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The Role of South-South Cooperation in Combatting Illicit Financial Flows*

By Manuel F Montes**

1. Key Dimensions of Illicit Financial Flows

In 2015, Illicit Financial Flows (IFFs) officially became a matter of tax policy and international tax cooperation.

In July 2015, in Addis Ababa, the member States of the United Nations (UN) agreed to "redouble efforts to substantially reduce illicit financial flows by 2030, with a view to eventually eliminating them, including by combating tax evasion and corruption through strengthened national regulation and increased international cooperation" (United Nations, 2015a, paragraph 23).

UN member States in Africa had led the way in breaking ground on the issue with the commissioning in 2011 of a High Level Panel on Illicit Financial Flows from Africa (led by former South African President Thabo Mbeki) by the Conference of Ministers of Finance, Planning and Economic Development of the African Union and the United Nations Economic Commission for Africa.

The Mbeki Panel Report (2015) took a decidedly different approach[1] to the question of the problem of the unwelcome transfer of capital from developing countries by recognizing that these losses could occur in non-crisis times, not just through the category of "capital flight"; these losses could be inflicted through economic transactions and through the tax system. Capital needed for development could be diverted even during boom times, including when foreign capital is gushing inward or external debt is being accumulated. The report recognized this issue as not

Abstract

Developing countries bear the brunt of costs from illicit financial flows (IFFs). These losses are the result of the facilities that the global system provides transnational companies, operating in multiple tax jurisdictions, to move their profits to favorable locations. International cooperation has been seen to be a key ingredient in restricting IFFs. However, a difference in interests in the treatment of many types of transactions between developed and developing countries is an obstacle to a fast solution of the problem. Developing countries must seek to seize the initiative to restrict their losses from IFFs. They can deploy various joint and concerted actions, within the umbrella of the principles of South-South cooperation for this purpose.

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Les pays en développement supportent la majeure partie des pertes liées aux flux financiers illicites. Ces pertes résultent des facilités que le système mondial accorde aux sociétés transnationales opérant dans divers pays, qui leur permettent de transférer leurs bénéfices vers ceux dont le régime fiscal est le plus favorable. La coopération internationale apparait comme un élément clé pour limiter ces flux financiers illicites. Toutefois, les différences qui existent entre les pays développés et les pays en développement dans le traitement des différents types de transactions font obstacle à une solution rapide du problème. Les pays en développement doivent prendre des initiatives pour faire en sorte de limiter leurs pertes liées aux flux financiers illicites. Ils peuvent déployer à cette fin diverses actions communes et concertées sur la base des principes élaborés à cet égard dans le cadre des mécanismes de coopération Sud-Sud.

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Los países en desarrollo soportan la mayor parte de los costos asociados a las corrientes financieras ilícitas (FFI). Estas pérdidas son el resultado de las facilidades que el sistema mundial proporciona a las empresas transnacionales, que operan en múltiples jurisdicciones fiscales, para trasladar sus ganancias a lugares convenientes. La cooperación internacional parece ser un elemento clave para restringir las FFI. Sin embargo, la diferencia de intereses en el tratamiento de muchos tipos de transacciones entre los países desarrollados y los países en desarrollo representa un obstáculo para una rápida solución del problema. Los países en desarrollo deben tratar de aprovechar la iniciativa para restringir sus pérdidas provenientes de las FFI. Podrían emprender diversas acciones conjuntas y concertadas dentro del marco de los principios de la Cooperación Sur-Sur para este fin.

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** Manuel F Montes is former Senior Adviser on Finance and Development of the South Centre.

specific to Africa and applicable to all other developing regions.

In applying the term "illicit," the Mbeki Panel Report (2015) insisted on the multi-jurisdictional nature of the category of "money illegally earned, transferred or used." Especially because it is now a matter of contention whether IFFs apply only to violations of the law, it is important from the outset to reiterate that IFFs apply even to legal acts in one location "when the intent. . . is to hide money even if legitimately earned" through facilities in other locations (Mbeki Panel Report, 2015, p. 23).

The report classified the types of IFFs into three kinds: (1) commercial activities, (2) criminal activities and (3) corruption.

Combatting IFFs has become an indispensable element of the UN development agreement, the "Agenda 2030" (United Nations, 2015b), organized around 17 Sustainable Development Goals (SDGs) among which Target 16.4 seeks to significantly reduce IFFs by 2030.

