

## Chapter 3

# Global enablers of illicit financial flows

IFFs have multiple origins and ways of crossing borders. Chapter 2 focuses on trade mispricing as one of the core mechanisms supporting IFFs. It shows the complex layers that lie behind the tracking of related practices, from data architecture, to historical legacy, to the current capacity of customs across the continent. Moving into the realm of the international legal system, this chapter highlights key foundations of the international taxation system (section 3.1), surveys selected mechanisms for tax evasion and tax avoidance (section 3.2) and sheds light on some of the system's global actors (section 3.3). The exposé does not cover ongoing reforms of international corporate taxation as these are addressed in chapter 7. Rather, taking stock of the shortcomings in the international taxation system, section 3.4 discusses the global movement for tax justice and the engagement of African stakeholders in reform processes, followed by some concluding remarks.

## LOOPHOLES IN MANY TAX TREATIES

in Africa

leave countries vulnerable to tax avoidance



## WITHOUT MINIMUM STANDARDS FOR INVESTMENT TREATIES

African countries risk

a race to the bottom to attract FDI



## 3.1 Key foundations of the international taxation system

### *From the Westphalian system to the international corporate taxation system*

The foundations of the principles that underline the international taxation system are anchored in what has become known as the Westphalian system. Based on a scholarly body of work that dates back to sixteenth- and seventeenth-century Europe, the Westphalian system core characteristics of territoriality, sovereignty, equality and non-intervention have come to prevail in the international legal system despite debate on and criticism of their adequacy (Osiander, 2001; Picciotto, 2013). As argued in this chapter and in chapter 4, these principles have come to prevail and explain both the dominance of unilateral taxation systems and the complexity of multilateral reforms.

In 1923, at a time when African countries were still under colonial rule, four economists, professors Bruins, Einaudi, Seligman and Sir Josiah Stamp worked under the auspices of the League of Nations to lay the ground for the first model tax conventions. In what has become known as the “report by the four economists”, their proposal was that income from business activities should be taxed by the country of source while in return the country of residence should have the primary right to tax income from investments such as dividends, royalties or interests.

The Financial and Fiscal Commission of the United Nations carried forward the work until 1954, when the Commission was dissolved. Two years later, the predecessor of OECD, the Organization for European Economic Cooperation (OEEC), established a Fiscal Committee with the aim of inheriting the role of the dissolved United Nations Commission.<sup>27</sup> Archives from OECD also show that the creation of the Fiscal Committee initially encountered opposition from some members due to their wish to focus on the use of a bilateral treaty strategy and avoid an international treaty binding OEEC member States. By 1959, the OEEC Council recommended for adoption the proposals made by member States in their bilateral conventions, namely on: (a) avoidance of double taxation on income, capital and estates of deceased persons; and (b) avoidance of double taxation on indirect taxes such as turnover taxes. The OECD Model Tax Convention, first published in 1963 as the *Draft Double Taxation Convention on Income and Capital*, subsequently became the industry standard (Picciotto, 2013). OECD estimates that by 2017, it had been used as the basis of more than 3,000 tax treaties around the world (OECD, 2017)<sup>28</sup>.

<sup>27</sup> See <https://archives.eui.eu/en/fonds/173529?item=OEEC.FC>.

<sup>28</sup> See <https://www.oecd.org/tax/treaties/tax-treaties-2017-update-to-oecd-model-tax-convention-released.htm>.

### *Permanent establishment and the arm's length principle*

The OECD Model Tax Convention on Income and on Capital (OECD Model Tax Convention) includes the same compromise between country of source and country of residence as the United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations Model Tax Convention). In effect, it means that the country of source has the right to tax active income while the country of residence has the right to tax passive investment.<sup>29</sup> In other words, both the United Nations and OECD tax conventions imply that the country of source is not entitled to tax income from foreign corporations even when such income originates from business activities in its territory (OECD, 2017).<sup>30</sup> Both models grant countries flexibility in defining corporations' country of residence using formal registration, place of management or any similar criterion. It is this flexibility that allows multinational corporations to move their residence to countries with preferential tax regimes even when they do not have any significant business activities in those countries. It is also this flexibility that sets the basis for BEPS.

Both the United Nations and OECD conventions stipulate that corporations not only pay taxes to the country in which they have legal residence but also to the countries in which they have a permanent establishment, a key legal concept in the determination of the source of income, whose definition was originally laid out in article 5 of the OECD Model Tax Convention. The list of the types of establishment that qualify for permanent establishment is broad and is based on an actual physical presence in the territory. Exceptions include facilities that only serve the purpose of storage, display or delivery. Permanent establishment is of critical relevance in the services economy as the taxation of services provided by foreign companies is growing in importance as a tax treaty issue.

The United Nations Model Tax Convention, in its most recent version, provides two options that allow developing countries to tax service providers. The first is the service permanent establishment provision, which expands the definition of permanent establishment to include foreign companies if they have a physical presence providing services in the country for more than a certain length of time. The second is a new article permitting developing countries to impose withholding taxes on management, consultancy and technical service fees, regardless of whether the provider of those services is physically

<sup>29</sup> The exact definitions of active income, passive income and portfolio income depend on a country's regulations. For taxation purposes, income received from business activities or wages, commissions and payment for services rendered are generally considered as active. Passive income includes regular earnings from a source other than an employer or contractor, that is, rental real estate and stock dividends and other activities as defined in a country's regulations and the tax treaties it is party to

<sup>30</sup> See <https://martinhearson.net/2012/10/17/would-a-new-article-in-the-un-model-tax-treaty-be-a-fundamental-change-to-international-tax/>.

present at all in the country. Both provisions are popular in Africa. However, in a study covering 149 tax treaties in force in sub-Saharan countries, only 33 per cent were found to include the service permanent establishment provision and 36 per cent, the service withholding tax (Hearson, forthcoming). The prevalence of tax treaties that omit both provisions is considered by taxation specialists to be a major constraint on the ability to increase integration by Africa into the global service economy (Hearson, forthcoming).

