# *Walking the talk* on Illicit Financial Flows: the G20's Responsibility in Combating Illicit Capital Flight

## - A policy brief for South Africa

*For every dollar that developing countries receive in aid, they lose ten in illicit financial flows. If African governments and development partners expect to meaningfully reduce poverty, the call for multilateral automatic tax information exchange must be supported and the country-by-country financial reporting standard should be adopted by the IASB in order to enable tax administrators to better detect the outflow of illicit money. South Africa has the opportunity to advance these measures on its own behalf as well as on behalf of the rest of the continent at the G20 Cannes Summit in November 2011.*

### Tackling Illicit Financial Flows – a critical challenge for Africa

Taxation is finally being recognised as a key source of sustainable development finance. However, a majority of African tax systems do not raise nearly enough revenue. The challenges of a large informal sector, low tax morale, and poor service-delivery are often cited as the major barriers to effective taxation. What is often overlooked is that African countries have lost substantially more tax revenue as a result of the difficulties in taxing the illicit flows[1] of money out of the continent.[2] Tax administrators face huge challenges in detecting these illicit outflows that occur through sophisticated tax avoidance schemes involving transfer pricing mechanisms, the exploitation of loopholes in the tax law, and are facilitated by the financial secrecy offered by tax havens to Multi-National Corporations (MNCs) and wealthy individuals. Tackling capital flight due to tax avoidance, evasion and corruption (including illicit financial flows) demands a review of the global financial system, and this is increasingly being called for in the aftermath of the global financial crisis.

Between 2005 and 2007, the lost capital as a result of bilateral trade mispricing from South Africa to the European Union and the US cost South Africa about US$1.4 billion in lost tax revenue.

(source: False profits: robbing the poor to keep the rich tax-free, Christian Aid report March 2009).

**This policy brief sets out the scale and impact of such tax dodging[3] behaviour on African economies and how South Africa can influence the G20 to put an end to it.**

### The Scale & Impact

Between 1970 and 2008, illicit financial flows from Africa amounted to about US$854 billion (of which US$175 billion flowed out of southern Africa), which could have satisfied the continent's external debt obligations and left a surplus of US$600 billion

[1] Whilst there is no precise definition for illicit financial flows, they are comprised largely of the following: proceeds of criminal activities, corruption and tax evasion, including abusive transfer pricing. See the Final Report from the Task Force on Development Impact of Illicit Financial Flows, available at: http://altermonde.jp/pdf/081107.pdf, accessed May 10, 2011.

[2] Commercial tax evasion (most of which is trade mispricing practices) constituted between 60% and 65% of illicit outflows in the world as at 2008. See Baker, R. *Illicit Financial Flows from Africa*: Hidden Resources for Development (Washington DC: Global Financial Integrity, 2001), at page 1.

[3] "Tax dodging" in this brief refers to tax avoidance and tax evasion practices as described throughout this brief.

to reduce poverty and stimulate economic growth.[4] The bulk of these illicit flows – an estimated 60-65 per cent of the global total - consists of paid or reduced taxes on profits that businesses, particularly MNCs, shift between tax jurisdictions in order to reduce their tax bills (to nil, in some cases).[5]

Further, the OECD recognises that developing countries lose more to tax havens than they receive in foreign aid.[6] It is therefore no surprise that the past 10 years of private sector-led economic growth and reliance on foreign aid have by and large failed to stimulate productive domestic enterprise, or raise sufficient revenue to meaningfully reduce poverty. If African governments are serious about improving the livelihoods of the majority of their citizens, then they can no longer afford to continue to lose tax revenue in this manner. Indeed left unabated, it is highly unlikely that African countries will meet all the Millennium Development Goals (MDG) by 2015 and the lives of impoverished communities will only get worse.[7]

*Mopani Copper Mines, PLC in Zambia*:

*A draft of an audit report commissioned by the government, the findings of which are disputed by the company, alleged that:*