In a discussion on combatting IFFs through South-South Cooperation, it is important to note at the outset that the South Centre is itself an instrument of South-South Cooperation. It is an intergovernmental body of developing countries, set up in 1995 under the leadership of President Julius Nyerere of Tanzania as an offshoot of the South Commission. There are now 54 member States.

In the area of tax policy and tax cooperation, the South Centre has a project, the South Centre Tax Initiative, launched in November 2016, to build a network of tax officials and experts from the South to advance the role of developing countries in the current global effort at tax reform and combatting illicit financial flows. The current chairperson of the South Centre Board is President Mbeki himself. The tax policy and cooperation program of the South Centre has convened three global fora, cumulatively attended by over more than two hundred tax officials from developing countries. The South Centre provides the secretariat, has publications and peer exchange programs for this project. Many of the analyses in this paper are drawn from this network building work, and many of the suggestions for action are part of the agenda of the South Centre's tax project. For more information on the South Centre Tax Initiative, please visit: https://taxinitiative.southcentre.int/.

2. South-South Cooperation

As an early practice of South-South Cooperation (SSC), in 1987, the South Commission was established to implement a decision from the 1986 Harare Non-Aligned Summit. The Commission identified ten major areas of SSC which involved finance, trade, industry and business, services, transport and infrastructure, food security, science and technology, environment, information and communications, and people-to-people contact (Chaturvedi, 2008). In this report, more than a quarter century ago, the South Commission (1990, p. 124) listed tax reform as a critical policy challenge for the developing countries. The concept of SSC has been elaborated in a series of official meetings in the UN and among developing countries. The principles that have been elaborated on SSC provide fertile ground for work on curbing IFFs.

Like IFFs, the category of South-South Cooperation (SSC) is an innovation from the community of developing nations. Like IFFs, there are new controversies surrounding this concept and its practice, particularly when it has the potential to upend norms and practices preferred by Northern countries.

In the UN, the Buenos Aires Plan of Action (BAPA) in 19 December 1978 articulated the basic principles of interaction and collaboration among developing countries, including respect for national sovereignty, non-interference in domestic affairs and equal rights (United Nations, 1978a and United Nations, 1978b).

Among the developing countries themselves, in 10-13 June 2008, in Yamoussoukro, Côte d'Ivoire, governments formally agreed on the **Yamoussoukro Principles** of South-South Cooperation. These were adopted in the Ministerial Declaration of the 32nd Annual Meeting of the Ministers of Foreign Affairs of the Member States of the Group of 77 (G77) and China, 26 September 2008, New York, USA (see G77 and China (2008, paragraph 65)).

It is important to highlight *selected* key principles as agreed among the developing countries themselves:

a. South-South cooperation is a **common endeavour of peoples and countries of the South** and must be pursued as an expression of South-South solidarity and a strategy for economic independence and self-reliance of the South based on their common objectives and solidarity;

b. South-South cooperation and its agenda must be driven by the countries of the South;

c. South-South cooperation must not be seen as a replacement for North-South cooperation. Strengthening South-South cooperation must not be a measure of coping with the receding interest of the developed world in assisting developing countries;

d. Cooperation between countries of the South must not be analyzed and evaluated using the same standards as those used for North-South relations;

e. Financial contributions from other developing countries should not be seen as Official Development Assistance from these countries to other countries of the South. These are merely expressions of solidarity and cooperation borne out of shared experiences and sympathies;

f. South-South cooperation is a development agenda based on premises, conditions and objectives that are specific to the historic and political context of developing countries and to their needs and expectations.

South-South cooperation deserves its own separate and independent promotion;

g. South-South cooperation is based on a strong, genuine, broad-based partnership and solidarity;

h. South-South cooperation is based on complete equality, mutual respect and mutual benefit;

i. South-South cooperation respects national sovereignty in the context of shared responsibility;

j. South-South cooperation strives for strengthened multilateralism in the promotion of an action-oriented approach to development challenges;

k. South-South cooperation promotes the exchange of best practices and support among developing countries in the common pursuit of their broad development objectives (**encompassing all aspects of international relations and not just in the traditional economic and technical areas**);

l. South-South cooperation is based on the **collective self-reliance** of developing countries;

m. South-South cooperation seeks to enable developing countries to play a more active role in international policy and decision-making processes, in support of their efforts to achieve sustainable development;

n. The modalities and mechanisms for promoting South-South cooperation are based on bilateral, subregional, regional and interregional cooperation and integration as well as multilateral cooperation.