Both the OECD Committee on Taxation and Fiscal Policy and the United Nations Committee of Experts on International Cooperation in Tax Matters have endorsed the arm's length principle, another core pillar of international taxation. It stipulates that transactions between entities of the same MNE are priced as if they happened between independent enterprises. In practice, the application of the principle should require the ability to identify a comparable product and price. While for standardized products this is relatively easy, it is difficult if not impossible for highly complex products or intangibles such as intellectual property or trademarks. As markets are thinner in developing countries, there is consensus that even with the best intentions, the arm's length principle is difficult to implement (Waris, 2017).

## 3.2 Selected mechanisms for tax evasion, tax avoidance and money-laundering

This section offers a brief overview of key features of the operationalization of tax avoidance and evasion in commercial activities. The main mechanisms for tax avoidance and evasion include trade mispricing, abusive transfer pricing, profit shifting and tax arbitraging. The discussion focuses on the latter three and also the use of tax havens and secrecy jurisdictions (for trade mispricing, see chapter 2).

### *Abusive transfer pricing and profit shifting*

In a globalized economy, MNEs operate their cross-border investments through the most tax efficient corporate structures (UNCTAD, 2015a), spreading their functions, assets and risks across multiple related entities located in different jurisdictions. In the case of many African countries, this practice has resulted in value-adding activities being transferred away from where the initial economic activity took place (World Bank, 2017a). These cross-border movements of goods and services require transfer pricing, a standard practice within MNEs that was not originally meant to be illegal. As such, transfer pricing operations have both an accounting dimension and an economic

efficiency objective. Notwithstanding these motivations, part of the theoretical economic literature has shown that a multinational company can manipulate transfer prices between subsidiaries located in different countries with a view to reducing their overall tax burden (Horst, 1971; Kant, 1990). Similarly, some studies on MNEs have established that the risk that multinational companies manipulate transfer pricing between their subsidiaries to make more profits appear in low-tax countries is mitigated when the foreign subsidiary is located in a competitive market (Schjelderup and Sorgard, 1997). This argument would imply that African countries where markets are less competitive would be more vulnerable to transfer pricing.

From an operational perspective, abusive transfer pricing, a form of trade mispricing, is enabled through the application of the arm's length principle. The practice is based on the excessive manipulation by MNEs of prices of cross-border transactions between related parties. The end result of abusive transfer pricing is to artificially shift profits from high-tax jurisdictions to low- or no-tax jurisdictions through the following three key channels:<sup>31</sup>

- (a) Trade mispricing through the manipulation of intragroup import and export prices whereby affiliates in high-tax countries import goods and services at high prices from firms in low-tax countries;
- (b) Debt shifting through intragroup financing, whereby an affiliate in a high-tax jurisdiction borrows from an affiliate in a low-tax jurisdiction and pays an artificially high interest rate to reduce its profits and tax burden;
- (c) Location of intangibles and intellectual property (for example, brands, research and development and algorithms) whereby an entity holds its intangible assets and intellectual property in a tax haven and charges its affiliates service fees for using these assets.

The BEPS reform package intends to curtail abusive transfer pricing (OECD, 2018b; chapter 7). The ambition is that the new set of measures will lead to greater alignment between profit outcomes and economic substance, by considering the true economic contribution by entities in a given tax jurisdiction.

### ***Tax arbitraging and tax treaty shopping***

There are more than 500 bilateral tax treaties in force in Africa (Hearson, forthcoming). Tax treaties play an important role in where and how profits, income and wealth are

<sup>31</sup> For real case examples of profit shifting, see Hearson (forthcoming).

taxed. These treaties were originally set up to harmonize tax treatment of cross-border investment and prevent investors incurring double taxation, that is, income is taxed in the source country where the activity takes place and also in the country where the investor or shareholder is located. Tax treaties have three main characteristics. First, they limit the rate at which the source State can impose withholding taxes. Second, they limit what can be subject to tax, for example through the definition of “permanent establishment”, which sets a minimum threshold of activity that must take place in a country before its Government can levy tax on the profits generated there by the taxpayer concerned. Third, tax treaties exempt some types of income earned in the source country from taxation in that country altogether, for example taxes on capital gains in particular circumstances.

Interestingly, caution in the inclusion of tax avoidance in definitions of IFFs, as discussed in the introductory chapter, is in contrast to its mention in the OECD Model Tax Convention, whose preamble states the Convention’s intention to avoid double taxation “without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States)” (OECD, 2017). The evidence of substantial losses due to tax evasion and tax avoidance in both developed and developing countries shows that these objectives have not been fully met. Rather, tax treaties provide unintended opportunities for tax avoidance through differences in clauses and concessions contained therein. Consequently, businesses can take advantage of more favourable tax treaties available in some jurisdictions by structuring their activities through these jurisdictions, reduce their tax liabilities and thus make use of tax arbitrage (OECD, 2017).<sup>32</sup> The practice of structuring a multinational business in such a way as to take advantage of differences in tax treaties is called tax treaty shopping.

