Trócaire Development Review, Dublin, 2009, pp. 97-113, ISSN 0790-9403

THE COHERENCE OF IRELAND'S FOREIGN DIRECT INVESTMENT POLICY WITH DEVELOPMENT AID OBJECTIVES[1]

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Policy coherence for development is achieved when policies across a range of domestic policy areas support, or at the very least do not undermine, the attainment of overseas development objectives. This article introduces the topic of policy coherence and analyses the coherence of Ireland's policy on inward and outward foreign direct investment with Ireland's overseas development objectives.

We recommend that Ireland consider a pilot tax sparing arrangement with Irish Aid partner countries, take further steps to facilitate outward investment in developing countries and significantly improve the legislation governing the behaviour of Irish citizens in the area of bribery and corruption.

In relation to Ireland's low rate of corporation tax, we find that Ireland does not compete with Irish Aid partner countries for international investment. Nevertheless, we recommend that within the context of any future renegotiation of EU corporation tax policies, Ireland should work to ensure that the position of developing countries is taken into consideration.

Introduction

Policy coherence for development (PCD) is firstly about doing no harm by ensuring that progress towards Ireland's development assistance goals is not undermined by policies which relate primarily to domestic goals in areas such as agriculture, trade and migration. Secondly, PCD is about searching for potential synergies and win-win scenarios, where domestic policies support development goals whilst securing other objectives too. According to Weston and Pierre-Antoine (2003), ensuring policy coherence for development means making all policies that affect developing countries "coordinated, complementary and non-contradictory". It is worth noting that full policy coherence is a notional concept that cannot be achieved in practice. What is deemed coherent today may not be coherent tomorrow, as the policy environment can change rapidly. Nevertheless, the pursuit of policy coherence on an ongoing basis should be considered a central pillar of Ireland's commitment to stimulate growth and reduce poverty in developing countries.

PCD seeks to represent the interests of the poorest developing countries within Irish and European policymaking processes and comprises three basic pillars: policy-relevant research, formal institutional structures for considering the interests of developing countries within domestic decision-making processes and meaningful oversight mechanisms within parliament, for civil society and with partner countries. Evidently, development interests can not always be placed ahead of national policy priorities and advocates of PCD should not seek to undermine the responsibility EU legislators have to their electors. Nevertheless, there exist opportunities to improve outcomes for developing country citizens as a result of Irish or EU policy that does not make domestic constituents worse off. In cases, where there is a conflict of interest, it is imperative that policy discourse assesses the relative merits of potential policy changes.

At EU level, PCD first came to prominence with the Maastricht Treaty in 1993. The Treaty states that "the Community shall take account of the objectives referred to in Article 130U [which refers to development cooperation] in the policies that it implements which are likely to affect developing countries". However, it took until 2005 for the EU to operationalise PCD into its work programme, when the Council, Commission and member states committed to action on PCD and a biennial PCD reporting process as part of the European

Consensus on Development (Commission, 2005).[2] In 2002, the annual OECD (Organisation for Economic Cooperation and Development) ministerial meeting called on the OECD to consider trade-offs and synergies across areas such as trade, investment, agriculture, health, education, the environment and development cooperation. Since then, the OECD Development Assistance Committee has featured countries' efforts to pursue PCD in its regular reviews of member country aid policies.

In Ireland, the agenda for PCD is set out in the White Paper on Irish Aid which positions policy coherence as one of the guiding principles of Irish Aid:

> We will work for a coherent approach to development across all Government Departments. Within Irish Aid itself, we will work to ensure coherence across the wide range of development assistance instruments employed and to minimise and eliminate inconsistencies and contradictions.[3]

Ireland's broadened understanding of the multiple policy dimensions to development assistance mirrors the country's own experience of economic growth over the last 15 years. While financial resources from the EU played a role in the modernisation of the Irish economy, most commentators would highlight the central role played by growth-enhancing EU policy frameworks. Similarly, the development challenge faced by developing countries should be seen within this more holistic framework. Hence, a broad range of policy areas and policy relationships with the developed countries is important for the future of developing countries.

