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Why do Development Finance Institutions use Offshore Financial Centers?

Presentation to Norfund board, 14 June 2017

“It is extraordinary that the CDC has routed its investments through tax havens … not a penny of the proposed £6 billion should find its way to a tax haven, and the Bill should be explicit in enshrining that principle.”

Kate Osamor, the Shadow Secretary of State for Development, CDC Bill debate, House of Commons, Nov 2016

Scope of paper

- Tax behavior of investors (not of the underlying investee enterprises)
- Indirect effects
- Taxes paid in developing countries
- Not a survey of current practice
- Also: signaling, and non-tax aspects of transparency
- Based on anonymous interviews with DFIs

Assumptions and background

- Assume DFIs are effective (does OFC use affect development impact?)
- Taxes on capital income (interest, dividends, capital gains). *Potentially* less important to LDCs than corporation and wage income taxes
- Large part of argument rests on need for pooling vehicles
- Trend in bilateral tax treaties towards lower source withholding rates
- OECD norm: tax profits at source, investors at residence

“The allocation of rights is especially important for low-income countries … they are essentially ‘source’ countries, the recipients of capital inflows and the site of production, not investors … the network of bilateral double taxation treaties based on the OECD model significantly constrain the source country’s rights.”

IMF (2014)

How do OFCs reduce taxing rights?

1. Concealment (illegal)
2. Treaty shopping
3. Indirect sale of assets (capital gains)

Summary of DFIs' case for using OFCs

DFIs claim:

1. OFCs are not typically used for tax reasons
2. But they do sometimes bring tax advantages
3. If DFIs stopped using OFCs, would invest via onshore OECD financial centers with equally / more favorable tax treaties
4. OFCs increase quantity of investment => net impact on taxes positive

Importing good institutions (Sharman)

1. Legal (court judgements, shareholder disputes, familiarity)
2. Legislative (financial instruments)
3. Funds (capital increase/decrease, FX transactions)
4. Banks demand it (collateral)
5. Neutrality

Challenges

1. Shouldn’t DFIs tolerates costs and inconveniences?
2. Obligation to use local institutions to help build capacity?

Economics of capital taxation

1. Taxes on capital income discourage investment. DFIs exist to target investments on cusp of viability. But …
2. ‘Third-best’ taxation. Narrow base, low administrative capacity, taxes on foreign investors matter
3. If socially optimal rate of capital income tax is positive, implies some investment will be discouraged. And that’s OK.
4. Regardless of views on economics, taxation is a sovereign decisions. That raises some issues …

Sovereignty

DFI views:

1. Countries know what to expect when they sign a tax treaty with Mauritius
2. Countries could solve these problems with new legislation

Challenges:

1. Can DFIs treat legislation as expression of sovereign / democratic will?
2. If not, does paternalistic license to 'override' legislation work on both directions?

Are OFCs being used to deprive LDCs of capital income taxes?

1. Yes. DFIs acknowledge this, but suggest magnitude is small. Recall net impact still potentially positive if tax rate down but base up.
2. DFI do not refuse a structure, if non-tax reason + tax advantage
3. We do not have the data to put a number on it.
4. Problem of establishing the counterfactual – DFIs use direct investment
5. DFIs do use OFCs to avoid taxes to avoid additional layer of taxes, to ensure no more tax due than via direct investment

How to define a tax advantage?

- DFIs would rather not.
- Is pooling somewhere else and acceptable counterfactual?

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

Mauritius

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

Transparency

1. DFIs argue largely institutional co-investors will not risk illegal evasion. However wealthy individuals are sometimes co-investors.
2. For money laundering and profit-shifting transparency a big deal. DFIs see less risks in their context
3. Clear public interest case when locally-relevant individuals involved
4. Unclear legal / contractual constraints
5. DFIs want to see international + national legislative solutions

Discussion

1. Signaling. “Legitimizing tax havens”
2. DFIs’ place in global development architecture
3. How much influence do DFIs have?
4. Collective action problem

Conclusion (author’s views).

If DFIs stopped using OFCs =>

1. Capital income tax rates up, investment quantity down.
2. Counterfactual arguments suggest small increase in rates.
3. The poorest countries hurt most if investment quantity falls
4. Risks seem skewed: “Stop using OFCs” is the wrong call.

This does not amount to an acceptance of the status quo

Recommendations.

1. If the argument is OFCs are used for legal gain, not tax, then the objective should be to use OFCs without also gaining a tax advantage. But genuinely hard to define that.
2. Much greater transparency. Describe tax arrangements, suggest counterfactual. Help governments and civil society identify where the leaks are.
3. Encourage progress towards information exchange: a more demanding ‘white list’ than Global Forum compliant.
4. Contemplate minimum withholding and source capital gains tax rates
5. Cooperate with IFIs, others, to pioneer use of local institutions
6. Experiment with making public ownership information a requirement