Some of the root causes of the validation of international tax avoidance and tax evasion lie in established theoretical arguments in some of the economic literature. In the tradition of rational choice explanations, an individual will choose to take the risk of tax evasion if deducting the costs of the consequent punishment of being caught from the individual’s (income-defined) expected utility of the benefits of not paying taxes yields positive gains (Allingham and Sandmo, 1972; Yitzhaki, 1974). Furthermore, proponents of a narrow

<sup>32</sup> A famous example of exploiting legal loopholes and tax treaties is the exploitation of differences between definitions of tax residency in the law in Ireland and the United States. According to the law in Ireland, a company’s residence is determined on the basis of the location from which the company is run, whereas United States law focuses on where the company is registered. If a company puts its intellectual property into a company registered in Ireland but controlled from a tax haven such as Bermuda with which Ireland has a tax treaty, in Ireland, the company is considered to be a tax resident in Bermuda, while in the United States, it is considered to be a tax resident of Ireland. As a result, royalty payments between them are untaxed or only minimally taxed.

utilitarian perspective argue that private sector spending is more efficient, and it should therefore keep the power to make decisions on how the money should be spent (Benk et al., 2015; Preobragenskaya and McGee, 2016). More generally, empirical studies show that financial rewards alone insufficiently explain tax evasion (for an overview of evidence from experiments, see Torgler, 2002, 2003; Feld and Frey 2006). Rather, “tax morale”, a moral obligation to pay taxes and “a belief in contributing to society by paying taxes” (Torgler and Schneider, 2009:230) are the main motivations for individuals and firms to comply (Luttmer and Singhal, 2014).

Conscious of international competition in international corporate taxation, many countries commit to double taxation treaties with a view to attracting higher levels of FDI (Barthel et al., 2009). Such decisions are based on assumptions of how taxation affects the operational mode of MNEs. On one hand, firms’ locational decisions on large fixed-cost investment projects in a given jurisdiction depend on the effective average tax rate on the returns from the investment, taking into account depreciation allowances and other provisions that affect the tax base (Devereux and Griffith, 1998, 2003). On the other hand, the amount of real investment to undertake in a given location depends on the effective marginal tax rate, that is, the tax rate on an extra dollar of income generated by investment. Inefficiency arises from a divergence between the social and private returns. As the decision maker, the firm maximizes its private rather than social returns. With regard to the objective of attracting higher levels of investment, econometric studies on the relationship between FDI and double taxation treaties show variance in results and underline the estimation and data challenges involved in such exercises (Neumayer, 2006; Barthel et al., 2010). These inconclusive empirical findings on the importance of tax treaties for FDI location decisions are also due to the complexity of the drivers of FDI decision-making in MNEs (Carr et al., 2001; Bergstrand and Egger, 2007). Highlighting the secondary role of taxation among these drivers in sub-Saharan Africa, recent findings suggest that treaties are not associated with increases in FDI in low-income economies (Beer and Loeprick, 2018).

In addition to their limited impact on FDI attraction, tax treaties have other flaws. First, many of the tax treaties signed by African countries are high risk as they omit many of the clauses, available through international and regional model tax conventions, that might limit the risk of tax avoidance (Wijnen and de Goede, 2013; Hearson, 2016). For example, both the United Nations and the OECD Model Tax Conventions include a provision that protects developing countries against tax avoidance through indirect transfers of real property. However, a large number of tax treaties signed by developing countries still omit this provision, leaving them vulnerable to the avoidance of capital



gains tax arising from the profit realized on the sale of non-inventory assets such as the sale of stocks, bonds, real estate and precious metals (see Hearson, forthcoming).

Second, many treaties, especially older ones, lack anti-abuse clauses and provisions for mutual assistance between tax authorities (Hearson, forthcoming). The revenue costs to African countries from tax treaty shopping are estimated to have amounted to \$3.4 billion in 2015 (Beer and Loeprick, 2018). Researchers from IMF and the World Bank further estimate the cost of treaty shopping in Africa to be about 20 to 26 per cent of corporate income tax revenue from each treaty with an investment hub (Beer and Loeprick, 2018). Their findings show that treaty shopping reduced revenue by 5 per cent in all African countries (equivalent to \$3.4 billion across the continent in 2015) and 14 per cent in those countries that have at least one treaty with an investment hub. This is the only estimate of the comprehensive costs of tax treaties in African countries to date. The revenue foregone has been specifically attributed to reductions in dividend and interest withholding tax. Janský and Palanský (2018), for example, provide illustrative country-level estimates of profit shifting and compare estimated corporate tax revenue losses, relative to their GDP and tax revenues, including for 14 African countries (Benin, Botswana, Burkina Faso, Cabo Verde, Côte d'Ivoire, Guinea-Bissau, Morocco, Mozambique, the Niger, Nigeria, South Africa, Togo, Uganda and Zambia).