The PCD agenda has understandably focused on major policy areas such as agriculture, trade and migration, while policy towards foreign direct investment (FDI) has often been neglected as an area of concern to developing countries. The fact that investment policy was not considered in the first European Commission biennial PCD report published in 2007 illustrates both the peripherality of the policy area within the EU PCD agenda and perhaps the lack of political will to review the impact of EU policy towards inward and outward direct investment on developing countries.

Any efforts to reflect PCD principles into FDI policy will occur within the context of pressure for regulatory changes in the wake of the global financial crisis. Within the EU and various multilateral organisations there has been a major shift in the tone and substance of policy debates about the rules governing financial and investment flows, tax havens and banking practices. While global regulatory changes are likely to have some impact on Ireland, an excellent opportunity presents itself to improve policy coherence in the area of FDI (as well as finance more generally) while at the same time reducing inherent risks in the international financial system.[4]

In this paper we take a fresh look at the coherence of Irish development aid objectives and Ireland's policy towards inward and outward FDI and make a number of recommendations for policy change. In doing so, we specifically review the validity of criticisms of the impact of Irish FDI policies on developing countries. First, we provide an overview of the trends in, and benefits of, FDI to developing countries.

Trends in foreign direct investment

At the outbreak of World War I, more than 80% of the foreign capital stock was located in developing economies, reflecting the importance of railway building, the extractive industries and the colonial control of international trade at that time.[5] Today, by contrast, the vast bulk of the global FDI stock is located in the developed world and contemporary FDI tends to be associated with activities which are intensive in the use of "knowledge capital" (patents, blueprints, formulae, managerial and work procedures, marketing knowledge, reputations and trademarks).

Nevertheless, in recent years FDI has been increasing in importance for Irish Aid partner countries. The graph below shows that in 2007 FDI as a percentage of GDP is higher than 5% for Vietnam (9.8%), Zambia (8.7%), Lesotho (6.6%) and Mozambique (5.5%). Ethiopia and Malawi performed less well in 2007 recording FDI inflows of 1.3% and 1.5% of GDP respectively. Since the early 1990s the trend for FDI into Irish Aid partner countries was upwards (see Figure 1). Vietnam and Zambia both experienced high levels of FDI in the early 1990s; these subsequently fell before increasing again after 2005.

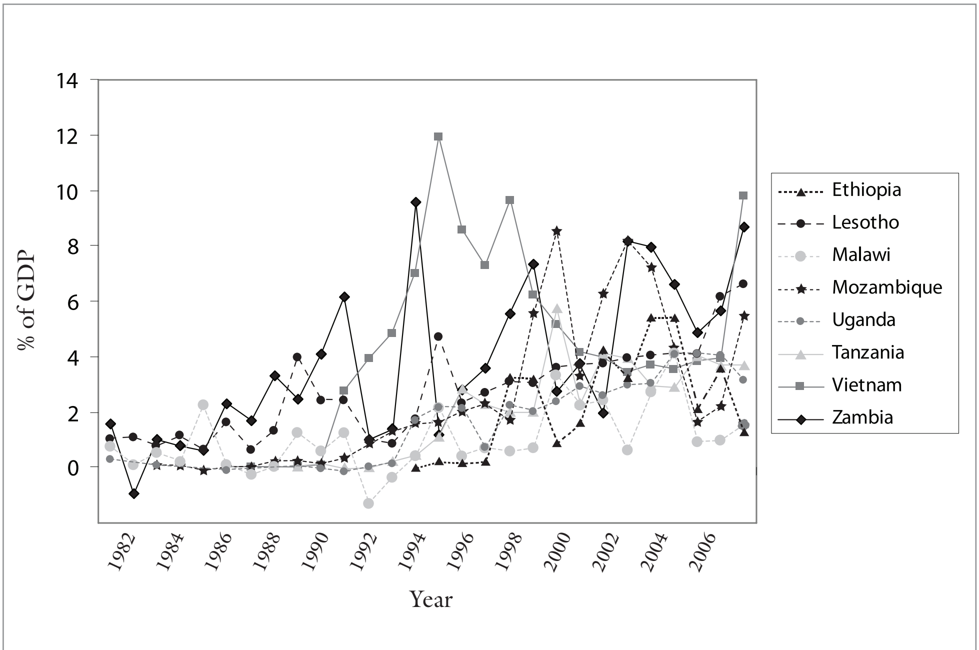

Figure 1. Foreign direct investment as % of GDP

Source: UNCTAD Database (2009)

