower-middle-income country
MCPP	Managed Co-Lending Portfolio Program
MIC	Middle-income country
OECD	Organisation for Economic Cooperation and Development
PEP	Politically exposed person
PIDG	Private Infrastructure Development Group
SDGs	Sustainable Development Goals
UK	United Kingdom
UNDP	United Nations Development Programme
UNECA	United Nations Economic Commission for Africa
UNCTAD	United Nations Commission for Trade and Development
UNU-WIDER	United Nations University World Institute for Development Economics Research
US	United States of America
WEF	World Economic Forum

Executive summary

Economic growth in some of the world's poorest nations is being held back by a lack of financing. International financial centres (IFCs) have a crucial role to play in mobilising such finance as they can provide secure jurisdictions, fund structuring and tax neutrality for both private investors and public-private co-financing.

Development finance institutions (DFIs), with extensive experience in the field and a mandate to raise finance for development, support the use of IFCs. They provide strong evidence of the value of IFCs compared with alternative methods of mobilising finance for development.

Our analysis concurs, estimating that IFCs galvanised additional finance to developing countries of $1.6 trillion between 2007 and 2014, boosting their gross domestic product (GDP) by $400 billion and tax revenues by $100 billion during that period. What's more, this was largely invested in infrastructure and financial services, which are crucial to inclusive economic growth.

It is in this context that it needs to be recognised that IFCs can also be conduits for illicit outflows from developing countries. This gives them a significant stake in ongoing reforms to tackle these issues.

These include the Global Forum on Transparency and Exchange of Information for Tax Purposes, which has led reforms to tackle tax evasion, setting standards for the exchange of information. As of mid-2017, these had raised $85 billion of new taxes for member countries (Global Forum, 2017a). The Financial Action Task Force (FATF) has also established effective global standards to combat money laundering and terrorist financing. The reforms have been complemented by a tightening of standards by IFCs and industry practitioners.

Our analysis suggests that these reforms are being effective, with a waning of illicit activity. However, there is a need for universal standards and more donor assistance to bolster the weak technical capacity and resources preventing developing countries from implementing reforms.

There is also a need to focus on the broader context of problems in developing countries, many of which are largely domestic, to tackle the root causes of corruption and low levels of tax mobilisation, such as commitment to building stronger domestic institutions, political commitment and international cooperation.

In conclusion, it is important that policy balance the trade-offs involved in fostering IFC intermediation of development finance, while ensuring that illicit activities continue to be tackled resolutely.

To achieve this, the development community must be more balanced in its approach to the debate on the possible advantages and disadvantages of utilising IFCs, to ensure the best possible outcome for the world's poorest nations.

1 Introduction

Since 2008, there has been a focus on reforming the global financial system to enable it to deliver growth and prosperity while avoiding a repeat of the financial crisis.

These reforms are particularly significant for developing countries, because their economic growth – and the poverty alleviation that depends on it – is being held back by a lack of finance. As the World Bank put it, the international community needs to move the discussion 'from billions' in overseas development aid 'to trillions in investments of all kinds: public and private, national and global, in both capital and capacity' (World Bank, 2015).

Since the global financial crisis, finance to developing countries has declined; this includes private finance, which is needed to co-finance public infrastructure and build the private sector (Tyson and Carter, 2016; Tyson, 2018).

IFCs have the opportunity to play an important role in overcoming barriers to investment in developing countries by providing investors with secure jurisdictions, financing structures for risk pooling, and tax neutrality.

This is crucial when it comes to the poorest countries – where financing difficulties are most acute and the need for risk mitigation is highest – and to co-financing by public and private investors, a key policy area (UNECA, 2015; Tyson, 2018).

DFIs, which have a mandate to raise financing for development and have vast expertise in the field, provide convincing evidence of the value of IFCs compared with alternative methods of mobilising finance for development.

Our analysis suggests that their views are well founded. Our assessment shows that IFCs boosted the level of finance channelled to those sectors key to inclusive economic growth by an estimated $1.6 trillion between 2007 and 2014. This led to an increase of $400 billion in the GDP and $100 billion in the tax revenue of developing countries during that period.

Against this backdrop, there have been multiple reforms aimed at tackling illicit activities, such as tax evasion and money laundering, that can be conducted through IFCs and other 'onshore' financial centres.

The G20-hosted Global Forum on Transparency and Exchange of Information for Tax Purposes (the Global Forum) has spearheaded reforms to tackle tax evasion. It has established standards of transparency, as well as for the exchange of information among the tax and legal authorities of participating countries, which will enable them to trace and tackle tax evasion. More than 150 countries have committed to implementing these 'powerful tools' by 2018, including all of the major IFCs (Global Forum, 2017a).

Similarly, the FATF has established global standards for combatting money laundering and terrorist financing that are proving to be effective. The reforms have been complemented by a tightening of standards by IFCs and industry practitioners, in moves that been lauded by the Global Forum and the FATF.

Data from the Bank of International Settlements (BIS) and the International Consortium of Investigative Journalists (ICIJ) suggest that the level of illicit activity in IFCs is declining in response to the reforms.

Consequently, it is important that policy balances the trade-offs involved in fostering IFC intermediation of development finance, namely, ensuring that illicit activities are tackled resolutely, but that IFCs' ability to channel crucial finance to developing countries is maintained.

Policy needs to look at implementing universal, not unilateral, standards and strengthening implementation in and for developing countries.

Many developing countries are not party to the reforms, partly because of a lack of technical capacity (and greater assistance is needed to tackle this), but also because the reforms need to be accompanied by top-down efforts to address the root causes of domestic corruption and tax evasion.

The danger of the current reform process is that, in their zeal, the various authorities will throw the proverbial baby out with the bath water when it comes to the crucial role IFCs play in financing developing countries, hampering efforts to raise further finance for development while having a negligible effect on corruption and tax evasion.

The development community must be more balanced in how it approaches the debate on all of the possible advantages and disadvantages of utilising IFCs, to ensure the best possible outcome for the poorest nations.

1.1 Structure of this paper

Chapter 2 begins with a review of the scope of and definitions used in this paper, including an assessment of the weaknesses of current academic evidence and a discussion of the methodology used in our analysis, which is based on the ICIJ database.

Chapter 3 reviews the recent reforms carried out in relation to IFCs as they pertain to developing countries. It includes an overview of the post-2008 reforms and discusses them in the context of developing countries.

Chapter 4 discusses DFI evidence of the value generated by IFCs in mobilising finance for development and estimates the mix of activities and level of incremental financing entailed. It concludes with an estimate of the effect of this incremental finance on the GDP and tax revenues of developing countries.

Chapter 5 discusses the policy implications of this paper and makes recommendations for future action.

2 Methodology and definitions

2.1 Scope

The focus of this paper is IFCs and developing countries. It excludes topics that are primarily relevant to advanced economies. Developing countries are defined using the World Bank's income level-based classifications and include lower-middle-income countries (LMICs).

The paper concentrates on two IFCs that are crucial to development finance: Mauritius and the British Virgin Islands. Mauritius was chosen because of its importance to investment in Africa, while the British Virgin Islands was chosen because of its importance to investment in and from China, as well as to intermediating investments in Latin America and the Caribbean (UNCTAD, 2015).

The Base Erosion and Profit Shifting (BEPS) initiative and the Extractive Industries Transparency Initiative (EITI) are beyond the scope of this paper, other than as they relate to transparency in the extractive industries.

2.2 Definitions

There is no agreed definition of an IFC. Some definitions seek to apply criteria based on a level of financial activity relative to GDP or the provision of services to non-residents. The International Monetary Fund (IMF) and the Financial Stability Board (FSB), respectively, adopt these approaches, for example (FSB, 2000). They have the advantage of objectivity, but can be too broad ranging (Carter, 2017).

Other organisations seek to define IFCs by identifying named territories. The Organisation for Economic Cooperation and Development (OECD) and the European Union (EU), for instance, have published lists of territories they define as IFCs in accordance with those organisations' policy goals.

Some definitions are narrowly based, for example, on transparency. The Tax Justice Network compiles a Financial Secrecy Index,[1] which ranks jurisdictions according to their level of secrecy and the scale of their offshore financial activities (Tax Justice Network, 2018).

As this paper examines the broad activities of IFCs, it adopts a definition based on financial activity, drawing on the approaches used by the IMF and Financial Stability Board. We define an IFC as a centre for financial services where the majority of activity consists of:

- relatively large numbers of financial institutions engaged primarily in business with non-residents
- financial systems with non-domestic assets and liabilities that are large in proportion to domestic financial intermediation and GDP
- financial systems that lack 'financial depth' in relation to asset markets, the resident investor base and resident financial institutions.[2]

This definition excludes large financial centres, such as London and New York, because of their well-developed financial markets. It does include Bermuda, the British Virgin Islands, the Cayman

1 https://financialsecrecyindex.com

2 See Svirydzenka (2016) for a fuller discussion of indexation of financial depth.

Islands, Guernsey, Ireland, the Isle of Man, Jersey, Luxembourg, Mauritius, the Netherlands and Panama.

2.3 Primary sources

The primary research for this paper ranged from interviews with multilateral development banks, DFIs, private equity funds and commercial banks to financial-service regulators in IFCs and professional practitioners, including in the legal, accounting and audit industries. All interviews were conducted under the Chatham House Rule[3] and none of these sources is quoted directly or otherwise acknowledged.

2.4 Secondary sources

The reviewed literature encompasses academic sources (as listed in the reference section) and material from major international organisations and agencies. These include the IMF, the FSB, the FATF, the BIS, the OECD and the United Nations (UN), including the United Nations Commission for Trade and Development (UNCTAD) and the United Nations Economic Commission for Africa (UNECA).

2.4.1 A note on the academic literature

Estimates of capital flows through IFCs vary considerably according to the methods, assumptions and data used (UNECA, 2015).

One method is to use well-respected sources of data on cross-border capital flows, such as the UN and the BIS. However, some IFCs do not report data to these organisations.

An alternative approach is to identify unexplained variances in a country's national accounts and assign this to capital flight (Kar and Cartwright-Smith, 2008 and 2010; Kar and Freitas, 2011; Ndukimana and Boyce, 2008 and 2011). For example, Ndukimana et al. (2010) use the residual differences between inflows and outflows recorded in the balance of payments for these purposes.