### ***Secrecy-based tax havens and non-cooperative jurisdictions***

Tax havens provide critical services that enable abusive tax avoidance and tax evasion. They offer low or zero taxation, moderate or light financial regulation, banking secrecy and anonymity. Tax havens are particularly attractive to high-net-worth individuals. Estimates show that the resulting loss amounts to 2.5 per cent of total tax revenue in Africa (Zucman, 2014). Definitions and criteria applied in identifying tax havens and similar concepts vary across institutions. For OECD, for example, tax havens are countries or jurisdictions with financial centres that contain financial institutions that deal primarily with non-residents and/or in foreign currency on a scale out of proportion to the size of the host economy; and in which non-resident-owned or -controlled institutions play a significant role.<sup>33</sup> For IMF (2000), offshore financial centres (OFCs) have relatively large numbers of financial institutions engaged primarily in business with non-residents.<sup>34</sup> Garcia-Bernardo et al. (2017) identify two types of OFCs, sink OFCs and conduit OFCs. A sink OFC is a jurisdiction in which a disproportional amount of value disappears from the economic system. In this classification, the top five sink OFCs are the British Virgin Islands, China, Jersey, Bermuda and Cayman Islands. A conduit OFC is a jurisdiction through which a disproportional

<sup>33</sup> See <https://stats.oecd.org/glossary/detail.asp?ID=5988>.

<sup>34</sup> See <https://www.imf.org/external/np/mae/oshore/2000/eng/back.htm>.

amount of value moves towards sink OFCs, and the top five are the Netherlands, the United Kingdom, Switzerland, Singapore and Ireland. OECD and European Union lists of tax havens and non-cooperative tax jurisdictions are discussed in box 3.

Although the terms tax haven and OFC are often used interchangeably, UNCTAD (2015a) specifies that the former refers to a political jurisdiction. In addition, tax havens not only offer the possibility of escaping from taxes but also from many other rules and regulations (UNCTAD, 2015a). In such cases, prosecution of economic and financial crimes and judicial cooperation with other countries are often limited, hence the associated term of “secrecy jurisdictions”. In contrast, OFCs comprise accountants, lawyers and bankers, and their associated trust companies and financial intermediaries, who sell services to the residents of other territories or jurisdictions wishing to exploit the mechanisms created by legislation in the tax havens and secrecy jurisdictions.<sup>35</sup>

The prevalence of offshore investment hubs underlines the link between investment and taxation. These links are further discussed in chapter 4. An offshore investment hub is defined according to four criteria initially developed by OECD: (a) no or low taxes; (b) lack of effective exchange of information; (c) lack of transparency; and (d) no requirement of substantial activity. UNCTAD (2015a) found 42 hubs that complied with these criteria and classified them into two groups, as follows:

- Jurisdictions identified as tax havens: These include small jurisdictions whose economy is entirely, or almost entirely, dedicated to the provision of offshore financial services.
- Jurisdictions (not identified as tax havens) offering special purpose entities or other entities that facilitate transit investment: These are larger jurisdictions with substantial real economic activity that act as major global investment hubs for MNEs due to their favourable tax and investment conditions.

It is estimated that between 30 and 50 per cent of global FDI is channelled through networks of offshore shell companies (UNCTAD, 2015a; Haberly and Wójcik, 2015; Bolwijn et al., 2018). Henry (2012) estimates that as at 2010, at least \$21 trillion to \$32 trillion had been invested through offshore secrecy jurisdictions. Secrecy is typically provided in relation to ownership registration and transparency, which obscures the

<sup>35</sup> The Corporate Tax Haven Index of the Tax Justice Network ranks jurisdictions according to how aggressively and extensively they contribute to helping MNEs avoid paying tax and erode the tax revenues of other countries (see <https://www.taxjustice.net/>). The ranking also indicates how much each place contributes to a global “race to the bottom” in corporate taxes. In 2019, the ranking was led by British Virgin Islands, Bermuda and Cayman Islands, followed by the Netherlands, Switzerland, Luxembourg, Jersey, Singapore, Bahamas and Hong Kong (China).

ultimate account holders and obstructs investigations on tax matters. Secrecy is of concern in much broader terms as it facilitates not only tax evasion, but also the laundering of proceeds of crime and corruption.<sup>36</sup>



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### Box 3

#### **The measurement of illicit financial flows for Sustainable Development Goal indicator 16.4.1**

Several institutions have established lists of tax havens. The OECD Committee on Fiscal Affairs' 2002 list of uncooperative tax havens based on tax transparency and exchange of information included seven jurisdictions (Andorra, Liberia, Liechtenstein, the Marshall Islands, Monaco, Nauru and Vanuatu), but all subsequently made commitments and were removed from the list.<sup>a</sup>

The European Union list of non-cooperative jurisdictions for tax purposes is updated periodically. Listed countries are identified based on recognized international tax standards, namely, transparency, fair taxation and implementation of the OECD BEPS minimum standards. As of October 2019, the list comprised the following jurisdictions: American Samoa, Belize, Fiji, Guam, Marshall Islands, Oman, Samoa, Trinidad and Tobago, United States Virgin Islands, Vanuatu.<sup>b</sup>

Oxfam (2019) notes that the European Union list does not include Bermuda, British Virgin Islands, Cayman Islands, Hong Kong (China), Panama, nor countries that are "too big to be listed", such as Switzerland and the United States. Moreover, European Union member States are exempted from the list, including Ireland, Luxembourg and the Netherlands.

Source: UNCTAD secretariat.

<sup>a</sup> See <https://www.oecd.org/countries/monaco/list-of-unco-operative-tax-havens.htm>.

<sup>b</sup> See <https://www.consilium.europa.eu/en/policies/eu-list-of-non-cooperative-jurisdictions/>.