When we compare FDI and ODA flows to Irish Aid partner countries, we find that ODA is a larger component of GDP for all Irish Aid countries with the exception of Vietnam, arguably the most developed of the nine countries. There is a clear negative relationship between the level of FDI and aid flows suggesting that they tend to go to the least developed countries, the least attractive for FDI (see Figure 2). This analysis suggests that policies that successfully increase FDI in Irish Aid programme countries might help reduce the need for aid in the future. However, there are complex processes of development behind these numbers and the relationship should be considered as suggestive rather than causal.

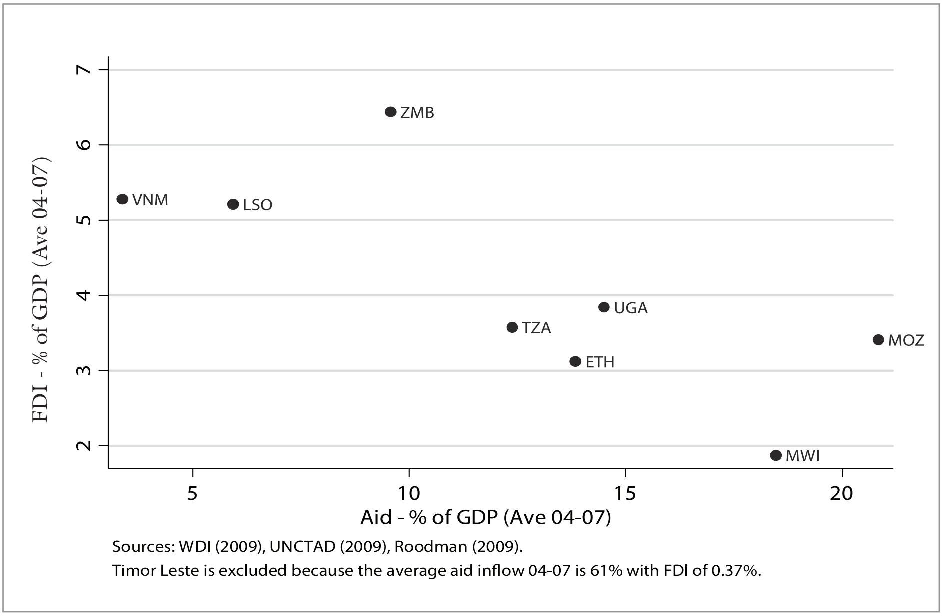

Figure 2. FDI and aid flows – Irish Aid programme countries

The relative benefits of foreign direct investment and aid

Aid is generally targeted at the poorest communities and can significantly alleviate suffering and improve livelihoods. In some cases, it can be used to help develop businesses, generally micro-enterprises that can stimulate economic growth. However, aid can distort incentives to engage in profitable activities and the evidence of the causal relationship between aid and economic growth at the country level is inconclusive. Conclusions from recent studies on the outcome of aid flows range from unconditional growth, growth only in certain macroeconomic circumstances, no growth effects, and growth depressing.[6] Other studies argue that by excluding geo-strategic aid and focusing instead on aid to infrastructure, agriculture and industry, the relationship with growth improves.[7]

On the other hand, FDI can benefit not just those directly employed but also the poorest in society as general economic growth is stimulated. While FDI can cause an increase in inequality in the short run, the longer term effects will depend on what policies are pursued. FDI can also lead to environmental degradation and poor labour conditions in some cases. Hence, the onus is on home and host-country regulation to protect against environmental and labour abuses.

Nevertheless, after 50 years of ODA to the poorest developing countries and the rapid development of the export oriented/high FDI Asian countries over the last 20 years, it is now widely acknowledged that a dynamic and diversified exporting base is central to achieving long run sustainable growth and poverty reduction in developing countries. The attraction of FDI and its associated technologies in a diverse range of sectors is a central ingredient in the strategy to develop exporting industries in low-income countries.