However, developing countries' national statistics suffer from weaknesses in methodology and data collection and often do not take into account the informal sector. This, rather than capital outflows, may explain the discrepancies in some instances and it is difficult to estimate the proportion of the residual differences that should be assigned to the various factors.[4]

Another methodology is to use statistical techniques to determine correlations between possible explanatory variables. However, these techniques only provide macro-level and non-causative evidence and often suffer from methodological problems relating to definitions and data. Indeed, the IMF describes these types of approach as 'highly tentative' and 'crude' (Crivelli, 2015: 23).

Academics and development agencies broadly recognise that existing methodologies have weaknesses. For example, the UN comments that policy-makers and experts 'have so far not arrived at a quantification of the value at stake' and describes such methodologies as 'limited and fragmented' and 'heuristic' (UNCTAD, 2015: 179).

The UN, OECD and EU have all recognised the need for more granular data to provide sounder evidence of the nature and extent of capital flows through IFCs (Barrios et al., 2016; UNCTAD, 2015; Crivelli, 2015; Johansson et al., 2017). For example, the IMF states that granular data are needed to get a 'much firmer grip on the issues' (Crivelli, 2015: 23).

2.5 Data sources

This paper includes data from the BIS, which provides cross-border locational data by residency on assets and liabilities held in offshore centres (as defined and named by the BIS) and from UNCTAD, the primary source of data on cross-border foreign direct investment (FDI).

2.5.1 The ICIJ database

In 2017, the ICIJ published a database (ICIJ, 2017) – dubbed the 'Paradise Papers' – containing

3 https://www.chathamhouse.org/chatham-house-rule

4 Although Ndukimana and Boyce (2010) counteract this argument by noting that discrepancies are unidirectional, whereas random errors would not be.

such granular data. It holds details of 290,000 companies, trusts and foundations (collectively termed 'entities' in this paper) (ICIJ, 2018), including officers, directors, shareholders and beneficial owners [5] in IFCs, including Bermuda, the British Virgin Islands, the Cayman Islands, Jersey, Guernsey and Mauritius. Consequently the database can be said to provide a reasonably representative sample of 'firm-level' activity in these territories.

As this information was is in the public domain and because of its potential value for research purposes, the author used the ICIJ database in this study to examine activities in Mauritius and the British Virgin Islands.

Nonetheless, the author acknowledges that the ICIJ obtained the source information illegally and emphasises that neither ODI nor the author condones, approves of or otherwise consents to such illegal activity.

Analysis was carried out for all of the Mauritius-domiciled entities in the ICIJ database, using data available as of May 2018. Because of the larger British Virgin Islands sample, analysis was conducted using fixed-interval sampling. This resulted in a sample of just over 300 entities, which is considered statistically representative relative to the population. As this paper is focused on the period of financial reform since 2008, both samples include only entities formed since 2007.

Because the ICIJ database does not consolidate series of special-purpose vehicles issued under a single master agreement, the analysis consolidated entities that appeared to be issued under such master agreements (based on group company structure and comparative features) to provide a more representative sample.

Each entity was categorised by purpose, based on the following:

- the entities, shareholders and beneficial owners identified in the ICIJ database
- information about beneficial owners and investments from publicly disclosed information
- professional experience (to ensure the categorisation was well grounded, entities were classified by the author and peer-reviewed 'blind' by legal professionals).[6]

The categories chosen and the basis for them are as follows:

- **FDI:** Inward FDI to developing countries, where investments were identified and where the entity domiciled in the IFC was identified as the subsidiary owning these investments, including entities whose beneficial owners include DFIs, such as the International Finance Corporation, Germany's KfW and the UK's CDC Group
- **Funds**: Funds managed by regulated investment funds or private equity funds that invest in developing countries through subsidiaries in IFCs
- **Trusts and foundations**: Trust and foundations located in IFCs, including family trusts or other special-purpose trusts associated with private wealth management
- **Tax structuring:** Entities whose purpose is identified as legal tax reduction and avoidance,[7] including entities whose activities are related to known tax-reduction structures and/or whose primary business has no other apparent substantive rationale for using an IFC

5 The ICIJ database contains a total of 765,000 entities from various sources. Only the Paradise Papers were used because they contain more recent transactions than other sources and this paper focuses on the post-2007 period.

6 The author is a chartered accountant and experienced product and risk controller at global investment banks. Relevant roles have included chairing regional new-product-approval committees, leading valuation and risk management for structured products, and leading work in the fields of forensic accounting and fraud investigations, including for internal investigations and with the UK's Serious Fraud Office.

7 Tax avoidance is the reduction of tax liabilities in a legal way.

- **Politically exposed person (PEP)-related:** Entities with beneficial owners who are politically exposed in developing countries
- **Negative indicators:** Factors indicating that entities were at higher risk of being used for illicit activities, including tax evasion,[8] corruption and money-laundering, for example, outflows from locations at risk of being engaged in illicit flows as defined by the US Department of State's Money Laundering Assessment
- **Not determined**: Entities for which no determination could be made because there was incomplete or insufficient information in the ICIJ database – for example, the ICIJ database included no details of shareholders, directors, beneficial owners or affiliates entities – and for which it was not possible to find further information from other sources.

This analysis has some weaknesses:

- It is a probability-based assessment of the purpose of entities because it remains reliant on professional judgement, even though it is based on information from the ICIJ, among other sources, and public information on companies and individuals. To ensure that the analysis is well grounded, the categorisation has been thoroughly reviewed by the author, peer-reviewed 'blind' by three legal professionals and any discrepancies reconciled.
- The ICIJ database only provides a count of entities and the details noted above. It does not provide any information about the assets these entities contain. This means that this analysis, based on a count of entities, may differ from an analysis based on value of assets and liabilities.

Nevertheless, because of its granularity, this analysis has produced a guide that is a useful addition to other methodologies aimed at gauging the activities of IFCs.

8 Tax evasion is the use of illegal means to dodge paying taxes.

3 Post-2008 reforms

As noted, since 2008, there has been significant reform of the international financial architecture, including IFCs. In this chapter, these reforms are reviewed for readers unfamiliar with them and discussed in the context of developing countries.

3.1 A brief overview

3.1.1 Reforms to tackle tax evasion

International reforms

International reforms have been led by the G20-hosted and OECD-led Global Forum on Transparency and Exchange of Information for Tax Purposes (the Global Forum). Its goals are to agree international standards of transparency to tackle tax evasion.

Its initiatives include an exchange of information – known as the Common Reporting Standard (CRS) – among its 150 participant countries. The information being exchanged is defined as 'foreseeably relevant information' for the enforcement of domestic tax legislation and includes details of legal and beneficial ownership of assets. The exchange is based on agreed standards of confidentiality and the proper use of data (Global Forum, 2017a and 2017b).

Since 2017, nearly 50 countries have exchanged information on a voluntary basis. Since September 2018, automatic exchange of information (AEOI) should now be taking place among all 150 participants (Global Forum, 2017a).

The exchanges of information are accompanied by peer reviews of compliance by participating states. These peer reviews are considered to be rigorous and include ratings of compliance with Global Forum standards.

By the end of 2017, 94% of the reviewed jurisdictions were rated as 'compliant' or 'largely compliant' (Global Forum, 2017a).

Participants in the exchange of information include IFCs. As of 2018, the participating jurisdictions included the British Virgin Islands and Mauritius, which were deemed 'largely compliant' and 'compliant', respectively,[9] with Global Forum standards (Global Forum, 2017a).

Unilateral reforms

The United States of America has declined to participate in the CRS process led by the Global Forum and has established its own standards for information exchange under its 2010 Foreign Account Tax Compliance Act (FATCA). This is designed to tackle tax evasion by US citizens by setting reporting requirements for foreign financial institutions that have US account holders, who are required to pay US taxes on worldwide income and to disclose assets held abroad.[10] The lack of US participation in the CRS process means that the state of Delaware – which is a major centre for incorporation – is not included in the reforms led by the Global Forum (Capital Economics, 2017).

In 2017, the EU published a unilateral list of 'non-cooperative' tax jurisdictions it considered to have 'deficiencies' based on 'risk indicators' relating to transparency and fairness in tax competition.[11]

As of October 2018, six countries remained listed as 'non-cooperative', as they had 'refused to engage with the EU or to address tax good

9 The British Virgins Islands second-round review was delayed because of the Hurricane Irma disaster in late 2017.

10 www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx

11 https://ec.europa.eu/taxation_customs/tax-common-eu-list_en

governance shortcomings'. In 2018, the bloc also put restrictions on the use of EU funds via these IFCs.[12]

3.1.2 Reforms relating to money laundering

International reforms
The inter-governmental Financial Action Task Force (FATF) was established in 1989[13] in a bid to combat money laundering around the globe. Its standards form the basis of the legal, regulatory and operational measures used by the international community to halt money laundering and terrorist financing and are applicable to all financial centres, including IFCs.

The FATF's most recent standards were published in 2018. They emphasise the need for a risk-based approach and preventive measures, including due diligence, to establish the beneficial ownership of assets, the source of funds and special procedures for politically exposed persons (PEPs). The FATF has recommended that these principles be embedded in the national financial regulation and supervisory frameworks of member countries (FATF, 2018).

Like the Global Forum, the FATF conducts peer or 'mutual' reviews of its member states. The British Virgin Islands had its most recent evaluation in 2008, carried out by the Caribbean Financial Action Task Force, a regional organisation within FATF. The review noted that, 'increased due diligence exercised by banks and the financial services … has discourage[d] launderers from using these institutions to transfer illegal proceeds' and that the British Virgin Islands had a 'robust public policy commitment to … the global fight against money-laundering and financing terrorism' (FATF, 2008: 17). The report made minor recommendations on the legislative framework and resourcing for investigative authorities (FATF, 2008).

Mauritius was last evaluated in 2008 by the Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG), another regional organisation within the FATF. The review was conducted as part of the IMF's financial-sector assessment programme, which found 'substantial improvements' in the country's anti-money-laundering and anti-terrorism framework, as well some areas for improvement (ESAAMLG, 2008).[14]

Unilateral reforms
The United Kingdom has also carried out unilateral reforms. While not a requirement of the global regulator, on 1 May 2018, the UK Government agreed to amend the Sanctions and Anti-Money Laundering Bill (now Act) to introduce a requirement for UK Overseas Territories (among them, the British Virgin Islands, Bermuda and the Cayman Islands) to create public registries of beneficial ownership by the end of 2020. This requirement can be imposed by an Order in Council[15] should this information not be public by this date.