The list expresses a set of ideals. South-South Cooperation is in an evolving mode, with partners shaping their offerings according to their existing capabilities both in terms of budgetary and bureaucratic resources. It is the case that Official Development Assistance (ODA) norms evolved out of practice and critique before being systematized in Organisation of Economic Co-operation and Development-Development Assistance Committee (OECD-DAC) practice. Even here there have been many transgressions by individual country practices of OECD standards; for example, the writedowns of least-developed country debts under the Multilateral Debt Relief Initiative were not supposed to be counted as part of ODA, but some countries have done that.

Some of the key elements of the Principles are worth noting. Yamoussoukro Principle f, which seeks to promote a "development agenda based on premises, conditions and objectives that are specific to the historic and political context of developing countries" is a basis for the fact that the deployment of enterprises, including private companies, are part of SSC. As part of their development effort, productivity has to be bred into the enterprise sector.

The Principles include an explicit decision that activities should not be evaluated in the same way as ODA. Financial flows from developing countries should not be counted and aggregated along with financial contributions from developed countries. SSC recognizes all aspects of international relations, not just traditional economic and technical ones. SSC is an exercise in collective self-reliance. SSC incorporates not just support for multilateralism but seeks to enable developing countries in playing a more decisive role in international policy and decision-making processes.

The subsequent discussion will explore the application of these principles in combatting IFFs.

3. Reforming the Global Tax System

Illicit financial flows arise from the exploitation by international companies operating in multiple tax jurisdictions of facilities to manipulate prices of economic transactions and transfer their profits to low or no-tax locations.

The current system evolved out of the system prevailing during the heyday of colonial trade and investment regimes. During the colonial era, economic transactions took place to a great extent within imperial trading blocs. Corporations from the home countries dominated the external economic transactions of the colonies. With the demise of colonial blocs, corporations have taken advantage of loopholes created by uncoordinated policies among tax jurisdictions, paying taxes in the lowest tax localities, if not to escape taxation altogether.

There is a global consensus that the international tax regime is broken and is in need of thoroughgoing reform. It does not mobilize sufficient revenues required to achieve sustainable development and poverty elimination objectives, such as those agreed among UN member States under the Agenda 2030 development framework. It increasingly relies on stakeholders with limited incomes and wealth for its revenues. It is increasingly unable to depend on the rich and on large international corporations for its source of revenues. The rules and standards that prevail in this system do not meet common notions of good governance, such as transparency, non-discrimination, equity, and the rule of law.

Developed and developing countries share a common cause to reform the system. In the developed countries, the inability of public revenues to keep pace with the expansion of their economies is disassembling the foundations of their social programs and welfare states. The pressures toward greater financialization are driven to a large extent by the withdrawal of responsibility by states in advanced economies to guarantee pension support to their retiring workers. Workers' pension funds must find ways to earn high returns in riskier, short-term investments.

In the developing countries, states have been reducing their reliance on traditional taxes, such as tariffs on trade, in an effort to attract foreign investors. However, strategies to attract foreign investors introduce their own trade-offs. Developing countries are twice as dependent on corporate income taxes compared to developed countries (IMF, 2014, Figure 1, p. 7) and must contend with a race to

the bottom of statutory corporate income tax rates (IMF, 2014, Figure 2, p. 22) that started in 1980 as both developing and developed country governments compete for investment. Thus, rules on the sharing of the corporate income taxes between developed and developing countries is a matter of special concern to developing countries. Restoring faster growth in most developing countries will require states to be more capable of leading the development effort through their own investments in infrastructure. Most developing country governments are unable to do this with severely restricted tax revenues.

In this global effort to reform tax systems, however, there is a distinct danger that the resulting global choices and mechanisms will turn against the less powerful stakeholders. The reason is that there is a fundamental difference in interest between developed and developing countries in regard to the treatment of enterprises that operate in more than one tax jurisdiction. This kind of enterprise is precisely the type that can engage in IFFs.