Criticisms of Ireland's outward and inward foreign direct investment policy

Though Ireland has long been known as a successful location for inward FDI, outward FDI by indigenous Irish multinational companies has grown substantially over the last two decades. Between 2001 and 2005, Ireland's stock of overseas direct investment grew by 34% annually, compared with an annual growth rate of 11% for the world. The "Forfás Statement on Outward Direct Investment", issued in September 2007, concluded that 3% of Irish outward direct investments projects are in Africa and 6% in developing Asia/Pacific countries.

A relevant question here is whether Irish policies and Irish legislation in regard to outward investment have been as supportive of the interests of potential host countries as are those of other EU and OECD countries. Ireland does poorly in the Center for Global Development Commitment to Development Index (CDI) with respect to outward FDI. In particular:

- The compilers of the Index judge Ireland to have neither tax sparing arrangements nor a system of tax credits in place to ensure avoidance of double taxation.
- Ireland is deemed not to be providing official assistance to firms in identifying direct investment opportunities nor to help developing countries to set up investment promotion agencies (though such assistance has been provided in the past).

- Under the heading "prevention of bribery and corrupt practices", Ireland is awarded only a mediocre rating on "publish what you pay" and on the Transparency International Bribe Payers' Index, which measures the perceived propensity of nationals to bribe abroad.[8]
- While Ireland does not restrict outward investment by pension funds in emerging markets, there is no official support for portfolio flows, for example by lending start-up capital to mutual funds investing in developing countries.[9]

We treat each of these issues in turn and assess criticisms by Christian Aid of Ireland's corporation tax regime for encouraging multinational companies with developing country subsidiaries to register their profits in Ireland at the expense of the host country.[10] We also investigate if Ireland competes with Irish Aid partner countries for FDI.

If these criticisms are valid, there is a sizable potential policy agenda for improving the policy space for outward FDI from Ireland and overcoming incoherencies related to Ireland's corporation tax regime to the benefit of developing countries.

Tax sparing

Tax sparing agreements have been used as a tool to promote economic development in numerous developing countries over the last 50 years. Tax sparing is a bilateral agreement where developed countries, such as Ireland, preserve the benefits of tax incentives offered by developing countries to foreign investors. In other words, the developed country "spares" the tax it would normally impose on the low or untaxed income generated in the developing country as a result of the tax incentive. Tax incentives used by developing countries have included generous tax treatment of investment expenditure, tax holidays and the provision of public goods at below market prices.

If the developed country did not grant this "phantom" tax credit under the tax sparing arrangements, this would negate the developing country's tax incentive which is designed to boost FDI.[11] For example, an EU/Irish based multinational firm may find that the benefits of tax incentives in a particular developing country are offset by higher home country taxes.

The Department of Finance notes that "in line with the OECD position which we follow generally in our treaties, we are in general not now in favour of giving tax sparing in our treaties. However in some recent negotiations with developing countries we have agreed to specific targeted and time-bound tax sparing provisions".[12]

A 1998 report by the OECD Committee on Fiscal Affairs entitled "Tax Sparing: A Reconsideration" stated that tax sparing is very vulnerable to taxpayer abuse and also that it is not necessarily effective in promoting economic development. The Committee expressed the view that tax sparing should only be considered in regard to states whose levels of development are considerably below that of OECD member states and that the provisions should be given in respect of projects and investments aimed at developing the domestic infrastructure of the source state.

Consequently, we have recommended in the Scoping Report on PCD that, within the context of double taxation treaties, tax sparing arrangements between Ireland and the least developed countries should be considered, with a possible pilot arrangement with an Irish Aid programme country.

Support for investment in developing countries

The Department of Enterprise, Trade and Employment (DETE) notes that Enterprise Ireland has a support service for clients interested in accessing opportunities in Africa and elsewhere. While a case for additional support could be made from a policy coherence perspective, the controversy over Irish export credit insurance for beef exports to Iraq in the 1980s may provide an explanation for the passive approach to this agenda.[13] It is clear, in any case, that any potential interventions would have to be very carefully designed.