3.1.3 Domestic and industry responses by IFCs

IFCs are subject to domestic legislative and regulatory frameworks. Regulated activities include companies, trusts and foundations, as well as the activities of financial-service providers, such as law firms, auditors and accountants.

The British Virgin Islands is regulated by the autonomous British Virgin Islands Financial Services Commission, established in 2001 under a legislative framework to regulate, supervise and inspect financial-services activities in the jurisdiction. It is responsible for licensing service providers who offer services to corporations, trusts and other entities registered in the territory. It undertakes regular audits and is mandated to impose penalties for non-compliance, ranging from fines to licence revocation. It operates an independent enforcement committee, which addresses issues arising from on-site inspections by its Compliance Inspection Unit (British Virgin Islands Financial Services Commission, 2014).

12 https://ec.europa.eu/info/publications/eu-anti-tax-avoidance-requirements-financing-and-investment-operations_en

13 www.fatf-gafi.org/home/

14 www.fatf-gafi.org/pages/easternandsouthernafricaanti-moneylaunderinggroupesaamlg.html

15 www.britannica.com/topic/order-in-council

The British Virgin Islands participates in the Global Forum, FATF and FATCA and has responded to more than 1,000 requests for the voluntary exchange of information on beneficial ownership since 2012. It also undertook a National Risk Assessment of money laundering and terrorist financing in 2016 and expanded its regulatory staff to ensure that it could meet its increased responsibilities (British Virgin Islands Financial Services Commission, 2014; Global Forum, 2015).

The British Virgin Islands introduced a digital platform in 2017, the Beneficial Ownership Secure Search (BOSS) system, which enables the provision of information on beneficial ownership to 'competent authorities', such as UK law-enforcement agencies and tax authorities. This information is provided on request and on a real-time and confidential basis.

The reforms have been well received. The Global Forum peer review in 2015 found the territory to be 'largely compliant' with transparency standards and fully compliant in terms of the exchange of information (Global Forum, 2015).[16]

This positive view was reiterated by David Richardson of HM Revenue and Customs, who testified to the Treasury Sub-Committee of the House of Commons in 2018 that the UK's Crown Dependencies and Overseas Territories were 'committed' to further reforms and in compliance with the CRS underpinning Global Forum exchange-of-information reforms (House of Commons, 2018a). The UK government says this has resulted in 'enhanced law enforcement access to beneficial ownership data' and 'enhanced intelligence leads and investigations on illicit finance' (Foreign and Commonwealth Office, 2018).

In Mauritius, activities are regulated by the Financial Services Commission under legislation established between 2007 and 2012 to licence, regulate, monitor and supervise the financial sector. It has similar mandates and activities to the British Virgin Islands Financial Services Commission. Mauritius has also responded to the new reform environment by revising its double taxation treaty with India following claims that it was encouraging 'round tripping'[17] and has introduced improved monitoring of investment in Africa (Mauritius Financial Services Commission, 2017).

Mauritius was peer-reviewed by the Global Forum in 2017 and found to be 'compliant'. The Forum was 'generally satisfied' with its exchange of information and beneficial ownership, accounting and bank information. Participating countries also reported satisfaction with the quality and timeliness of Mauritius' information exchange (Global Forum, 2017d).

In addition to following domestic regulations, service providers in IFCs are required to conduct due diligence on their clients – called 'know your customer' (KYC) – to establish beneficial ownership information and the source of funds. Clients are required to provide identification and credible detail as to the source of funds. Background checks are completed as part of the client on-boarding process and on an ongoing basis.

Service providers are particularly sensitive to dealings with politically exposed persons and countries that are deemed to be high risk in terms of involvement in corruption or other illicit flows. This monitoring is the subject of the aforementioned audit and oversight by regulators. KYC standards are the same as those used in all major global financial centres and, as many service providers belong to global organisations, they are also subject to stringent international regulatory oversight and professional standards.

3.1.4 Effectiveness of reforms

The well-executed and effective reforms are resulting in increased tax mobilisation for the territories in question. The Global Forum estimates the reforms to have raised $85 billion

16 The only notable criticism was that the exchange of information needed to be timelier. However, the tardy responses were largely related to companies that had been struck off the register or otherwise already dissolved, and due to an exceptionally high number of requests from one partner in 2014.

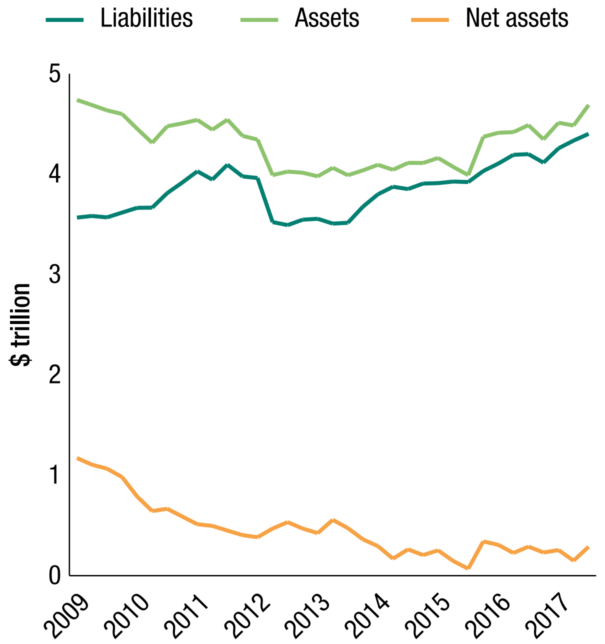
17 Whereby money flows from one country to another, often an IFC, then returns to the original country as foreign direct investment.

of additional taxes as of July 2017 and has dubbed the Common Reporting Standards[18] a ‘powerful’ tool (Global Forum, 2017a). It noted that, ‘the tax principles underpinning the global financial system have moved from opacity and incongruity to transparency and coherence … The era of bank secrecy is over’ (Global Forum, 2017a; OECD, 2018a: 5).

Similarly, HMRC had raised an additional £2.8 billion of tax revenues as of June 2018 using information from exchange-of-information agreements. HMRC went on to describe the then-forthcoming CRS as ‘the holy grail’ and ‘a big step forward, in terms of giving [HMRC] systematic worldwide data on people trying to evade tax (House of Commons, 2018a).[19, 20, 21]

The effects of the reforms can also be seen in other data. For example, from 2009 to 2017, gross assets held in IFCs increased (in line with global financial activity), but net assets declined by 75% to less than $0.5 trillion, according to BIS and Capital Economics data. This suggests that assets ‘parked’ in IFCs – previously identified as a method of avoiding taxation (ERD, 2015) – have declined, while intermediation has increased (Figure 1).[22]

Figure 1 Net assets held in IFCs, 2009–2017 ($ trillion)



Note: BIS locational banking statistics provide data on the outstanding assets and liabilities of internationally active banks located in reporting countries to counterparties and capture around 93% of all cross-border interbank business, including ‘offshore centres’. Data on other IFCs have been sourced from Capital Economics.
Source: BIS, Capital Economics (2017).

18 www.oecd.org/tax/automatic-exchange/common-reporting-standard/

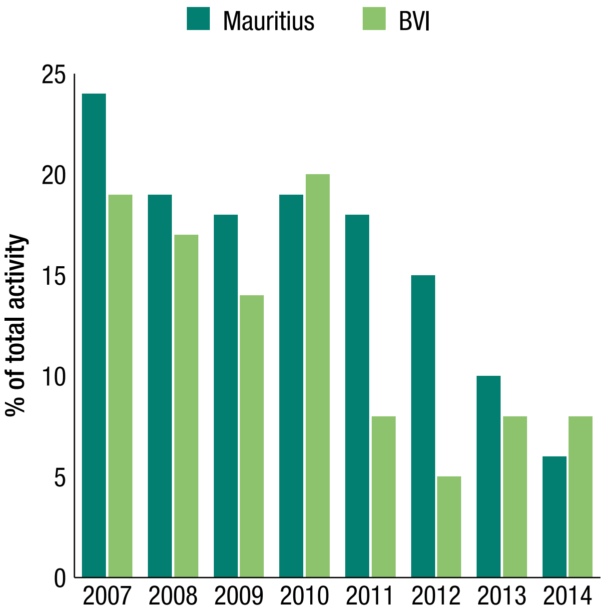
19 David Richardson, Director General of Customer Strategy and Tax Design at HMRC, also said that, ‘some very useful data has come out of the leaks, but it has, in a sense, been a bit of a ragbag of data, not provided in a clean format and much of it not relevant to tax purposes or not relevant to the UK’. He noted that ‘slightly random information leaked by journalists is not the way to run the tax system. The way to run the tax system is a comprehensive, systematic approach that means that everybody is tackled.’ He added that the ICIJ had refused a request to release the Paradise Papers to HMRC (House of Commons, 2018a).

20 HMRC has established a new department to address offshore tax evasion within its fraud investigation department. It had opened 839 investigations from its inception in 2016 to when the exchange of information started (Financial Times, 2018).

21 The ICIJ has refused to provide HMRC with the database and refused to return the data to the law firms from which they were illegally obtained.

22 Other agencies estimate more. The Tax Justice Network (2012) estimates, for example, ‘at least’ $21 trillion to $32 trillion of private financial assets are held in IFCs. These figures are calculated by taking non-bank offshore deposits from the BIS for 2010 and then leveraging them with an assumed ‘liquidity ratio’, which represents the average cash holding in a hypothetical investor’s offshore portfolio. There are flaws in this approach. BIS locational statistics do not include offshore deposit data. It publishes total assets (termed ‘claims’). These include not just deposits, but also loans, debt securities, other debt instruments, equities, investment funds, financial derivatives, employee stock options and monetary gold. As of 2010, this figure was $1.1 trillion for offshore assets, not $4.0 as the Tax Justice Network estimates for cash deposits alone. Furthermore, the ‘leverage’ ratio is subjective and speculative, as there is little basis for assuming a ‘typical’ portfolio globally. Even if there were, it is likely to fluctuate significantly in relation to asset composition over time (Tax Justice Network, 2012; Cobham and Jansky, 2017).