- *about US$29 million lost per year between 2003 and 2008 due to abusive transfer pricing;*
- *about US$95 million lost per year from inflated costs; and*
- *about a further US$50 million a year in dividend loss to the government which has a 10% shareholding in the company.*

*(source: Action Aid, drawn from 2010 Grant Thornton Pilot Audit Report on Mopani Copper Mines, PLC).*

**How Unscrupulous Companies Dodge Tax**

**Transfer pricing.** A transfer price is the adopted book value for a good or service transacted between related entities.[8] MNCs can abuse transfer pricing transactions to shift profits from high tax jurisdictions to low tax jurisdictions, and thereby minimise their overall tax liability in the country where profits are earned. Many countries will have within their income tax laws an anti-abuse provision that contains the 'arm's length principle.' This essentially means that related companies that trade with each other are obliged to use a price, (or range of prices) that a company would be expected to pay for a certain good or service, if purchased from an un-related company in the marketplace. Whilst it is often difficult to determine what the fair market value or price for a good or service is, if a company does not use an

*SABMiller Group*:

- *SABMiller is the world's second largest beer company, and monopolises the brewing industry in many African countries;*
- *The SABMiller Group has more tax haven companies than brewing and bottling plants in Africa;*
- *SABMiller brews, markets and sells a number of original African beers to Africans, such as Castle, Stone, and Chibuku, but many of the trademarks for these beers do not belong to SABMiller's African subsidiaries, in the countries where they were created, but instead to its Dutch subsidiaries in order to take advantage of the preferential tax treatment of royalties.*
- *ActionAid estimates that this results in African governments losing about US$16 million (South Africa loses US$8 million) in tax a year due to royalty payments;*
- *African governments also lose an estimated US$13 million in tax a year due to management fees paid mostly to SABMiller's Swiss subsidiaries;*
- *Including tax losses due to payments to SABMiller's subsidiaries in Mauritius, ActionAid estimates developing countries lose about US$30 million a year;*
- *There is no suggestion that these practices were illegal.*

*(source: Calling Time: Why SABMiller should stop dodging taxes in Africa, Action Aid, 2010).*

[4] See Baker, R. *Illicit Financial Flows from Africa*: Hidden Resources for Developm Global Financial Integrity, 2001), at page10.

[5] See Footnote 4, at page 1.

[6] See Footnote 4, at page 17.

[7] Ibid.

[8] Transfer pricing as defined by the OECD. See http://stats.oecd.org/glossary/detail.asp?ID=2757.

arm's length price in its transactions with a related company (e.g. by setting artificially  high or low prices), then it is evading tax.  However, related companies that shift profits in this manner, but comply with the letter (and not substance) of the law, are avoiding tax (which is technically legal).

**Secrecy jurisdictions** ('tax havens') facilitate transfer pricing abuse between related companies. There are between 50 and 72 of these jurisdictions in the world that guarantee financial secrecy—a safe haven for companies and wealthy individuals to hide their assets and avoid paying the tax on their assets that might otherwise be due in other jurisdictions.  Most tax havens are located in OECD countries, with the largest in the USA (Delaware).[9]  About US$11 trillion is currently held in tax havens, resulting in an annual tax loss of US$255 billion.[10] Secrecy jurisdictions deprive rich and poor governments, but have a debilitating impact on the latter.

*"We support the [G20] in playing a bigger role in global economic governance as the premier forum of international cooperation.  We expect new positive outcomes in the fields of economy, finance, trade and development from the G20 Cannes Summit in [November] 2011."*

*(source:  Art. 14 of the Sanya Declaration of the BRICS Leaders Meeting, Sanya Hainan, China, April 14, 2011.*

**2011: A Turning Point in the Tax and Development Agenda**

In the wake of the global financial crisis, French President Nicolas Sarkozy expressed his concerns about the gaps in global financial regulation and the effects of financial secrecy, particularly in offshore tax havens. At the G20 Summits in London (2009) and Seoul (2010), world leaders further highlighted the problems of secrecy jurisdictions and transfer pricing and promised to take action.