While Ireland has no specific support for portfolio flows, DETE argues that Irish policies do not discourage investment in developing countries. It is difficult furthermore to see the logic of the CDI suggestion on lending start-up capital to mutual funds investing in developing countries, in particular for a small country like Ireland.[14]

One area where Ireland would have much to offer developing countries, given the history, experience and success of the Industrial Development Agency (IDA), is in the establishment of investment promotion agencies, either bilaterally with Irish Aid partner countries or under the auspices of the Foreign Investment Advisory Service, a service managed by the International Finance Corporation (IFC) in Washington. The IDA has in the past been involved in helping design Costa Rica's strategy to attract FDI and in establishing the highly-rated Costa Rican Investment Promotion Agency, CINDE.[15]

Bribery and corruption

Research by the World Bank and others has shown that countries that tackle bribery and corruption can improve growth performances and significantly reduce the effects of poverty such as the incidence of child mortality and preventable diseases like AIDS and malaria.[16] Developing countries cannot do this by themselves. Ireland and other wealthy nations need to eradicate bribery and corruption by their own companies.

Recent OECD reports are critical of Ireland's efforts to prevent the practice of bribery and corruption abroad by Irish companies.[17] The OECD reports the absence in Ireland of efforts to raise awareness amongst the business community that bribing foreign public officials is a crime and the absence of the obligation for public officials to report allegations or suspicions of wrongdoing as well as adequate whistleblower safeguards. The OECD reports also note that prosecutions are only brought if part of the crime was committed in Ireland.

The Department of Finance comments that "Ireland's compliance with international money laundering standards was evaluated by a Financial Action Task Force on Money Laundering (FATF team) in 2005 which found Ireland's compliance level to be broadly comparable with other EU countries". According to the Department, the areas where the money laundering regime was found deficient will be addressed in a forthcoming Criminal Justice Bill on money laundering. Ideally, this upcoming legislation will position Ireland at the centre of best practice and as an example to other countries. While a provision was introduced in the 2008 Finance Act (s. 41) expressly denying the tax deductibility of bribes, it might also be made, in future legislation, an offence under Irish law to bribe public officials overseas.

The Department of Enterprise, Trade and Employment reports that it is "actively engaged in creating awareness amongst companies and relevant agencies, of the OECD Convention on combating bribery of foreign officials".[18] It points out that "different units of the Department are working in their respective areas to ensure that the OECD initiative is brought to the attention of all relevant parties and bodies”.[19] Nevertheless, there is need for greater efforts to raise the level of awareness of the adverse effects of foreign bribery within the public administration, Enterprise Ireland, Irish companies and the Irish accounting and auditing professions. There is also need for procedures on reporting information and/or suspicions to law enforcement authorities in Ireland. In addition, comprehensive measures to protect public and private whistleblowers in order to encourage employees to report suspected cases of foreign bribery without fear of retaliation might usefully be put in place.

Corporation tax and related activities

Ireland is one of the most FDI-intensive economies in the world. In part, this is explained by its English language and common law environment, its political stability, the skills and experience of the IDA, the country’s human capital endowment and membership of the EU. The low rate of corporation tax, however, is also widely recognised to be a key factor in attracting inward FDI. The question then is whether this low rate might encourage mobile multinational corporations to locate in Ireland rather than in some developing countries. If so, it poses an issue of policy coherence.

A 2008 Christian Aid report, *Death and Taxes: the True Toll of Tax Dodging,* argues that “while the government of Ireland has in recent years laudably increased its aid budget, at the same time it has adopted many of the characteristics of a tax haven, thus helping to facilitate tax losses in developing countries”.[20] It does this via three distinct channels: direct competition for FDI, transfer pricing and illegal transfer mispricing.

It is important to note firstly that Ireland does not meet the OECD criteria to be defined as a tax haven. These criteria comprise: (i) no or very low taxes; (ii) a lack of exchange of information; (iii) lack of transparency; and (iv) no requirement for commercial activities to be substantial in the country.[21]

As to whether Ireland attracts FDI projects away from developing world locations, even IDA Ireland will not always know if a project has been secured at the expense of a low-income country, thus ruling out any attempt at a compensatory policy of moderating grants for inward investment when the nearest competitor is a developing economy. Whether this is so will in any case depend on the type of project. Numerous middle-income economies may well be in the frame for some offshore service projects such as call centres, but given that even the UK has a sizeable call centre sector, there is no guarantee where these projects would go if Ireland were not the chosen location. In one of Ireland's important FDI-dominated sectors, pharmaceuticals, it is known that the alternative locations competing with Ireland include Singapore and Puerto Rico, but neither of these are low-income economies or Irish Aid partner countries. For many of Ireland's other FDI-dominated sectors, as the downsizing announcements from the Dell Corporation show, it is more likely that the alternative locations considered would be in Central and Eastern Europe.