Figure 2 IFC-intermediated tax structuring (2007–2014, % of total activity)



Source: Author's analysis based on the ICIJ database.

This pattern of decline in tax avoidance can also be seen in the ICIJ data. For example, in Mauritius, the number of entities involved in tax structuring declined as a percentage of total activity from 24% in 2007 to 6% in 2014 – a 75% reduction. In the British Virgin Islands, it declined from 19% in 2007 to 8% in 2014, a near 60% drop. Data are not available for the period since 2014, but given the reforms since then and the peer reviews conducted, further reductions are to be expected (Figure 2).

It is more difficult to assess the effectiveness of the reforms when it comes to money laundering, because (as discussed in Chapter 2) there is a lack of reliable data. Even where estimates do exist, they have not been replicated as a time series over the period of the reforms.

3.2 Developing countries and the reforms

3.2.1 The context of developing countries

The economic and political characteristics of developing economies are fundamentally different to those of advanced economies. The most pertinent trait for the purposes of this paper is their relatively weak institutions, including weak government capacity, a corrupt rule of law and poorly regulated financial systems (McMillan et al., 2017; World Bank, 2017).

Such a fragile institutional environment can lead to heightened corruption, accompanied by illicit outflows, diverting the funds of developing economies that are already capital-starved. Angola, Côte d'Ivoire, the Democratic Republic of the Congo, the Republic of Congo, and Nigeria, for example, have all experienced high levels of capital flight because of a combination of these factors (Beck, 2011; Arezki et al 2013; Ndukimana et al., 2014; Boyce and Ndukimana, 2014; Ndukimana, 2016).

It has been claimed that IFCs facilitate both corruption and tax avoidance and evasion, giving developing countries a significant stake in IFC reform.[23] There is, indeed, evidence that IFCs can facilitate illicit outflows from developing countries because of their lack of transparency, enabling money to be laundered without detection (see, for example, Ndukimana, 2014 and 2016; UNECA, 2015).

However, this needs to be placed in the context of the weak domestic institutions in developing countries, which render the control of corruption ineffective. The ongoing reforms of IFCs are unlikely to stem illicit outflows without being accompanied by stronger domestic institutions and political integrity in developing countries (for example, Acemoglu and Robinson, 2008; McMillan et al., 2017; World Bank, 2017).[24]

It is also important to remember that the problem of illicit outflows is largely an issue for those developing countries that have sizeable

23 For example, the Tax Justice Network attributes low taxation in developing countries to 'the global failure to challenge tax havens' (Tax Justice Network, 2016).

24 See www.worldbank.org/en/topic/governance for a fuller discussion of the role and weaknesses of institutions in developing economies and related current policy approaches.

natural resources. The majority of countries, especially the poorest ones, do not have these natural resources and, therefore, the problems associated with them (UNCTAD, 2015).

Developing countries also have lower levels of tax mobilisation relative to GDP than advanced economies. For example, low-income countries typically collect taxes of around 18% of GDP and middle-income countries around 25%, compared with an average of 39% for advanced economies (Besley and Persson, 2014; ERD, 2015; UNCTAD, 2015).

Again, this has been linked to IFCs. For example, it is alleged that tax evasion is common in the extractive sector and that firms use IFC entities to conduct illicit or inappropriate transfer pricing and trade-invoicing arrangements (for example, Ndukimana, 2014 and 2016; UNECA, 2015).

However, as in the case of corruption, the academic evidence suggests that the main driver of low tax collection in developing countries is the structural makeup of their economies and the presence of weak institutions. Low per capita income and high levels of informal economic activity impede the government's ability to collect taxes, as the tax base is lower and it is difficult to tax informal jobs and firms (ERD, 2015; UNCTAD, 2015). Moreover, many revenue authorities do not have the capacity to collect tax effectively. This is particularly pertinent in the extractive sector, where the authorities simply do not have the institutional capacity to monitor or challenge tax arrangements (IMF, 2011; Besley and Persson, 2014; ERD, 2015; UNECA, 2015; UNCTAD, 2015).[25]

When it comes to corruption, tackling issues in relation to IFCs is unlikely to have a material effect unless these core issues are addressed. Indeed, one could argue that the domestic problems associated with tax globalisation are more important than developing countries' engagement with IFCs. This view is echoed by the UN, which noted in 2015 that, 'Africa may face tax avoidance practices that do not require direct investment links to offshore hubs' (UNCATD, 2015).

It is also important to note that most developing countries, especially the poorest ones, do not have particular problems relating to IFCs. This is an important consideration when examining the trade-offs in policy for developing countries and will be discussed further in Chapter 5 (UNCTAD, 2015).

3.2.2 Developing countries' participation in financial reform

Developing countries are not fully participating in financial reform. As of 2017, for example, only five developing countries had committed to a specific deadline for implementing CRS[26] (Global Forum, 2017b).

Developing countries 'without financial centres' are not being asked to commit to the new standard, even though some of them (for example, Nigeria and Kenya) have substantial financial sectors. Only half of sub-Saharan African countries are participating, including those with high levels of alleged corruption in the extractive sector, such as Angola, the Democratic Republic of the Congo and Mozambique.

Few voluntary requests for information have been made by developing countries and the Global Forum sees this, rather than cost or complexity, as the main barrier to greater exchange of information with them.[27]

FATF's 37 members are predominantly advanced economies.[28] Its standards are being implemented by developing countries, but there

25 This affects the taxation of extractive industries, which, as previously noted, is beyond the scope of this paper. Briefly, however, the key barrier to increasing taxation on the extractive sector is weak domestic governance. This includes difficulties in determining the value of extractive-related exports and validating inter-company transfer pricing and debt. Indeed, the UN notes that most developing countries 'lack the means to verify the quantity of natural resources produced' (UNECA, 2015: 28).

26 www.oecd.org/tax/automatic-exchange/common-reporting-standard/

27 www.oecd.org/tax/transparency/technical-assistance/africa/

28 Although a number of developing countries are also included as associate members and observers.

have been concerns about their ability to execute them, largely due to a lack of institutional capacity and some unintended consequences (including reduced financial access, increased transaction costs and the withdrawal of correspondent banking relationships).

Developing countries have sought to manage these problems either by implementing reduced controls, including reduced verification of client identity for low-value transactions or products, or by sequencing implementation across financial institutions and transactions based on perceived risk (Bester et al., 2008).

There seem to be two main reasons for this lack of participation. Firstly, as mentioned, many developing countries lack the institutional capacity to execute the reforms. Recognising this, the Global Forum offers technical support to developing countries to help them implement the CRS, including in the areas of legislative framework and building the capacity of tax authorities. This has included an Africa-specific programme to tackle illicit outflows from the continent and to build capacity in national tax administrations. Initiatives are currently underway in Burkina Faso, Cameroon, Gabon, Ghana, Kenya, Liberia, Morocco, Nigeria and Uganda (Global Forum, 2017a).

The Addis Tax Initiative, launched by the governments of Germany, the Netherlands, the UK and the US, has also committed resources to helping countries with capacity building for domestic revenue mobilisation and 'more ownership and commitment' for improving mobilisation.[29]

However, the reality is that building such institutions is an uncertain and multi-year process and, to date, the initiatives have been too small and short term to have significant effects.

Secondly, there appears to be a lack of political will to execute reforms in some countries. In nations where corruption is high, it may be that the politicians, themselves, are corrupt, so unwilling to participate. The Global Forum recognises these 'political challenges' and describes implementing the CRS as 'a sensitive matter which may undermine certain financial interests' (Global Forum, 2017b: 7).

The Global Forum has tried to mobilise political support. The Yaoundé Declaration in November 2017 saw African ministers of finance making commitments to lead tax transparency and information exchange for Africa (Global Forum, 2017c). However, to date, little concrete action has been taken.

Finally, to guard against the inappropriate use of information, the Global Forum has made participation in the exchange of information contingent on meeting certain standards of confidentiality and data protection. For many developing countries, these conditions are unlikely to be met in the foreseeable future for the aforementioned political and capacity reasons.

3.3 Conclusion

In summary, then, since 2008, there have been significant reforms of the global financial architecture, including in relation to IFCs.

The Global Forum has led efforts to counter tax evasion, including the exchange of information among tax authorities and the peer-review of compliance with standards. It believes its reforms are 'powerful tools' (Global Forum, 2017a) – a view shared by tax authorities such as HMRC and supported by data, which show a decline in 'parked' assets and tax structuring in IFCs.

Similarly, the FATF has enforced its standards in relation to money-laundering and terrorist financing. It is harder to assess the impact here due to a lack of data.

The international initiatives have prompted a tightening of standards and regulations in IFCs and their service providers. This is evident in the positive peer reviews by the Global Forum and the FATF of current practices and regulatory environments.

For developing countries, however, the reforms have yet to yield significant results, predominantly due to their structural characteristics and weak institutions. In some countries, the lack of progress is partly attributable to a lack of political commitment (World Bank, 2017).

29 www.addistaxinitiative.net/index.htm

These issues are essentially domestic problems and not related to IFCs. Unless developing countries take this on board, they are unlikely to realise the benefits of the global reform programme (such as greater tax mobilisation or the stemming of illicit outflows). This is discussed further in Chapter 5.

4 The value of IFCs to developing countries

In Chapter 4, we explore in more detail the value of IFCs when it comes to mobilising finance for development. We examine the size and scope of this role, as well as evidence suggesting that FDI and funds for developing economies are the dominant activity of IFCs. IFCs thus play a key role in steering additional finance to sectors vital to inclusive economic growth.

4.1 The 'value proposition'

Developing economies, ironically, are characterised by an inability to access finance for development. In low-income countries, household savings are low because of their structural link to per capita income. Domestic banking sectors are small and domestic capital markets are either weak or absent, so their finance is most likely to come from international sources (ERD, 2015).

This problem is most acute in the poorest countries, where private finance is minimal, financial systems are underdeveloped, with low levels of private credit and deposits, and the cost of borrowing is highest (Griffiths-Jones et al, 2013; UNCTAD, 2015; Tyson, 2018).

Mobilising international private finance is vital to development (UNCTAD, 2015). However, the reality is that international private investors are reluctant to invest in developing countries because of the high risk of doing so, not least because of their political and macroeconomic instability (Tyson, 2018).