This year the G20 is hosted by France.  The momentum is building across the globe for measures to tackle the type of tax avoidance outlined above, with the G20 process in 2011 being critical to achieving this.  In addition, the Sanya Declaration of the BRICS Leaders Meeting[11] calls for the strengthening of global economic governance, and amplifying the voice of developing and emerging countries in international affairs based on universally accepted principles of international law, collective-decision making and mutual respect.  In their Draft Resolution on Illicit Financial Flows, the AU Conference of African Finance Ministers have committed to determine the scale, nature, and impact of illicit financial flows on development, and sensitise African governments, citizens, and international development partners on their findings, as well as to "mobilise political support and sensitisation of putting in place rules and regulations which are necessary to combat illicit financial outflows."[12]  The Nairobi Declaration on Taxation and Development equally calls on the G2O, the UN, African governments and other international state and non-state actors to challenge tax

[9] See Tax Justice Network **Financial Secrecy Index** available at http://www.financialsecrecyindex.com/2009results.html.

[10] Tax Justice Network, Tax Us If You Can, at page 3, available at http://www.taxjustice.net/cms/upload/pdf/tuiyc_-_eng_-_web_file.pdf

[11] Sanya Declaration of the BRICS Leaders Meeting, Sanya, Hainan, China, 14 April 2011

[12] Article 1(d) of the Draft Resolution on Illicit Financial Flows (Resolution L8) of the AU Conference of African Finance Ministers, March 24-27, 2011.

South Africa is:

- a member of the BRICS countries;
- a member of the G20;
- Chair and co-founder of ATAF;
- Co-chair of the OECD Tax & Development Task Force;
- a member of the UN Committee of Experts on International Cooperation in Tax Matters;
- a member of the Steering Group of the OECD Global Forum on Transparency & Exchange of Information for Tax Purposes; and
- a non-permanent member of the UN Security Council until 2012.

leakages, financial secrecy offered by offshore financial centres, and increase the transparency of transactions among MNCs.[13]

**The pivotal role of South Africa**

South Africa's increasing international influence offers it a unique opportunity to lead in the campaign for fairer and effective taxation throughout Africa. The South African Revenue Service considers itself to be "on the front line with the most advanced tax administrations in the world in combating these [tax avoidance] schemes."[14] South Africa also chairs the G20 development working group, and the subgroup within it working on tax and development. It also chairs 2 of the key bodies instructed by the G20 to deliver on its tax and development agenda: the African Tax Administration Forum (ATAF) and the OECD Task Force on Tax and Development. These two bodies work together, alongside the UN Tax Committee, the IMF and the World Bank, to formulate an agenda that will be brought to the G20 summit in France in November 2011.

**Key policy measures – and South Africa's role**

**1. Tax haven information exchange**

Since 2009, the G20 has been steering the OECD to improve information exchange by tax havens. So far, the result has been the conclusion of a large number of new Tax Information Exchange Agreements (TIEAs) with tax havens. South Africa is a beneficiary of this process, and is currently negotiating 15 such treaties. However, there are two key problems faced by low-income countries:

- As these are bilateral agreements, low-income countries have neither the capacity nor the political influence to secure large numbers of TIEAs; and
- TIEAs are based on information exchange 'on request,' which means the process of accessing information from a tax haven through a TIEA is difficult, time-consuming, and not automatic.

India has reportedly called for a global system of automatic tax information exchange which would resolve both these issues and make it difficult for tax havens to guarantee financial secrecy to wealthy individuals and companies whose assets may be liable to tax in other jurisdictions. That is, tax information exchange tackles the problems of illicit financial flows and tax avoidance and can therefore be of major benefit to low-income countries as well as G20 members themselves. Importantly, the OECD Council of Europe Multilateral Convention on Mutual Assistance in Tax Matters is

[13] See generally Article 3 of The Nairobi Declaration on Taxation and Development available via www.taxjusticeafrica.net.