<sup>36</sup> The Financial Secrecy Index of the Tax Justice Network measures not only the level of secrecy of jurisdictions, but also their role globally in enabling practices that enable money-laundering, tax evasion and the concentration of untaxed wealth. The ranking shows that the world's most important providers of financial secrecy include some of the wealthiest economies. The top 10 out of the 112 jurisdictions ranked in 2019 were as follows: Cayman Islands, United States, Switzerland, Hong Kong (China), Singapore, Luxembourg, Japan, Netherlands, British Virgin Islands, United Arab Emirates. The top ranking African countries in 2020 were Kenya (ranked 24), Nigeria (34), Angola (35), Egypt (46), Mauritius (51), Cameroon (53) and South Africa (58).

### *Corruption and money-laundering*

It is generally established that IFFs in Africa and corruption are closely interrelated (Reed and Fontana, 2011; Ayogu and Gbadebo-Smith, 2014). Corruption is variously defined as concerning “the use or misuse of public office for private gain”, “State capture”, “patronage and nepotism” and “administrative corruption” (Campos and Pradhan, 2007). More specifically, articles 15 through 25 of the United Nations Convention against Corruption (2003) list a series of acts associated with corruption as follows: the active or passive bribery of domestic or foreign public officials, including staff of international organizations; the embezzlement and misappropriation or other diversion of property by a public official; the obstruction of justice; the active and passive trading in influence; and the abuse of functions and illicit enrichment. Reed and Fontana (2011) identify three main mechanisms through which corruption contributes to IFFs. First, corruption is a source of proceeds, often in the form of bribes. Second, it is a means to facilitate the creation of illicit funds, such as corrupt tax administrators who ignore tax evasion or interpret tax regulation to reduce the tax burden of a taxpayer in return for a bribe. Third, corruption can be an enabler of IFFs by compromising the institutions tasked with anti-money-laundering obligations. For example, entities with anti-money-laundering obligations may collude with clients to not fulfil their obligations or financial intelligence units may be prevented from performing their function by not being provided with sufficient independence, legal powers and resources.

With regard to the first mechanism, there is ample evidence of the two-way relationship between corruption proceeds and origins of IFFs. Studies on the illicit trade of wildlife, for example, have underlined the correlation between ivory trade and State corruption (Lemieux and Clarke, 2009; Douglas and Alie, 2014). Corruption within institutions mandated to enforce wildlife legislation makes it difficult to curb illegal wildlife trade (Abotsi et al., 2016). In addition, there is evidence that this illegal trade, estimated to be a multibillion-dollar business, also provides funding to finance the bribing of public officials (Anderson and Jooste, 2014). With regard to transfer mechanisms, the symbiotic relationship between corruption and money-laundering, in particular, has been subject to scrutiny (Chaikin and Sharman, 2009). On one hand, corruption facilitates money-laundering and, on the other hand, money-laundering makes grand corruption possible and profitable (Reed and Fontana, 2011; Chaikin and Sharman, 2009; UNODC and World Bank, 2007).

In the context of money-laundering, corruption proceeds often result from the payment of commissions, payments from a protective “umbrella” or stakes of corrupt politicians in established businesses. In the legal jargon, corrupt acts are labelled as “predicate offence”, “underlying offence”, “criminal conduct”, “unlawful activity” or “infraction

sous-jacente”, depending on the country’s legal tradition (World Bank, 2004). In legal terms, “property” is defined broadly to include assets of every kind, including corporeal or incorporeal, moveable or immovable, tangible or intangible and legal documents or instruments, showing evidence not only of title but also interest in related assets (World Bank, 2004). Money-laundering operations generally require criminals to use intermediaries, either individuals or legal persons, through schemes that add opacity and establish distance between them and the identity of the account owners. As part of these schemes, corporate vehicles and trusts are among the most often used mechanisms in cases of money-laundering (World Bank, 2004).

With regard to the magnitude of the revenue and other losses due to corruption in Africa, AfDB (2015) estimates that around \$148 million per annum is lost to corruption. In addition, Bates (2006) and Ayogu and Gbadebo-Smith (2014) argue that by destroying “institutions as investment” the net losses from corruption are likely to be far greater than the first-level account of bribery.

### 3.3 Global actors of the network of tax evasion, tax avoidance and money-laundering

Perpetrators of tax-related IFFs are to be found among MNEs and high-net-worth individuals. For these actors, IFFs are facilitated by a large network of entities comprising non-financial institutions such as tax advisors, lawyers, accountants, notaries, trust and company service providers, real estate agents and providers of gambling services, as well as banks, wealth management firms and other financial institutions.