Foreign investors are overwhelmingly headquartered in developed countries. They have enormous advantages in the scale of their capital, in technology, and in the variety of their products. Developed countries choose tax rules that guarantee that their tax systems are based on the total earnings of these enterprises. These rules are called "residence-based" taxation. These rules are codified in the OECD's double taxation model (the OECD being the intergovernmental organization of developed countries).

Developing countries that play host to foreign investors seek to obtain revenues from operations in their territory. They are adversely affected by rules that facilitate the transfer of income earned in their borders to other jurisdictions. These rules are called "source-based" taxation, obtaining taxes where economic activity takes place.

If the consequence of the global tax reform is to strengthen "residence-based" taxation, then developing countries will be bearing the cost of the collective interest to reform tax rules.

In May 2014, the International Monetary Fund (IMF, 2014) published an analysis of the international tax system, using the word "spillovers" to call the impact of tax policies of individual countries on other countries. This study finds that "the network of bilateral double taxation treaties based on the OECD model significantly constrain the source country's rights" (IMF, 2014, p. 12), the source country being where the actual economic activities occur.

In the study, IMF staff state that the international tax system requires thorough reform. The fact that the estimated spillover impacting on non-OECD countries is twice as large as that on OECD countries speaks to the urgency of this reform. The IMF (2014, p. 1) suggests that "Limiting adverse spillovers on developing countries requires not just capacity building, but also addressing weaknesses in domestic law and international arrangements".

When they found themselves desperately seeking taxpayer resources to bail out their financial sectors in the wake of the 2007-08 financial crisis, North Atlantic authorities, all responsible for the world's leading economies, asked the Group of Twenty (G20) and OECD to launch the Base Erosion and Profit Shifting Project (BEPS). The outcomes of BEPS, launched in September 2015, confirm the existence of a need, or a set of needs, for a thoroughgoing reform of international tax cooperation.

The BEPS outcome did not respond to the most critical needs of developing countries in tax cooperation, even though the cooperation and participation of developing countries would be required to make the BEPS proposals effective in meeting the needs, even of developed countries.

BEPS explicitly avoided dealing with the split between residence and source taxation, despite the fact that the global community has reached agreement earlier that "all companies, including multinationals, pay taxes to the Governments of countries where economic activity occurs and value is created, in accordance with national and international laws and policies" (Addis Ababa Action Agenda, Paragraph 23).

There is no place in the BEPS project structure for two of the most important tax issues confronting developing country officials in generating revenue from activities of foreign companies in their jurisdictions: (1) taxation of technical services and (2) the treatment of enterprises in extractive industries.

Change in the "right direction" for the global tax system will require that those parties with the greatest interest in seeing it happen have the sufficient capability and force to participate actively in the international processes of change. Developing countries have the greatest interest in the matter of international tax cooperation but they are hampered by the following weaknesses:

a) Weaker technical capabilities compared to developed countries

b) More sources of disunity among developing countries because of the great variety in levels of income, geography, history, and political systems

c) Significantly smaller resources for coordination, research, and joint action in the international arena.

The South-South cooperation principles enunciated in Yamoussoukro provide guideposts to a path for developing countries to overcome these weaknesses and participate actively in a reform process that is in their interest. Change can be more feasible and accessible with strategies that help overcome weaknesses of developing countries.

The change being sought is in two arenas: (1) changes in international norms and rules on tax cooperation and (2) changes in national policies and administrative practic-

es. In the case of (2), other developmental organizations, such as the IMF, play an important role, but it would still be important for developing country authorities to form their own judgements and make decisions consistent with interests of their nations and their poorer citizens.

The principles of South-South Cooperation can be applied in three specific areas:

(1) Drawing on Yamoussoukro Principles a, b, k, and l, SSC must be directed at upgrading the capacity of country authorities in researching the design of effective tax policies for their own countries, drawing on lessons and experiences from the developing country context;

(2) Drawing on Yamoussoukro Principles j, k, l, and m, SSC should seek to strengthen and better coordinate developing country engagement with and negotiations in international tax cooperation activities such as in the OECD-G20 processes, the UN tax cooperation work, and regional cooperation activities; and

(3) Drawing on Yamoussoukro Principles f, g, h, and i, SSC can establish international tax cooperation mechanisms among developing country authorities, for arriving at agreed norms and mutual action at the regional and global levels.