[14] Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act 1962, South African Revenue Service, www.sars.gov.za/home.asp?pid=5981

a step in this direction for multilateral automatic tax information exchange. **South Africa should sign and ratify this Convention, and through its position in the G20 and Global Forum, exert its influence to pressure and encourage all G20 members and tax havens located in OECD and non-OECD countries to do the same.**

**2. Country-by-country financial reporting**

It is clear that global accounting standards need to be changed in order to increase the transparency of financial transactions and tackle tax dodging. Country-by-country reporting ('C-by-C reporting') is a proposed accounting standard that could be implemented either by national securities exchange regulators (the US, EU and Hong Kong haven taken steps in this direction) or at the global level by the International Accounting Standards Board (IASB). The IASB is a technical body based in London which sets international financial reporting standards in use in most countries, including South Africa. The G20 has in the past instructed the IASB to make changes to its governance and reporting standards, and could be persuaded to do so again.

C-by-C reporting would require MNCs to report key financial information about each of the countries in which it operates and the name it trades under in each country in their annual accounts. The key information would include the company's sales, purchases, financing costs, labour costs and employee numbers, pre-tax profit, and tax payments to the government of the location where it is trading.

A number of G20 countries support the disclosure of limited information (payments to governments) in the extractive industries, with France and the UK speaking out in favour of a global standard. But this measure would neither apply to companies engaged in other sectors nor would it require companies to report on as extensive information as proposed under the C-by-C reporting standard. It is therefore unlikely to be as useful to tax administrators in many African countries. **At the G20, South Africa should champion the adoption of a Country-by-Country reporting standard by the IASB that requires mandatory disclosure of a broader set of financial information, across all sectors, and at a global level.**

**Conclusion**

Fair and effective tax collection is essential for raising the revenue required to finance the public goods and services that people need. It can be a powerful tool to redistribute wealth, thereby addressing poverty and inequality. Taxation, specifically direct taxation, also improves state-citizen accountability. But unless illicit financial flows are curtailed as proposed in this policy brief, it is unlikely that African tax systems will be able to fulfil these important roles in society.

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The Economic Justice Network of the Fellowship of Christian Councils in Southern Africa (EJN) envisions the harnessing of resources of the southern African region for its people, with a view to bringing about economic justice through the transforming agency of Christians compelled by the gospel of Jesus Christ. Its mission is to strengthen the commitment of the church in its advocacy work on economic justice and to act as a catalyst for engaging people in the promotion of just economic and social structures. The Network establishes mechanisms to bring the experience and concerns of the marginalized and the poor people to the agenda of the church and society.

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**The South African Council of Churches (SACC)** is well known for the part it played in the struggle against apartheid, the globally - condemned oppressive policy of our former Government. It is now engaged in assisting the reconstruction of the nation and the development of South Africa's fragile new democracy. Its mission is "to work for the moral reconstruction in South Africa, focusing on issues of justice, reconciliation, integrity of creation and the eradication of poverty and contributing towards the empowerment of all who are spiritually, socially and economically marginalised."

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**National Labour and Economic Development Institute (NALEDI)** was formed in 1993 and carries out labour and economic research. NALEDI's mission is to conduct policy-relevant research aimed at building the capacity of the labour movement to effectively engage with the challenges of the new South African society. Besides research, NALEDI's work also includes managing multi-institutional projects at national and international levels.

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The **Tax Justice Network-Africa (TJN-A)** is a Pan-African initiative established in 2007 and a member of the global Tax Justice Network. TJN-A seeks to promote socially just, democratic and progressive taxation systems in Africa. TJN-A advocates for pro-poor taxation and the strengthening of tax regimes in order to promote domestic resource mobilization. TJN-A aims to challenge harmful tax policies and practices that favour the wealthy and aggravate and perpetuate inequality.

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