In support of the last point, one of the leading international experts in the field of FDI location, James Hines Jr, argues that corporation taxes will only be a crucial determining factor when other location factors – such as the existence of a pool of well qualified labour, reasonable infrastructure, business-friendly and robust political structures and membership of wider economic unions such as the EU – are similar. This again suggests that Ireland's main competitor countries for the type of FDI that it attracts will be much more advanced economies than those with which Irish development assistance is concerned. Finally, it should be noted that the Foreign Investment Advisory Service consistently argues against the effectiveness of tax incentives in attracting FDI to developing countries.[22]

Over the longer run, however, discussions within the EU on corporation tax harmonisation or consolidation may threaten the sustainability of Ireland's low-tax regime. If this comes to pass, it could become a plank of Ireland's negotiating position in such discussions that whatever changes in EU tax policy occur should not worsen the position of developing countries. In that way, even if Ireland is eventually to see its corporation tax advantage eroded, something positive in the direction of policy coherence would be gained.

Irrespective of who Ireland competes with for FDI, it is at least theoretically possible that the low Irish rate of corporation tax may encourage the "export" of taxes from developing countries to Ireland if Irish-based multinational subsidiaries engage in intra-firm trade with related subsidiaries in developing countries. This can arise through illicit transfer mispricing (the deliberate misuse of transfer pricing), whereby intermediary goods in a firm-specific cross-border supply chain are illegally distorted to minimise that firm's total tax liability.

Regulations under which multinational companies attribute prices between subsidiaries is governed by national tax laws and in most countries by the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. While the practice of transfer pricing is fully legal when conducted within these regulations, it is worth asking, as a question for further research, whether the current regulations lead to a fair outcome for developing countries. From a PCD perspective, a tightening of the pricing procedures at the global level may lead to an increase in tax revenue for developing countries.

Which countries might suffer tax losses were transfer mispricing to be an issue? A 2006 Forfás report highlights chemicals, electronics, printing/publishing, computers and finance as the sectors dominated by multinationals in Ireland. We argue that these sectors are more likely to be engaged in intra-firm trade with subsidiaries in Europe, Asia and the US rather than Irish Aid partner countries.[23] However, at an EU and global level the importance of multinational extractive industries in Irish Aid partner countries and the growing multinational presence in Asia makes regulations related to transfer pricing an important PCD issue.

A Christian Aid report of March 2009 provides estimates of the losses to developing countries from transfer mispricing, which it suggests is used to artificially depress profits and avoid tax in high tax countries.[24] The report suggests that the loss in tax revenues to low-income countries from false invoicing and abuse of transfer pricing is $22.4 billion per annum. This in turn is based on Raymond Baker's estimate that 7% of global trade is characterised by false invoicing between unrelated parties and transfer mispricing within multinational companies.[25] The World Bank has not published specific estimates on the impact of mispricing but has claimed that between $1 trillion and $1.6 trillion is lost each year to illegal activities including corruption, drugs, counterfeit and illegal arms trade and tax evasion.[26] A consensus around Baker's estimates does not yet exist. Nevertheless, effective implementation of existing transfer pricing regulations represents a clear and worthy starting point and the size of the figures suggested by Baker justifies deeper investigation into the extent of false invoicing and possible transfer pricing abuses.

On the question of banking secrecy, which is also covered in the Christian Aid report, it is worth noting that the proposals adopted in the wake of the April 2009 London meetings of the G20 targeted the banking secrecy laws of jurisdictions such as Austria, Luxembourg and Switzerland.[27] Ireland was not identified on this list as engaging in questionable banking practices.

Conclusion

While current FDI flows to Irish Aid partner countries are modest, the importance of FDI to developing countries as they move away from dependency on development assistance cannot be overstated. Supportive policies in the area of direct investment would help to maximise the effectiveness of the Irish Aid programme. While mindful of the pitfalls, we recommend, as countenanced by the OECD report on tax sparing, that Ireland should consider a pilot tax sparing arrangement with Irish Aid countries. In doing so it may be worth conducting further research on which if any Irish Aid programme countries might represent suitable locations for Irish outward direct investment projects.