4. Stemming Illicit Financial Flows through SSC

The effort of combatting IFFs must be embedded in and understood within the broader context of global tax reform and the reforms that are required to meet Agenda 2030. This section will present some specific areas where SSC can be applied to reduce illicit financial flows.

4.1 Exchange of Information

First, there are clear possibilities for establishing more robust exchange of information modalities to reduce illicit financial flows. Even BEPS recognized the importance of greater exchange of information among tax authorities by promulgating what is called country-by-country reporting (CBCR). The problem is that the BEPS process only requires the disclosure of information (of sales, profits, etc.) to tax authorities and these can only be disclosed to other tax authorities if they qualify with regard to privacy protection standards of developed countries.

The current practice has always put developing countries at a disadvantage in respect to obtaining information from developed country tax authorities. Before BEPS, countless requests for information from developed country authorities did not elicit timely responses or are not responded to at all. Under the BEPS process, developing countries have to install a computerized data base running an OECD program, which has significant start-up costs (including the digitization of the original data from taxpayer statements).

As a matter of South-South Cooperation, developing country authorities can establish their own mechanisms of information exchange, beginning with joint work among tax intelligence units at the regional level. The objective is to increase the information flow, independent of the often unduly elaborate standards required by OECD countries. The African Tax Administration Forum (ATAF) have introduced the ATAF Mutual Assistance in Tax Matters (AMATM) process, which has pioneered the joint audit of companies operating in tax jurisdictions. An expansion and normalization of this practice could be an important next step.

In its paper on Accelerating the IFF Agenda for African countries, Global Financial Integrity (GFI) *et al.* (2017) call on African governments to join African tax information sharing networks and to require country-by-country reporting by multinationals. As elaborated in the same paper, there are other informational innovations that developing countries can undertake as a matter of South-South Cooperation. Countries can require the disclosure of beneficial ownership, especially from government contract bidders.

4.2 Manage Tax Competition At Least at the Regional Level

Developing countries compete with each other for foreign investment. It is a sovereign right for every country to offer investment incentives to foreign investors as part of its development program. A major portion of these incentives take the form of tax incentives even though the evidence does not support the proposition that offering tax advantages promotes inward investment. However, since competitors offer tax incentives, every country feels the need to offer these incentives.

As a matter of South-South Cooperation, developing countries, particularly at the regional level where tax competition is most intense, can coordinate their incentives structure to avoid ruinous competition. There are some policies that can be considered in this regard:

1. Developing countries can jointly decide not to give tax incentives on profits, but give incentives on actual business activities – such as number of employees, or size of the payroll, or introduction of new technologies, and so on.

2. Developing countries can agree on a minimum tax rate on profits, below which no country will offer an incentive. Because each country has different methodologies of what can be deducted from earnings to arrive at profits, cooperating developing countries can agree on a list of which deductions can be included in a profit calculation that will be subject to a minimum tax, without requiring each jurisdiction to change its method of calculating profits.

3. At the domestic level, developing countries can work together to disclose the cost of their investment incentives to domestic legislature and to civil society, as some countries are doing (a method that includes concealing the actual company receiving the incentive). By making this a common endeavor, foreign investors will not feel disadvantaged when they invest in jurisdictions that apply this methodology.

4.3 Concertedly Strengthen Transfer Pricing Disciplines and

Prohibit Trade Misinvoicing

Developing country authorities can also strengthen each other's transfer pricing practices and consider passing legislation to prohibit trade misinvoicing.

In recognition that the largest channel of IFFs is through trade misinvoicing, all countries are under pressure to strengthen their transfer pricing audit capabilities. The tussle that many developing country authorities and experts have with the BEPS outcome is that it protects a strong version of the separate entity principle, instead of moving towards a tax treatment that treats transactions among related companies differently.

As a matter of South-South Cooperation, tax authorities among developing countries can strengthen their transfer pricing capabilities. There is an OECD-United Nations Development Programme (UNDP) project called "Tax Inspectors Without Borders" which is supposed to train developing country officials on transfer pricing procedures. The problem is that many developing country officials find that, while many of the procedures are interesting in an ideal world, they are not practical for developing countries. For example, the OECD methodology requires that an audit should be based on "comparable prices" of similar transactions. Developing countries do not have the diversity of companies and transactions to find truly comparable prices.