#### *Tax advisory firms and other non-financial institutions*

Facilitators of tax-related IFFs operate mostly from tax advisory firms. *The Global Tax Advisory Market in 2019* report estimates that the market was worth \$34.4 billion in 2018. The global tax market grew by 6.5 per cent between 2018 and 2019, a higher rate than the 5.3 per cent growth rate registered between 2017 and 2018 (Source Global Research, 2019). The market is expected to continue on this upward trend in 2020 and beyond, with the world’s largest consulting firms, the so-called big four, controlling 87 per cent of market share. The report further reveals that the financial services sector is the largest sector for global tax work, with almost a third of the world’s tax advisory market in 2017, valued at \$6.64 billion. Amid the different areas of work, transfer pricing is a major source of business, with a market value of \$5.18 billion in 2018. *The Global Tax Market in 2019* report singles out three major drivers of tax advisory work: a complex global

tax landscape; a growing convergence between tax and risk management, including reputational risk; and foresight on automation. The appetite for risk is a critical element of tax optimization schemes and partly explains why large tax advisory firms are often cited in ongoing investigations of tax evasion and aggressive tax optimization schemes.<sup>37</sup>

The evidence of poor tax compliance of European offshore account holders shows the extent of the central role played by financial institutions in making tax evasion possible. Although not all offshore private wealth evades taxes, the rate of non-compliance to tax obligations is generally high, with estimates ranging between 75 and 90 per cent across countries for which compliance data is available (Alstadsæter et al., 2018). Furthermore, Zucman (2017) argues that the apparent increase in compliance rates among European account holders is a mechanical consequence of the fact that the volume of assets held in Switzerland by European individuals in their own name has gone down, whereas the volume of funds channelled through screening entities has not. As part of compliance requirements in the financial sector, the role of these screening entities is to verify each onboarding customer against a number of sanction lists and criminal databases that are issued by global law enforcement agencies.

Money-laundering relies on the services of non-financial businesses and professions that include lawyers, accountants, notaries, trust and company service providers, real estate agents, providers of gambling services and online gaming services and dealers in precious stones and metals, among others. Among the traditional actors, money launderers count on the confidential and privileged nature of the lawyer–client relationship, although anti-money-laundering compliance requirements have now been extended to them. Among other key actors, the increasing role of the luxury industry and of real estate as vehicles for money-laundering has been a cause for concern (European Parliament, 2017).

### ***Banks and other financial institutions***

Funds from IFFs are ultimately deposited in financial institutions such as banks; securities, mortgage and insurance brokers; and currency exchange agencies (World Bank, 2004). Financial institutions can be unknowingly vulnerable to money-laundering given the variety of services they provide and the global dimension of their operations. However, they can also be complicit in money-laundering schemes. Famous cases of indictment of banks for anti-money-laundering lapses or sanctions violations by the United States Department of Justice provide evidence of the central role that financial institutions play in the facilitation of IFFs. For example, in 2012, after many years of legal

<sup>37</sup> See, for example, <https://www.icij.org/investigations/luanda-leaks/read-the-luanda-leaks-documents/>.

proceedings, HSBC Holdings agreed to forfeit \$1.256 billion for anti-money-laundering violations and illegally conducting transactions on behalf of customers in a group of countries subject to sanctions enforced by the United States Office of Foreign Assets Control at the time of the transactions.<sup>38</sup> Financial institutions in the informal sector also house facilitators of IFFs. Taxing those in the informal sector is difficult owing to the absence of data, mobility of individuals and inability of individuals to pay tax (Ezenagu, 2019). A telling example of unrecorded inflows and outflows is the transfer of remittances through informal channels, such as the hawala system (UNODC, 2018).

Under Sustainable Development Goal 16, the objective of curbing IFFs is noted alongside that of ensuring responsive, inclusive, participatory and representative decision-making at all levels. The lack of gender diversity in the decision-making bodies of banks and other institutions was put in the spotlight in the aftermath of the 2008 global financial crisis. Poor gender diversity in senior leadership positions in financial institutions and the role of groupthink and reckless decision-making in provoking the crisis was underlined.<sup>39</sup> In a series of papers that followed the crisis, IMF research showed that the presence of women and a higher share of women on the boards of banks was associated with greater bank stability and a lower share of non-performing loans (Sahay et al., 2017). However, there has been little change in gender diversity performance among the leadership of financial institutions and there is limited evidence from studies based on econometric methods in ascertaining innate behavioural differences between men and women. Instead, research results pinpoint the role of acquired behaviours in determining group attitudes and decision-making. Studies on gender parity show poor performance in the global financial services sector. Across all positions, women represent 32 per cent of new recruits in financial services globally and 17 per cent in asset management (Boston Consulting Group, the Sutton Trust, 2014).

## 3.4 The movement for tax justice

### *Key actors in the global fight for tax justice*

The present report argues that the fundamental flaws of the international corporate taxation system are sustained by the dominant principles of the Westphalian system (Palan, 2002). However, until the early 2000s, the international corporate taxation system proved to be resilient to calls for change due to the growing complexity of

<sup>38</sup> See <https://www.justice.gov/opa/pr/hsbc-holdings-plc-and-hsbc-bank-usa-na-admit-anti-money-laundering-and-sanctions-violations>.

<sup>39</sup> See <https://www.theguardian.com/business/2018/sep/05/ff-it-was-lehman-sisters-it-would-be-a-different-world-christine-lagarde>.

international trade, the growth in international flows of capital, the growth of the service industry and the disruptive effect of the digital economy. The seeds of change were planted in the aftermath of the 2008 global financial crisis. As most countries faced soaring government debt, media reports about MNE profit-shifting activities were met with increased attention by some Group of 20 countries.

At the multilateral level, a few initiatives were established as early as the 1980s to improve tax-related standards. The Multilateral Convention on Mutual Administrative Assistance in Tax Matters was developed by OECD and the Council of Europe in 1988, updated in 2010 and signed by 130 jurisdictions (OECD, 2019b). In the same vein, the Global Forum on Transparency and Exchange of Information for Tax Purposes was set to be the multilateral framework through which the international standards on tax transparency and exchange of information would be monitored and reviewed. Finally, the Financial Action Task Force was established as an intergovernmental body that develops and promotes policies to protect the global financial system against money-laundering, terrorist financing and the financing of the proliferation of weapons of mass destruction. As such, the Financial Action Task Force recommendations are recognized as the global anti-money-laundering and counter-terrorist financing standard.