IFCs can play a significant role in mitigating the risks associated with developing countries for private investors, thus mobilising the private finance these countries need. IFCs have two key advantages, which we explore in the next two sections.

4.1.1 IFCs' sound rule of law mitigates risk in developing countries

Many developing countries have legal and political systems that create uncertainty for investors. Problems include corrupt judiciary, unpredictable and lengthy legal processes, and political interference in private property rights and dispute resolution. Problems that can occur include asset appropriation, capricious demands for taxation and politically motivated disputes (McMillan et al, 2017; Tyson, 2018).

Such problems are difficult for private investors to manage and they can undermine investments to such an extent that the most common response is simply not to invest (Carter, 2017; Tyson, 2018).

IFCs mitigate these problems. Entities and transactions that are domiciled in IFCs are subject to the legal jurisdictions of advanced economies, such as the UK and US. This includes contracting, dispute resolution and collateral arrangements. For example, the British Virgin Islands maintains an efficient and respected judicial system based on English Common Law with a dedicated Commercial Court, with ultimate recourse to the Privy Council.

Thus, IFCs can provide access to jurisdictions and legal processes that are fair, predictable and impartial, with principle-based entities and transactions that allow investors to offset much of the risk of investing in developing countries. Investors can avoid having to rely on potentially weak, corrupt and politically influenced legal systems in developing economies (FSB, 2000; UNCTAD, 2013; UNCTAD, 2015; Hay, 2016; Carter, 2017).

4.1.2 IFCs facilitate fund-based investments in developing countries

IFCs provide a neutral location for funds to be amalgamated from multiple investors and then collectively invested in developing countries. The diversification and tranching of pooled funds reduces the risk of such investments to acceptable levels for international private investors.

IFCs also offer tax neutrality. While private investors are taxed in those countries where they are domiciled and where their investments are made, IFCs' tax neutrality ensures they are not taxed a third time at fund level (UNCTAD, 2013; 2015; Hay, 2016; Capital Economics, 2017; Carter, 2017; Tyson, 2018).

This is important for developing countries in two ways. First, public-private co-financing has become central to policy initiatives mobilising the aforementioned 'billions to trillions' for development. IFC entities are used as the co-financing jurisdiction for pooling funds for this purpose (World Bank, 2015; UNECA, 2015).

Second, institutional investors – including mutual funds, pension funds and life insurers in advanced economies – have significant appetite for investing in developing economies and, again, are crucial to mobilising the 'billions to trillions' of funds needed by those countries (World Bank, 2015; UNECA, 2015).

Because of their fiduciary responsibilities, however, institutional investors are unable to buy assets that are high risk or illiquid. This effectively prevents them from making direct investments in individual projects or firms in developing countries. IFCs help them to overcome this hurdle by hosting funds that facilitate the diversification and structuring they need (Tyson and Carter, 2015; Tyson, 2018).

4.2 DFI support for IFCs' role

DFIs have attributed much of the increased mobilisation of finance for development to the use of IFCs, underpinning the financial centres' role in development finance. These institutions are highly experienced and play a critical role in development finance themselves, so their views should be given significant weight. Moreover, the DFIs were recently tasked with a new agenda of co-financing with private investors, which rely on IFCs for risk mitigation, so their views in this regard have become even more relevant.

DFIs echo the aforementioned rationale for using IFCs. The International Finance Corporation says the institutions use them to make 'substantial cross-border investment' for 'legitimate reasons'. These include: 'legitimate and lawful tax planning'; providing 'an appropriate investment vehicle'; because 'the host country may lack an effective environment for the enforcement of contractual terms [and] shareholder protections'; or to assist 'parties to a joint venture or partnership from different jurisdictions [that] want neutrality in selecting the jurisdiction for their venture' (International Finance Corporation, 2014 and 2016).

The UK channels development financing through IFCs for similar reasons. Its DFI, CDC Group, which invests exclusively in low-income countries, marshals more than a $1 billion of private co-financing annually for investment in poor countries.[30] It says that, 'the use of intermediate jurisdictions may be necessary to provide straightforward and stable financial, judiciary and legal systems for investment, and thereby further CDC's developmental impact' (CDC Group, 2017a).

In June 2018, CDC Group also defended its use of IFCs to the UK House of Commons International Development Committee. Nick O'Donohoe, group chief executive, said CDC used 'offshore, neutral jurisdictions' for several reasons, 'to provide legal certainty, because, in some of the countries we invest in, the legal systems do not sufficiently protect the assets that we are investing'. It was also 'to mobilise more money than just our money, so bringing in other investors from non-UK jurisdictions'. This is 'often more efficient through an offshore vehicle', he added (House of Commons, 2018b).

More than $20 billion of public and private co-financing, meanwhile, has been channelled by funds to developing nations via Mauritius, led by the Private Infrastructure Development Group

30 Average for 2015–2017 using the averages of the OECD and MDB methodologies (CDC Group, 2017b).

(PIDG), which is owned by a consortium of DFIs. This money has gone to some of the poorest countries in the world, including Burkina Faso, Mali, Tanzania, Ghana, Cameroon, Côte d'Ivoire and Rwanda, and is financing infrastructure essential to their economic development.[31]

Norway's Norfund – widely regarded as one of the best-governed development agencies globally – also uses IFCs. Its rationale for doing so is that IFCs provide protection against the investment risk of developing countries resulting from 'weak legal systems and/or where there is a risk of corruption in the legal system, [and] the administration and enforcement of laws and rules can be ineffective and unpredictable' (Norfund, n.d.).

Norfund also offers up a cautionary tale for those who think that multilateral development banks and DFIs should not use IFCs. Under political pressure, in 2009, it stopped using non-OECD IFCs. As this prevented it from channelling funds through Mauritius, in 2010 and 2011, Norfund made no new investments in sub-Saharan Africa. Pipeline deals in the agricultural and small and medium-sized enterprise (SME) sectors – essential to job creation and poverty alleviation – ground to a halt, because Norfund was unable to restructure them. Norfund, itself, commented on this negative effect of the restrictions, saying that 'the practical consequences of the restrictions on the use of OFCs have made it more difficult to invest in a number of enterprises in Africa' (Norwegian Government Commission on Capital Flight from Poor Countries, 2009; Norfund, 2012: 5; Carter, 2017).

Box 1 Case studies of Mauritius-based DFI investment

Injaro Agricultural Capital Holdings

The sub-Saharan African countries of Burkina Faso, Cote d'Ivoire, Mali and Niger are among the poorest in the world, ranking in the bottom 12 of the 188 countries in the United Nations Human Development Index. Ninety percent of the rural population in these countries lives below the poverty line and there is widespread food insecurity because of the region's reliance on subsistence agriculture in the face of drought and conflict.

Injaro Agricultural Capital Holdings helps farmers in Cote d'Ivoire, Mali and Niger by improving farm productivity, market access and business acumen. This assistance has helped boost incomes for more than 9,500 farmers living in poverty and insecurity in this highly deprived region.

Injaro Agricultural Capital Holdings is a private company, domiciled in Mauritius, to provide a neutral location for the pooling of funds from its DFI and private investors, which include CDC Group, French development institution Proparco, the Dutch Development Bank (FMO), the Soros Economic Development Fund and the Alliance for a Green Revolution in Africa.

The Emerging Africa Infrastructure Fund

The Emerging Africa Infrastructure Fund invests in large-scale infrastructure essential to African economic growth. It provides low-cost and long-term loans for infrastructure development and has raised nearly $1 trillion, of which 73% has been funnelled to low-income countries and 66% to fragile and conflict-affected states.

It is led by PIDG, with co-investments from the DFIs of the UK, the Netherlands, Switzerland and Sweden, as well as the African Development Bank (AfDB). It co-mingles funds with private insurers and investment banks. The fund is structured as a new company, domiciled in Mauritius, with a management company incorporated in Guernsey. This provides it with a neutral location that facilitates the pooling of finance from its multiple investors and lower-risk investment in the sub-Saharan region.

Source: CDC Group, UNDP, Injaro Investments, Emerging Issues Task Force (EITF).

31 The Africa Infrastructure Investment Funds I, II and III and the Emerging Africa Infrastructure Fund (www.emergingafricafund.com).

Any moves to prevent IFCs being used as intermediaries in development finance, therefore, are only likely to reduce the amount of development finance available, particularly for low-income countries. Other development agencies concur. The UN believes that the use of offshore investment hubs and offshore vehicles by international investors is 'not motivated primarily by tax considerations … offshore hubs provide an attractive neutral location for investment' (UNCTAD, 2013 and 2015).

The UN has also highlighted the regional importance of certain IFCs – including Mauritius, for investment in Africa, and the British Virgin Islands, for investment in Asia – noting that their use reduces the cost of finance for developing countries (UNCTAD, 2015).

Box 2 Case studies of British Virgin Islands-based investments

International Finance Corporation: expanding Bhutan's hazelnut exports
Bhutan's economy has seen strong growth but suffers from a concentration of employment in low-income subsistence agriculture. It also has a fragile Himalayan environment that is susceptible to land degradation and climate change.

In 2015, the International Finance Corporation, the Asian Development Bank and the Global Agriculture and Food Security Program jointly invested $12 million of equity to expand Mountain Hazelnut Venture Private Limited (MHV).

MHV is a smallholder farmer-based hazelnut production project that provides saplings, agricultural inputs and cropping advice to local farmers and develops degraded mountain slopes that are otherwise fallow. Its goal is to increase farmer incomes through export growth to European and Asian food producers.

The investment was made through a British Virgin Island company which facilitated the blending from more than six donor countries and the lead DFIs.

The China–Africa Fund for Industrial Cooperation
The China–Africa Fund for Industrial Cooperation is a state-owned fund for investing in Africa, backed by China's foreign-exchange reserves and the Export-Import Bank of China. Launched in 2016, it aims to provide up to $60 billion of finance to support industrialisation in Africa – a key policy goal for inclusive economic growth – including $40 billion of grants and concessional finance.

As of September 2018, the fund had made investments in 92 infrastructure, manufacturing and agriculture projects in 36 countries, with $23 billion of co-financing from private Chinese companies.