There are more practical approaches such as the Brazilian "fixed margin" method and the Argentine "Sixth" method which is more practical for developing country authorities. As a matter of South-South Cooperation, developing countries can strengthen technical cooperation in the application of more practical transfer pricing audit methods.

As a matter of South-South Cooperation, developing countries can jointly legislate prohibitions against trade misinvoicing, a practice that now lives within the gray world of ambiguous norms and practices under the preferred OECD methodologies. This effort can begin by agreeing on a model law which defines the kinds of transactions subject to prohibition.

4.4 Coordinated Participation in International Standard Setting in Tax Standards and Practices

Developing country authorities are active participants in international fora that debate and set standards for tax policy and tax cooperation. Developing country officials attend these various fora, most often at the expense of their own governments. It is important for developing countries to attend these events in pursuit of their own interests, to make sure that standards being agreed protect their taxing rights and are practical for their situation.

The OECD, being well resourced and staffed, is the major player among these fora. The OECD secretariat is accountable to the 36 member States of the OECD. Under the BEPS Agenda, the OECD secretariat has been pursuing the Inclusive Framework where developing country officials attend, theoretically on an equal footing. It is still the case that the secretariat for the Inclusive Framework is the OECD.

In participating in this fora and in the other OECD forum called the Global Forum on Transparency and Exchange of Information for Tax Purposes, developing countries should consider, as a matter of South-South Cooperation and in line with the Yamoussoukro Principles, to begin to undertake prior consultation among themselves to better advocate the developing country interest. The prospective developing country participants can begin to form caucuses around different issues (recognizing that the variety of development levels and economic structures is much larger than those for developed countries).

There is also the 25-member UN Committee of Experts on Cooperation in International Tax Matters which is composed of nominees by UN member countries, selected for balanced regional representation. The members act in their personal capacity, because UN member States have not mandated the Committee to have an intergovernmental character, though its work is in the tradition of a similar committee set up during the era of the League of Nations between the two 20th century world wars. It is important for greater coordination among the developing country members of the Committee; this is an activity that the South Centre has been supporting.

Member States of the United Nations should also support the work of the Committee. The Government of India has contributed to the trust fund of the UN committee to support the participation of developing countries in the subcommittee meetings of the UN body.

Developing countries are member States of the International Monetary Fund and the World Bank. Their representatives to these bodies must begin working more explicitly toward identifying the developing country view to tax and illicit financial flows matters and seek the recognition of these positions in the operations of these institutions. The Group of Twenty-Four (G24), which is the caucus of developing country executive directors at the Bretton Woods institutions, inaugurated a project on key issues of international tax cooperation.

5. Final Comments

Developing countries bear the brunt of costs from IFFs. These losses are the result of the facilities that the global system provides transnational companies, operating in multiple tax jurisdictions, to move their profits to favorable locations. International cooperation has been seen to be a key ingredient in restricting IFFs. However, a difference in interests in the treatment of many types of transactions between developed and developing countries is an obstacle to a fast solution of the problem. For example, developing countries seek to obtain tax revenues where economic activities take place, while developed countries prefer to be able to tax income and profits as remitted to their territory. Recent international efforts at reforming the tax system have been dominated by developed coun-

try officials through the OECD and these efforts raise much skepticism about whether developing country interests will be addressed.

Developing countries must seek to seize the initiative to restrict their losses from IFFs. They can deploy various joint and concerted actions (as discussed in this paper), within the umbrella of the principles of South-South cooperation for this purpose.

Endnote:

[1] See also Montes, Danish, and Uribe (2018).

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The South Centre is the intergovernmental organization of developing countries that helps developing countries to combine their efforts and expertise to promote their common interests in the international arena. The South Centre was established by an Intergovernmental Agreement which came into force on 31 July 1995. Its headquarters is in Geneva, Switzerland.

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The South Centre
Chemin du Champ d'Anier 17
PO Box 228, 1211 Geneva 19
Switzerland
Telephone: (4122) 791 8050
E-mail: south@southcentre.int
https://www.southcentre.int

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This brief is part of the South Centre's policy brief series focusing on tax policies and the experiences in international tax cooperation of developing countries.

Efforts to reform international cooperation in tax matters are exhibiting a distinct acceleration. The direction of change must recognize and incorporate innovations in developing country policies and approaches, otherwise the outcomes will obstruct practical paths to development.

The policy brief series is intended as a tool to assist in further dialogue on needed reforms.

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