There has also been increasing awareness among African countries on having given away more taxing rights than other regions during their bilateral treaty negotiations (Daurer, 2014; Hearson, 2016). A press release by a group of finance ministers from developing countries, for example, stated: “The global tax system is stacked in favour of paying taxes in the headquarters countries of transnational companies, rather than in the countries where raw materials are produced. International tax and investment treaties need to be revised to give preference to paying tax in ‘source’ countries” (Francophone [Low-Income Countries] Finance Ministers Network, 2014). Strikingly, tax justice has become a rallying point for a coalition of civil society organizations, supported by academic research and revelations by investigative journalists and whistle-blowers.

Civil society organizations have uncovered many cases of IFFs, raised public awareness and put pressure on revising harmful practices. They play a vital role in closing the gap between IFFs being considered as a technical issue and as a political and social concern. Investigative journalists have also played a key role in uncovering the mechanics, spread and magnitude of IFFs. Following the release of a group of papers in 2017, for example, and the public attention that followed, in a number of countries, legislative bodies conducted enquiries into transfer pricing and tax avoidance (see, for example, France, Assemblée Nationale, 2019; chapter 7).



The movement for tax justice has been active on many fronts in Africa. African countries created the African Tax Administration Forum (ATAF) in 2009, initially to stimulate the exchange of information and collaboration between national tax authorities. In addition to information exchange, ATAF aims to improve the capacity of African tax administrations, improve revenue collection, provide a voice for African countries on regional and global platforms to influence the international tax debate, and develop and support partnerships between African countries and development partners.

With regard to tax treaties, many developing countries have begun to reconsider their content. Malawi, Rwanda, Senegal, South Africa and Zambia are among those countries that have cancelled or renegotiated tax treaties in recent years, while others, such as Uganda, have undertaken reviews (Hearson, 2015). Perhaps in response to the international debate and the threat of further cancellations, Ireland and the Netherlands, for example, have reviewed the impact of their treaty networks on developing countries and offered partial renegotiations (Netherlands, Ministry of Finance, 2013; Ireland, Ministry of Finance, 2015). The net effects of these negotiations have yet to be fully assessed. In addition, civil society groups have begun to mount campaigns against particular tax treaties, for example, a lawsuit challenging a treaty between Kenya and Mauritius.<sup>40</sup>

With regard to abusive transfer pricing and tax avoidance, the consideration of affiliates of MNEs as separate independent entities has been increasingly contested. The intensification of global value chains and the resulting increase in trade in intermediates have led affiliates to become ever more integrated. However, as noted by the Independent Commission for Reform of International Corporate Taxation (2018), “revisions to transfer pricing rules continue to cling to the underlying fiction that an MNE consists of separate independent entities transacting with each other at arm’s length.” Yet the corresponding accounting treatment of MNEs as consisting of separate entities is also reflected in tax treaties negotiated with African countries and in the national tax law of African countries.

<sup>40</sup> The Tax Justice Network Africa challenged the Kenya–Mauritius tax treaty signed in 2012. It highlighted that the treaty never came into force because the Government of Kenya did not follow the ratification procedures required by law. In addition to the procedural issue, Tax Justice Network Africa claimed that the tax treaty led to revenue loss and encouraged tax avoidance. In 2019, the High Court in Kenya agreed with the position of Tax Justice Network Africa on the procedural issue but held that it had not successfully proven the claim of revenue loss and tax avoidance and did not bring expert witnesses to substantiate the claim. Thus, the court could not rule on that claim, but ruled that the tax treaty was invalid. At the time of writing, the case is on appeal. At the same time, a new treaty to avoid double taxation was signed between the two countries in 2019 (Lewis et al., 2013; ActionAid, 2016; [www.theeastafrican.co.ke/business/Court-nullifies-Kenya-tax-deal-with-Mauritius/2560-5052628-948m33/index.html](http://www.theeastafrican.co.ke/business/Court-nullifies-Kenya-tax-deal-with-Mauritius/2560-5052628-948m33/index.html)).

### *Towards a reshuffling of taxing rights? The state of African engagement in international taxation reform*

The limited institutional capacity in most African countries on international taxation issues is an illustration of the inadequacy of the international taxation system of the past 100 years. It is widely agreed, for example, that the separate entity approach and the tools to implement it are likely too complex and expensive for many African countries to manage (Waris, 2017). Similarly, dynamics of engagement in international taxation reform are shaped by substantial differences in institutional capacity and emerging imbalances in the likely impact of new regulations. Reed and Fontana (2011), for example, observe that regimes on anti-money-laundering imposed on developing countries have been much stricter than those forced on secrecy jurisdictions in advanced countries.

In 2012, further to decisions made in the aftermath of the financial crisis, in the context of fostering more transparency on international taxation and better alignment of taxation with economic activity, the Group of 20 called on OECD to reform the international corporate tax system. In 2013, OECD published a report titled “Addressing base erosion and profit shifting”. The report documents the impact of profit shifting by multinational corporations. Furthermore, acknowledging the changing landscape of globalization, it states that the current conventions may not have kept pace with changes in global business practices. The report further states that some multinational corporations have engaged in aggressive tax optimization practices which raise “serious compliance and fairness issues” (OECD, 2013).