These investments were channelled through British Virgin Islands companies to Africa to provide investment protection for both the fund and co-investors and have been instrumental in financing manufacturing and agricultural ventures in some of the poorest countries in Africa, including Zambia, Malawi and Rwanda.

Sun Art Retail, a private multi-billion investment in e-commerce and hypermarkets in China
In an illustration of the large-scale financing conducted through the British Virgin Islands, Alibaba, one of China's biggest and most innovative e-retailers, acquired Sun Art Retail Group Limited, one of China's largest hypermarkets for $2.9 billion in November 2017. The deal was facilitated through British Virgin Islands-domiciled corporations to allow investors (including the Alibaba subsidiary undertaking the deal) to co-mingle funds in their preferred UK legal jurisdiction. Sun Art Retail is listed on the Hong Kong Stock Exchange.

The deal illustrated the scale and importance of the British Virgin Islands' role in raising private finance for investment in middle-income countries – in this case, billions of dollars in a single transaction – as well as its role in supporting international capital markets, the development of which is a key policy goal for many developing countries.

Source: International Finance Corporation, UNDP, China People's Daily (2018), Hong Kong Stock Exchange, Financial Times (2017).

To further illustrate the rationale behind and value of IFCs to DFIs (and hence the value of their domicile in Mauritius), Box 1 shows two contrasting case studies of trillion-dollar infrastructure funds and the microfinancing of subsistence agriculture in some of the poorest countries in sub-Saharan Africa, where the barriers to investment are particularly high.

Box 2 shows typical DFI investments to LMICs domiciled in the British Virgin Islands. Such countries generally have better access to finance than the poorest countries, but face significant financing constraints in sectors critical to economic growth and job creation, including infrastructure and the small and medium-sized business sector. IFCs help to tackle these limitations by combining 'ring-fenced' finance for these sectors with legal protection and a neutral location for co-financing and fund management. It also shows two private-sector deals which, while not DFI-led, illustrate the role of IFCs in mobilizing private finance for development, a key goal of IFI and G20 policy.

4.3 The balance of activities in IFCs

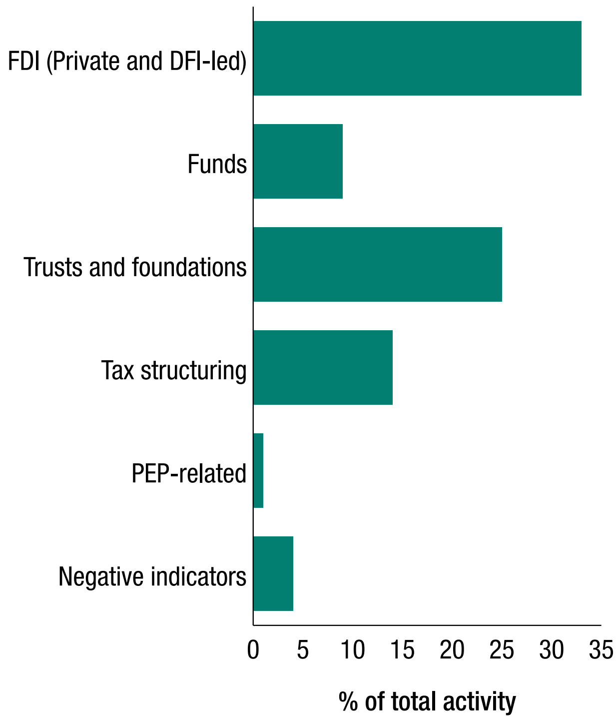
In assessing the value of IFCs to developing countries, it is useful to consider whether their operations are dominated by activities that actually bring value to developing countries. As can be seen from the following analysis of the British Virgin Islands and Mauritius, most activities that are important to developing countries relate to FDI and fund-based investments – both essential sources of finance for development.

In Mauritius, between 2007 and 2014, 33% and 9% of entities domiciled there were involved in FDI and emerging-market funds, respectively. Both predominantly channelled investment to Africa (Figure 3).

The results for the British Virgin Islands are similar, with 41% and 16% of entities involved in FDI and emerging-market funds, respectively (Figure 4).

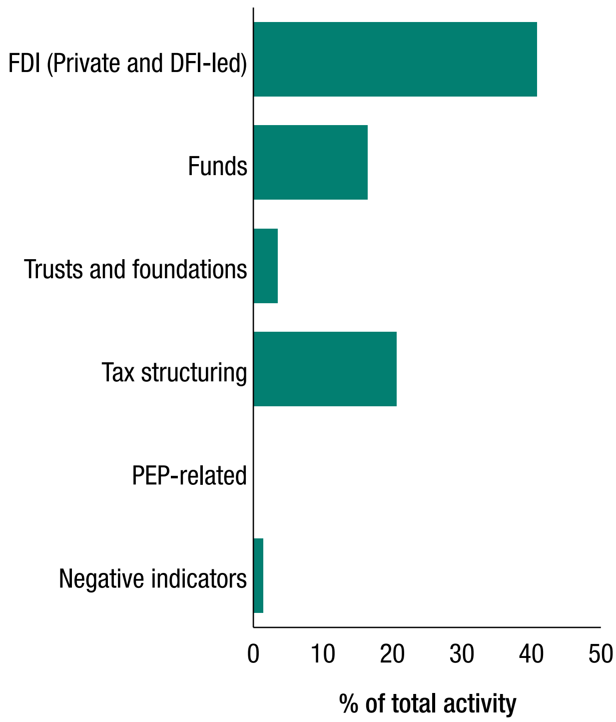
In the case of the British Virgin Islands, most FDI is *between* developing countries, as the British Virgin Islands is used extensively for FDI from Greater China. Some 56% of all FDI intermediated by the British Virgin Islands is from China, Taiwan or Hong Kong, according to our analysis.

Figure 3 Purpose of Mauritian entities (2007–2014, % of total activity)



Source: Author's analysis based on the ICIJ database.

Figure 4 Purpose of British Virgin Islands entities (2007–2014, % of total activity)



Source: Author's analysis based on ICIJ database.

Box 2 illustrates the range and scale of these transactions from multi-billion-dollar commercial transactions linked to Asian capital markets to specialist public and private co-investments in key sectors for inclusive economic development in low-income countries.

The UN has noted inter-developing-country investment as a speciality of the British Virgin Islands, reflecting the fact that China has become an increasingly important source of investment for poorer countries in Asia and Africa. This includes investments made as part of China's Belt and Road initiative, infrastructure investment and private-sector development and (as discussed in Box 2) public and private investment from China (UNCTAD, 2015).

Moreover, since 2007, the percentage of activities relating to FDI and emerging-market funds has increased. This trend has been most notable in the British Virgin Islands, where the

Box 3 Further findings on Mauritius from the ICIJ database

Thirty-three percent of entities in Mauritius were FDI related and involved investments in some of the most difficult environments globally, including Equatorial Guinea, the Democratic Republic of the Congo, Zimbabwe and Tanzania. They also included FDI in sectors critical to economic development and job creation, including infrastructure, agricultural processing and manufacturing, as well as those areas crucial to achieving the Sustainable Development Goals (SDGs), such as healthcare.

FDI included co-financing with DFIs, such as the International Finance Corporation, CDC Group and KfW, which invest largely or exclusively in the world's poorest countries.

Nine percent of the entities were funds, many belonging to the major global investment houses, which manage pension funds, insurance funds and other advanced-economy household savings vehicles. They also included private equity funds and venture-capital funds, whose money typically tends to come from high-net-worth individuals and sovereign wealth funds.

As noted, and as illustrated in Figure 5, between 2007 and 2014, combined FDI and fund activity increased from 47% to 78% of new entities.

Fourteen percent of entities followed a pattern more in keeping with activities unrelated to investment in developing countries and motivated by other factors, such as tax planning. Mauritius has double tax treaties with 44 countries, encouraging its use as both a centre for FDI and tax planning. Most notable here were US venture-capital companies in the high-tech and biotech industries. Such activities are legal and primarily driven by the tax frameworks of source and recipient countries, as well as the opportunity to take legal advantage of tax-rate differentials, of US rules exempting non-remitted funds from US taxes, and of double-taxation treaties. As noted, and as illustrated in Figure 2, between 2007 and 2014, such activity declined from 24 % to 6% of new entities.

Five percent of entities had indicators of illicit activity. These included entities connected to politically exposed persons and those with beneficial owners in locations with a reputation for money laundering (Cyprus, Nigeria and Angola). Of these, less than 1% had been identified by the ICIJ as relating to illicit activity, suggesting a worst-case scenario of 5%.

Twenty-five percent of entities related to trusts and foundations. It is difficult to assess their activities. Many may be used for legitimate purposes, including private wealth management and inheritance planning. Others may be used for illicit activities, such as tax evasion. However, it is not possible from the ICIJ database to determine whether such entities are being used for legitimate or illicit purposes.

Fourteen percent were entities where the ICIJ database included no details of shareholders, directors, beneficial owners or affiliates entities and so no determination could be made.

Source: Author's analysis based on the ICIJ database.

Box 4 Further findings on the British Virgin Islands from the ICIJ database

Forty-one percent of entities were FDI related. FDI was focused on investment to and from Greater China. It was well diversified across a broad range of industries, including agricultural processing, industrial manufactured goods, chemicals, technology, consumer goods and tourism. FDI to Africa and Latin America was more concentrated in the mining and telecommunications sectors. Global FDI was also well diversified and typically related to the global investments of multinational corporations.

Sixteen percent of entities were funds, including many of the major global investment houses that manage pension funds, insurance funds and other advanced-economy household savings vehicles, as well as various private equity funds.

As noted, and illustrated in Figure 5, between 2007 and 2014, combined FDI and fund activity increased from 54% to 75% of new entities.

Twenty-one percent of entities followed a pattern consistent with tax planning rather than investment. For the British Virgin Islands, the most common category was UK-based real-estate companies. As noted, and illustrated in Figure 2, between 2007 and 2014, such activity more than halved from 19% to 8% of new entities, partially driven by recent changes in UK tax rules in relation to real estate owned by foreign companies.

Less than 1% of entities had indicators of illicit activity, and no politically exposed persons were found in the British Virgin Islands sample. This supports the findings of the Global Forum peer-review and the British Virgin Islands Financial Service Commission of a strong control environment in the territory.

Four percent of entities related to trusts and foundations.