The significant capabilities within the Irish enterprise agencies could also be leveraged to provide further support to Irish Aid partner countries either bilaterally or under the auspices of the Foreign Investment Advisory Service. We have noted Ireland's poor record on the implementation of bribery and corruption awareness programmes and suggest that this could be addressed more conscientiously.

In relation to Ireland's low corporation tax regime, we have argued that Ireland does not compete with low-income developing economies for international investment. While acknowledging the potential importance of transfer mispricing at an EU and global level, we argue that any possible transfer mispricing that exists is not likely to transfer profits from Irish Aid partner countries to Ireland. Nevertheless, with respect to any future developments on corporation tax policy at EU level (including discussions on the proposed Common Consolidated Corporate Tax Base), we recommend that if Ireland is to yield ground, it should use the resulting moral capital to seek to ensure that the needs of developing countries are taken into consideration.

Finally, as the worldwide recession and banking crisis have unfolded, there has been a major shift of tone and substance in international policy debates on finance and investment flow regulation. Ireland will be affected by any global regulatory reforms as it has benefited from "light touch" or a principles-based regulatory regime and the location of eight of the top ten hedge funds in the IFSC in recent years. On the other hand, the recent moves by the US authorities against offshore tax havens in the Caribbean and the ongoing international campaign against locations with strict financial and bank secrecy laws have reduced the competitive advantages of some of the IFSC's main competitors.

Irrespective of the impact of international regulatory changes on Ireland, an excellent opportunity presents itself to improve policy coherence in the area of FDI (as well as finance more generally) while at the same time reducing inherent risks in the international financial system.

Endnotes

1 This research was undertaken as part of a four year research programme funded by the Advisory Board of Irish Aid (ABIA) with the Institute of International Integration Studies (IIIS) at Trinity College Dublin. The first project, a Scoping Report on Policy Coherence for Development (PCD), was published in 2009. See www.tcd.ie/iiis for details.

2 European Commission (2005a)

3 Government of Ireland (2006)

4 The IFSC (International Financial Services Centre) is said to have benefited from Ireland's "light touch" or principles-based regulatory regime, for example, as has the UK sector; European economies may well move more towards a harmonized approach.

5 Barry, F. and Hannan A. (2003), pp.91-105

6 See the following papers for a sample of the literature: Easterly, W. (2007a); Easterly, W. (2007b); Collier, P. and Dollar, D. (2001); Easterly, W., Levine, R. and Roodman, D. (2004).

7 See Bobba, M. and Powell, A. (2007)

8 The relevant question relating to "publish what you pay" is: Has Ireland participated in initiatives to promote transparency in payments, taxes, receipts, and expenditures that its multinationals pay to foreign governments? Examples include the Extractive Industries Transparency Initiative (EITI), the G-8 Anti-Corruption and Transparency Action Plan, the Kimberly Process to control trade in "blood diamonds", and the World Bank trust fund to combat bribery.

9 While portfolio flows are not considered part of FDI, we briefly discuss the coherence of related Irish policy.

10 Christian Aid (2008a)

11 Toaze, D. (2001)

12 Government of Ireland (2008b)

13 The export credit insurance provided by the Irish government meant that the Irish taxpayer guaranteed to pick up the tab if the buyer defaulted. This was one of the matters which led to the establishment of the Beef Tribunal.

14 See Roodman, D. (2007) for further details.

15 See Clark, M. (1997), pp.71-97.

16 World Bank figures suggest that $1 trillion is paid annually in bribes worldwide. This is over twenty times the amount OECD countries provide in international aid every year.

17 See for example http://www.transparency.ie/Files/2007oecdphase2reviewireland.pdf.

18 Government of Ireland (2008a)

[19] ibid.
[20] Christian Aid (2008a)
[21] OECD (2001)
[22] See e.g. Wells L., Allen, N., Morisset, J. and Pirnia, N. (2001)
[23] Forfás (2006)
[24] Christian Aid (2008b)
[25] Baker (2005)
[26] World Bank (2007)
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