As part of the BEPS Framework, from 2012 to 2015, OECD and the Group of 20 undertook a review of the OECD international corporate tax instruments. Efforts were directed at closing the gap in international rules, in particular those that “allow corporate profits to disappear or be artificially shifted to low/no tax environments, where little or no economic activity takes place” (OECD, 2016). The initiative also meant to reform the permanent establishment definition and curb the tendency of multinational corporations to avoid permanent establishment status in countries in which they have significant business activities.

A major outcome of the review was the creation of a multilateral instrument to introduce changes to existing tax treaties. The instrument includes options for anti-abuse rules and rules to prevent avoidance in specific areas, including permanent establishment and capital gains. Other important outcomes were the introduction of a framework for country-by-country reporting of financial data by MNEs and, in 2016, the creation of an innovative “inclusive monitoring framework” which now counts 136 countries,

including 25 from Africa.<sup>41</sup> In the years that have followed, OECD has embarked on an ambitious project to reform the international corporation system. However, as shown in the discussion of the state of progress in the reforms of the international taxation regime in chapter 7, this is proving challenging. In practice, the challenge lies in the definition of new rules that would satisfy all parties, developed and developing countries and corporations active across different global industries, combined with the embeddedness of digitalization across value chains.

There have also been more calls for collaboration on international taxation in the context of the Sustainable Development Goals. In this context, in 2016, the United Nations, the World Bank, IMF and OECD launched the Platform for Collaboration on Tax. The Platform aims to better frame technical advice to developing countries as they seek both more capacity support and greater influence in designing international rules in light of the growing importance of taxation in the debate on how to achieve the Goals. While the initiative illustrates broad interest in the topic, there has only been one global conference of the Platform to date.<sup>42</sup>

Notwithstanding capacity constraints, a number of African countries are present in international tax bodies (table 6). African countries that have not joined the BEPS Framework have not done so for a number of reasons. First, many cannot comply with the four “minimum standards” set by the Group of 20 and OECD, namely, country-by-country reporting of corporate financial information; preventing tax treaty abuse; curbing harmful tax competition; and resolving disputes between States that create double taxation. Second, countries are sceptical about their ability to participate meaningfully in the Framework’s intense Paris-based work programme. Third, the availability of adequate human resources is limited, which is a major hindrance to fully engaging with, presenting and defending an African position (ATAF, 2019). The outcome statement of the ATAF meeting highlights the disconnect between the policy and administrative levels of a country, emphasizing challenges of information-sharing between the two. On one hand, commitments at the policy level to join the BEPS Framework have been made without consideration of the compliance burden entailed. On the other hand, revenue officials participating in negotiations often struggle to gain the political support to follow through on their negotiating positions.

<sup>41</sup> See <https://www.oecd.org/tax/beps/g20-finance-ministers-endorse-reforms-to-the-international-tax-system-for-curbing-avoidance-by-multinational-enterprises.htm>.

<sup>42</sup> See <https://www.oecd.org/ctp/platform-for-collaboration-on-tax.htm>.

Table 6

**African representation in international tax bodies, as at September 2019**

Organization or agreement	Number of African members	Countries (steering groups only)
Global Forum on Transparency and Exchange of Information for Tax Purposes	31	
<i>Steering group</i>	2	<i>Ghana, Kenya</i>
Multilateral Convention on Mutual Administrative Assistance in Tax Matters	10	
<i>Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports</i>	7	
<i>Common Reporting Standard [on automatic exchange of information] Multilateral Competent Authority Agreement</i>	6	
Inclusive Framework on BEPS	25	
<i>Steering group</i>	4	<i>Côte d'Ivoire, Nigeria, Senegal, South Africa</i>
<i>Multilateral Instrument on BEPS</i>	12	
United Nations Committee of Experts on International Cooperation in Tax Matters	6	Djibouti, Ghana, Kenya, Liberia, Nigeria, Zambia

Source: Hearson (forthcoming) based on OECD and United Nations membership lists.

### 3.5 Concluding remarks

This chapter has focused on a selected set of avenues for enabling IFFs. All of them are likely to have a detrimental effect on financing for development. Tax treaty shopping, in particular, exemplifies the complexity of international taxation and stiff tax competition among countries. Considering the dominant features of the current international corporate system, race to the bottom as a strategy for attracting FDI is likely to continue. While the fiscal costs of a treaty might be a price worth paying for its investment promotion benefits, the evidence that tax treaties attract investment into developing countries is contested and unclear (Sauvant and Sachs, 2009; Hearson, 2018). Moreover, this debate should account for the effect of tax treaty shopping on the competitiveness of local firms. As only international firms can shift profits and reduce prices through lower taxes, local firms are subject to higher local tax rates. As shown in chapter 4, potential development gains or losses can be further exacerbated by the interaction between taxation issues, international investment agreements and the regulatory framework of mining value chains.

In light of the 2030 Agenda for Sustainable Development, the fundamental features of the international taxation system underline the need for further research on the

distributional impact of profit shifting. Although not addressed in this report, there is evidence that globally, profit shifting results in reduced corporate income taxes (Zucman, 2019). Considering the financing needs of African countries, some of the losses might be compensated by a broadening of the tax base, as investigated in chapter 6.