Seventeen percent were entities where the ICIJ database included no details of shareholders, directors, beneficial owners or affiliates entities and so no determination could be made.

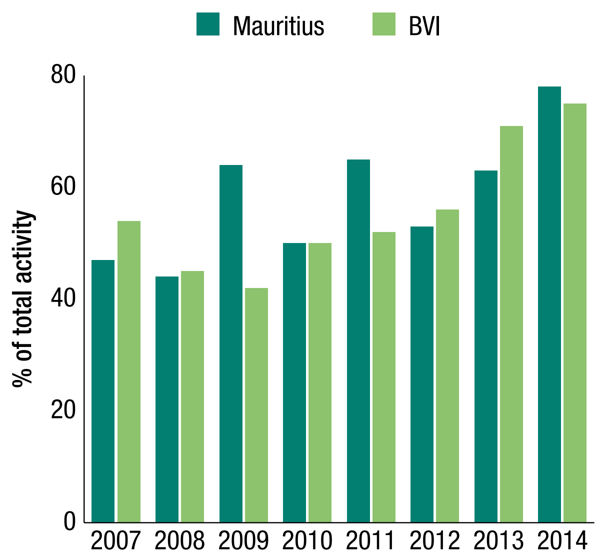
Source: Author's analysis based on the ICIJ database.

percentage of such activities increased from 54% in 2008 to 75% in 2014 and, in Mauritius, from 47% in 2007 to 78% in 2014, though it dipped between 2011 and 2014 (Figure 5).

In contrast, activities relating to 'negative' uses of IFCs are more limited. In Mauritius, our analysis suggests that less than 1% of entities involve politically exposed persons, with a further 4% having 'negative indicators'. Of these, not all are likely to be involved in illicit activities, so the worst-case scenario of 'negative' activity is less than 5%.

In the British Virgin Islands, no politically exposed persons were found in the sample and less than 1% of entities were found to have negative indicators. Again, of these, not all are likely to be involved in illicit activities, so the worst-case scenario of 'negative' activity is less than 1%.[32]

Figure 5 FDI and fund activity in Mauritius and the British Virgin Islands (2007–2014, % of total activity)



Source: Author's analysis based on ICIJ database.

32 It is not possible to estimate the figure more accurately from the sample, for example, where this is between 1.00% and 0.001%

4.4 The incremental effects of IFCs

To show that IFCs boost development finance in addition to intermediating finance, it is necessary to show that the finance they generate is incremental to what would otherwise have been mobilised through direct investment.

Furthermore, this additional finance needs to be channelled to sectors that have positive effects on inclusive economic growth. Sectors such as infrastructure and financial services contribute significantly to GDP growth, while the agricultural and manufacturing sectors are important to job creation. In contrast, the extractive sector plays a more minor role in fostering inclusive economic growth, with potential tax revenue its main contribution (Beck, 2011; Batiano et al., forthcoming).

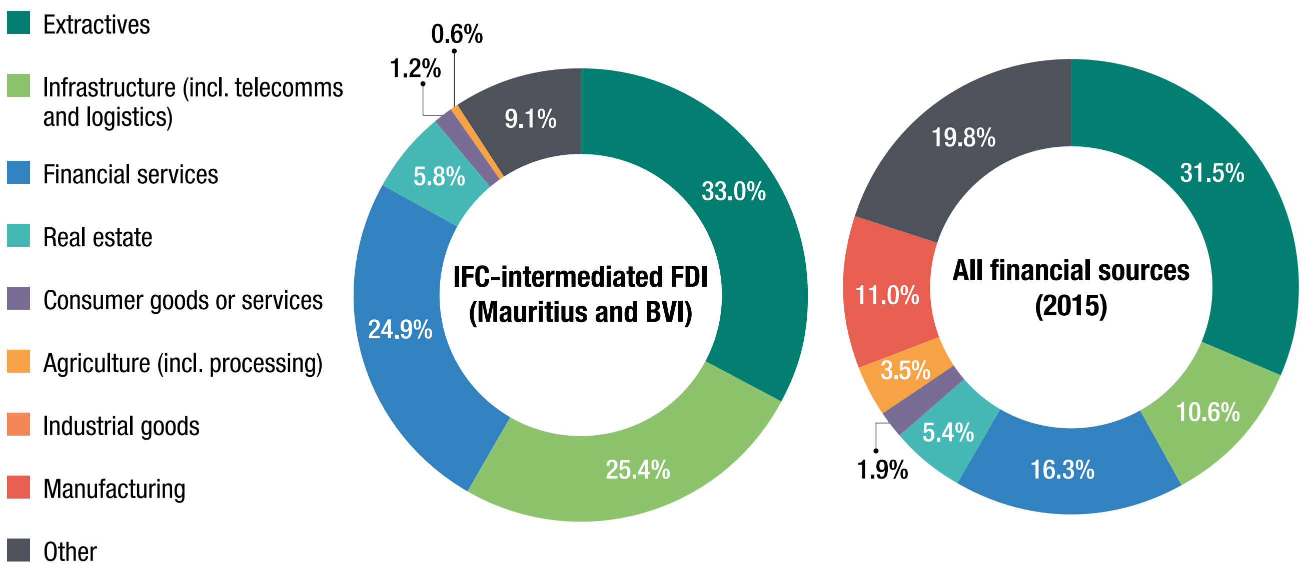
Figure 6 shows the proportion of FDI and funds intermediated by IFCs (Mauritius and the British Virgin Islands) to Africa by sector. It compares these data against finance not intermediated via IFCs in Africa.[33] As can be seen, there are significant differences in the composition of finance intermediated and not intermediated via IFCs.

The level of financing channelled to financial services and infrastructure is significantly larger when finance is intermediated by IFCs than when it is not. Indeed, the share going to financial services is 24.9% for IFC-intermediated finance, but only 16.3% for non-IFC-intermediated finance.

For infrastructure, the share is 25.4% for IFC-intermediated finance and 10.6% for non-IFC-intermediated finance. This is probably driven by the infrastructure sector's frequent use of co-financing between DFIs and private investors; this is often structured via IFCs to both co-mingle funds and to take advantage of the protections afforded by an IFC domicile given its highly capital-intensive and long-term nature.

This can be extrapolated using the UNCTAD estimate of $6.5 trillion of IFC-intermediation stock of developing-country FDI and the incremental percentages mobilised. This suggests that financial services had received an additional $0.6 trillion in investment and that infrastructure had received some $1.0 trillion worth of extra

Figure 6 IFC-intermediated and non-IFC-intermediated finance by sector for Africa and the Middle East (% of total FDI and funds, 2007–2014, or total financial stock)



Source: Author's analysis based on ICIJ database; Batiano et al. (forthcoming).

33 Which included non-IFC intermediated FDI, domestic bank lending, domestic capital markets, international bank lending and non-IFC-intermediated international capital markets (Batiano et al., forthcoming)

investment as of 2015 thanks to the use of IFCs (UNCTAD, 2015).

IFCs do not have as great an effect on other sectors. Around 30% of both IFC-intermediated and non-IFC-intermediated finance goes to the extractive sector, meaning their effect is fairly neutral. Similarly, investment flows to the real-estate sector are around 5%, regardless of whether they are intermediated by IFCs or not. The findings on the extractive sector are particularly interesting, as some commentators claim the extractive sector is using IFCs for tax-avoidance and evasion purposes (see, for example, Ndukimana et al., 2015).

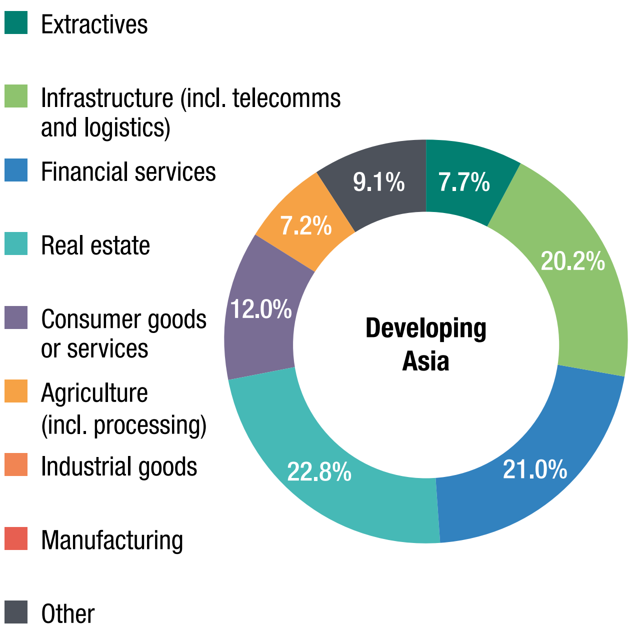
Manufacturing and agriculture are the only sectors where the share of finance is larger when it is not intermediated by IFCs, probably because they are dominated by SMEs, which tend to get funding from domestic banks and microfinance institutions.

The evidence is more difficult to assess in developing Asia, as there are no comparative data available for non-IFC-intermediated finance by sector. However, some observations can be made.

The Asian sectors in which IFCs intermediate are more diverse than in Africa. The extractive sector is less important, for example, accounting for only 9% of IFC-intermediated finance. There is also a greater proportion of finance being intermediated to consumer goods and services. These differences reflect the more diverse and mature structure of the developing Asian economies (Figure 7).

It is useful to assess the effect of this additional finance on economic growth. We can do this by way of a simple estimate. As noted, $1.6 trillion of incremental investment stock was facilitated by IFCs between 2007 and 2014. This corresponds to 0.82% of developing-country GDP during that period. The rule of thumb is that investment of 1% of GDP generates an increase in GDP of 0.25%, on average, so this equates to an annual increase in the GDP of developing countries of 0.21%, or $400 billion, and additional tax revenue of $100 billion at their average tax mobilisation rates (IMF, World Economic Outlook Database, October 2017; World Bank, 2013; Aizenman et al., 2013; UNCTAD, 2013 and 2015).

Figure 7 IFC-intermediated finance by sector in developing Asia (2007–2014, % of total FDI and funds)



Source: Author's analysis based on the ICIJ database.

4.5 Conclusion

IFCs are major hubs for the intermediation of finance for developing countries, with 30% of all international investment stock being channelled through them. As of 2012, this totalled more than $6.5 trillion (UNCTAD, 2015).

This paper estimates that of this $6.5 trillion, $1.5 trillion is incremental finance that would not have been mobilised had it been financed directly from source to recipient countries. It also flows predominantly into those sectors that are key to growth – infrastructure and financial services.

Furthermore, the GDP and tax-mobilisation effects of this finance can be estimated at $400 billion and $100 billion, respectively, between 2007 and 2014. This is down to the value that IFCs bring to development financing, by providing sound and secure legal jurisdictions and neutral domiciles for co-financing and funds.

This is particularly important for the poorest countries. They have the most to gain from IFC investment, as their economic growth is heavily constrained by a lack of finance and because the advantages IFCs offer investors in such risky investment environments are particularly strong. The UN has emphasised this aspect, commenting that, 'this is especially pertinent for … the least developed countries where needs … are often more acute' (UNCTAD, 2013 and 2015: 197).

This value is why DFIs support the use of IFCs. IFCs offer significant advantages, both for their own investments and for the private investors with whom they co-invest. This makes them vital to DFIs' ability to carry out their mandate to mobilise private finance for development.

Were DFIs unable to use IFCs, their ability to mobilise financing for developing countries would be severely curtailed, with a knock-on effect on those economic sectors that are key to inclusive growth. Investors would be deterred from making investments without the protections afforded by IFCs (Carter, 2017; Tyson, 2018).

There is a need to explore the significant advantages of IFCs to developing countries and examine the trade-offs between the increase in finance for development that IFCs bring to developing countries and the illicit outflows they facilitate. This is discussed in the next chapter.

5 Policy recommendations and conclusions

As discussed, IFCs play an important supporting role in galvanising finance for development. This critical function needs to be balanced against the control of illicit outflows from developing countries through IFCs. This concluding chapter offers a number of policy recommendations to ensure that these twin goals are achieved.

5.1 The need for multilateral reform

Cooperation to establish transparency in the global financial system requires a universal approach, because it is a systemic problem. Anything less is simply likely to divert illicit activities to non-cooperating jurisdictions.

Consequently, the major international organisations, such as the UN and OECD, advocate a multilateral approach. They highlight the risks of unilateral action (such as that of the US, the UK and EU, as mentioned in Chapter 3), which threatens to undermine the effectiveness of global initiatives (Global Forum, 2018b; UNCTAD, 2015). Indeed, the Global Forum has said that, 'unilateral action is a challenge to the collective dynamic … [and] obtaining truly durable, long-term solutions' (OECD, 2018b: 8).

The UN has also criticised the approach of 'naming and shaming' individual IFCs, because it has focused attention on individual jurisdictions while leaving many of the largest ones 'untouched'. In this regard, it notes that Luxembourg, the Netherlands and Delaware have been excluded from unilateral reforms by the EU and US, in whose jurisdictions they lie, despite their greater role in intermediating financial flows for tax-planning purposes than other IFCs (UNCTAD, 2015).

Part of this divergence of approach has been driven by differences of opinion on what is appropriate transparency. The Global Forum's CRS will make beneficial ownership data and related information on assets available to all participating tax authorities. The UK is unilaterally calling for public registers of beneficial ownership. A global standard for appropriate transparency needs to be established.

5.2 Developing countries need to fully participate in reforms

The focus on execution needs to be extended to developing countries. As discussed in Chapter 3, developing countries' participation in reforms is fragmented.

This would appear to stem from two issues. The first is that the priority of the Global Forum and the FATF has been implementation in advanced economies. The second is a lack of developing-country political will and capacity, both financial and institutional, to undertake reform.

An inevitable part of progressing reforms is to prioritise and sequence implementation in a way that sets precedent. Fragmented execution will undermine effectiveness, however, and the Global Forum and the FATF need to advance reform in all countries. To this end, the Global Forum should mandate all developing countries to set timetables for implementing the CRS.

At the same time, it is also important that developing countries do not divert scarce resources from resolving their fundamental issue: weak domestic institutions that struggle to tackle low tax mobilisation and corruption (ERD, 2015).

Prioritising commitments to reform, therefore, should be based on risk. For example, priority should be given to developing countries with large financial sectors that may become alternative conduits for illicit activity, not to low-income countries with limited financial and extractive sectors.

Furthermore, greater resources need to be provided to assist developing countries in carrying out reforms. Developing countries need technical assistance and other resources to implement the new standards. As discussed in Section 3.2.2, the Global Forum and other donors offer such technical advice, but we would suggest that it is not sufficient. More needs to be done.

5.3 Greater political commitment by developing countries

Tackling developing countries' fundamental problems in relation to low tax mobilisation and corruption means strengthening their institutions. This requires a long-term approach and is dependent on political commitment.

In a minority of developing countries, his kind of political commitment is difficult to achieve, however, when it comes to tax and corruption, because it can challenge vested interests. The Global Forum is all too aware that the key barrier to the participation of developing countries is not the 'persistent myth of secrecy jurisdictions', the cost or complexity of executing the exchange of information, or a lack of requests from developing countries. It is 'political challenges', as the reforms 'may undermine certain financial interests' (Global Forum, 2017b: 7).[34]

Building political commitment requires domestic political leadership. Recent elections in some countries have brought to power political leaders with a mandate to tackle corruption. In addition to taking domestic action, they have called on advanced economies to provide greater cooperation in tracing and returning illicit assets acquired from the proceeds of corruption. They have emphasised that policies to address problems in IFCs, alone, are unlikely to be effective.

For example, the High-level Panel on Illicit Financial Flows from Africa notes that 'little progress' could be made by shutting down 'some of the smaller jurisdictions most commonly thought of as tax havens, when the great majority of potentially risky flows go through some of the biggest economies' (UNECA, 2015: 106).

Advanced economies should consider how such domestic leadership in developing economies can be more fully supported.

One option would be to include higher-level representation of developing countries in the Global Forum and FATF. Although many have observer status and are present on sub-committees, greater and more visible representation would ensure that their issues in relation to implementing CRS and domestic reforms – including appropriate resourcing and prioritisation – are better addressed.

5.4 Universal standards for investors

As discussed, DFIs support IFCs because they help them to carry out their mission to mobilise finance for development – especially in low-income countries. As a result, IFCs are widely used by DFIs for their transactions.

To address concerns about the integrity of their activities in IFCs, DFIs have established internal guidelines to ensure high standards of integrity and due diligence in relation to IFC-based transactions. Each DFI has its own standards. However, the standards typically run along the following lines:

- Conduct due diligence to confirm beneficial ownership in relation to projects and the integrity and business reputation of prospective clients and partners. This is similar to the KYC process of service providers, as discussed in Chapter 3.
- Only use IFCs that are 'compliant' or 'largely compliant' with the standards of tax transparency of the Global Forum.
- Conduct due diligence to confirm that the structure of the transaction is legitimate and not designed for tax evasion and that clients pay legitimate taxes in the host country.

34 www.oecd.org/tax/transparency/technical-assistance/africa/

Standards based on these or similar principles are used by DFIs including the International Finance Corporation, MIGA, CDC Group, Norfund and KfW (International Finance Corporation, 2016; CDC Group, 2017a, b; Carter, 2017).

It would be useful if policy-makers agreed a list of acceptable uses of and conditions for IFCs for both private and public investors. One approach would be to develop the DFIs' standards. Such an approach has already been backed by the UN (UNCTAD, 2013) and should be incorporated into multilateral policy-making.

5.5 Conclusion

As discussed in this paper, there is a need for developing countries to mobilise 'billions to trillions' of finance if economic development and the Sustainable Development Goals are to be met.

IFCs have an important role to play in this mobilisation. However, this needs to be balanced against the need to robustly tackle tax evasion and corruption from the perspective of developing countries.

In examining this issue, it is important to realise that while advanced economies have raised billions in additional tax revenue as a result of reforms to IFCs, this is unlikely to be replicated in developing countries. This is because developing countries' problems in increasing tax mobilisation are primarily down to domestic issues, including large informal sectors and weak institutions. Illicit outflows are prevalent in only a few developing countries, however, primarily those with substantial extractive resources.

In contrast, all countries would benefit from increased investment and the long-term boost to GDP growth and tax revenue it would bring. This paper estimates that IFCs mobilised an additional $1.6 trillion of finance between 2007 and 2014, resulting in an incremental annual boost to GDP of $400 billion and some $100 billion in additional tax revenues for developing nations during that period.

This matches the annual tax losses due to IFCs, estimated by UNCTAD,[35] of $100 million annually, leaving developing countries (as of 2012) no worse off on the tax front as a result of IFC engagement at current levels of IFC-intermediated finance.

Furthermore, any increase in mobilisation – such as that being carried out by IFIs today – would be of net benefit to developing countries. This is particularly noteworthy given the current policy priority of MDBs and IFIs to increase the private finance mobilised for developing countries from 'billions to trillions'. If this policy is successful, the contribution to tax from incremental finance mobilised via IFCs will change from neutral to positive, especially if it is complemented by the successful execution of reforms to tackle tax losses.

More detailed quantitative analysis is needed of the trade-offs involved. Some institutions have already dipped their toes in the analytical water in this regard. For example, the UN found that multinational corporations in developing countries are paying $730 billion of tax annually compared with $100 billion of tax losses as a result of profit shifting (UNCTAD, 2015).

The UN concurs with our conclusion, noting that 'in tackling tax avoidance, it is important to take into account the overall contribution to … the future tax base', as well as investment and related GDP (UNCTAD, 2015: 203).

From the perspective of developing countries, there is a danger that the current reform process will throw the baby out with the bathwater, that their ability to mobilise the finance needed for economic growth will be damaged and that the resultant reduction in GDP growth and tax mobilisation will dwarf any gains from preventing tax evasion and tackling corruption.

A more balanced debate that reflects the potential gains, as well as the potential losses, of IFC engagement for developing countries is needed before there is irreparable damage done to the economic growth prospects of the world's poorest and most vulnerable countries and the poverty alleviation that depends upon them.

35 Some NGOs – such as the Tax Justice Network and Oxfam – quote a higher figure of $170 million annually, based on UNCTAD's 2015 World Investment Report. However, UNCTAD's report actually has a lower figure of $100 million, which is used in this report. The author contacted the Tax Justice Network and Oxfam in a bid to reconcile the discrepancy, but received no reply.

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