Chapter 4

The regulatory environment of illicit financial flows with a special focus on selected sectors

This chapter provides an overview of the regulatory environment within which IFFs are conducted. It focuses on selected sectors while also addressing the wider regulatory environment. IFFs stem from some parts of the productive economy (chapters 1–3). In Africa, extractive industries have been singled out (UNECA, 2016). In what follows, cross-cutting data constraints across value chains are highlighted (section 4.1) with a brief rationale behind the focus on extractives. The regulatory framework within which IFFs in extractive industries operate is discussed in section 4.2. Section 4.3 sheds light on other sectors that are also prone to high risks of illicit practices. Section 4.4 offers an introduction to the broader regulatory environment on taxation, corruption and money-laundering. In addition to the regulations in home States, FDI projects are subject to binding bilateral agreements between home and host States, and these are examined in section 4.5. Finally, much like the international legal system discussed in chapter 3, the broader imbalance in terms of engagement between investors and the host country in the sectors most prone to IFFs is partly rooted in the structural inequalities of the international economic system, and these are examined in section 4.6, followed by some concluding remarks.

IN AFRICA, TAXATION CLAUSES IN MINING CONTRACTS VARY WIDELY.

For example, royalty rates range from:

5%
on gold in Ghana

2-2.5%
on copper in the Democratic Republic of the Congo

0.075%
on bauxite and
3%
on iron ore in Guinea

AFRICAN COUNTRIES MUST COORDINATE MORE

on tax in the mining sector

4.1 Data opacity across value chains and the special case of extractives

Difficulties in the analysis of IFF risks across value chains are compounded by the opacity that characterize some of its segments. Indeed, a company's supply chain can involve multiple tiers of suppliers, potentially delaying the company's request for compliance information about upstream suppliers. Companies could submit inquiries to their first-tier suppliers, that in turn could either provide the required information or initiate the inquiry process up the supply chain to the next tier. The process could continue until inquiries reach the level of the production facility. These difficulties were apparent in the application of the 2012 Dodd-Frank Act on industries involved in consumer products. The application of the disclosure requirement of the Act revealed that a majority of companies with final products that relied on minerals as intermediates were unable to determine the country of origin of the conflict minerals in their products and whether such minerals benefited or financed armed groups in the countries covered (United States, Government Accountability Office, 2015).

With regard to sectoral characteristics, research on the sources of risks of IFFs shows that a mineral such as gold is more prone to IFFs than an agricultural product such as cocoa (Brugger and Engebretsen, 2019). For the latter, the risks are mostly related to smuggling, and in the gold sector, the risks are present from exploration to the awarding of contracts, through production, processing, assaying, selling, customs and final export (Brugger and Engebretsen, 2019). At the exploration stage for example, illicit practices include inflating expenditure, bribery and illicit transfers of trade samples collected. During the production stage, there is also evidence that the tax deductibility of internal loans that surpasses a permissible threshold as a result of reinvestment or expansion may result in a particular risk (Miyandazi, 2019).

The sources of IFFs in the extractive sector can be classified in three categories (Le Billion, 2011): proceeds of corruption derived from the abuse of public authority for personal gain; revenues from illegal resource exploitation that prevent the State from receiving its legal share; and tax evasion initiated by the investor. These three causes are not mutually exclusive and often occur together. The first cause, corruption and its associated dysfunctional institutions, is often cited as a key enabler of the negative association between natural resource abundance and development, leading to what has been coined the "resource curse" and the so-called "paradox of plenty" (Auty, 1993; Sachs and Warner, 1995; Karl, 1997).

The magnitude of the second cause, illegal exploitation and trading of minerals, is such that transparency initiatives such as the Kimberley Process Certification Scheme help uncover the extent of discrepancies between actual and reported production in the minerals sector. It has been shown, for example, that due to smuggling and underreporting, the global production of diamonds was nearly twice as large as previously estimated, although the lack of more recent data limits further investigation of the issue (World Bank, 2008).

With regard to the third cause, tax evasion, countries need to weigh the costs and benefits associated with building specialist capacity for assessing tax in the extractive sector. If the tax office believes there is a consistent and wide gap between the market and the values reported by exporters, it may warrant investing in the specialized information and expertise, as well as laboratory services, needed to verify and potentially challenge exporters' declared values. Building these sector-specific auditing capabilities can be expensive and challenging, as it requires deep knowledge about how prices are set and deals are struck for each product. Tax assessors also need a detailed understanding about how tax filings are impacted by other aspects specific to extractive industries, such as the importation of specialized machinery, the procurement of technical services and hedging and financing arrangements – especially the use of debt – which can be more challenging to assess (United Nations, 2017). Finally, more general tax avoidance challenges associated with, for example, capital gains tax and indirect transfers, are also significant across mining value chains.

4.2 Illicit financial flows and the regulatory framework of the extractive sector in Africa

As stated in chapter 2, mining policies and activities in Africa should be guided by the African Union AMV. Mining operations should also be subject to several international guiding principles such as the United Nations Guiding Principles on Business and Human Rights. These frameworks are soft law instruments and as such are not legally binding. This section focuses on the dominant features of domestic legislation of relevance to extractive industries and on mining contracts.

The legal and regulatory framework at the domestic level

The extractive sector is subject to the hierarchy of the legal norms of the host country. Although practices of domestication of international laws vary, domestic laws are the default rules when no other special normative regime referring to the primacy of international law over domestic law applies (Chibundu, 2010). As shown in figure 12, the hierarchy of legal norms includes the constitution, followed by a body of national laws that comprise the mining code, and laws on investment, trade, taxation, labour protection, infrastructure and environmental protection and other country-specific legislation.[43] The constitution sets out the most fundamental principles for the governance of economic activities, such as State sovereignty over natural resources, ownership and protection of property, the protection of local communities and protection of the environment and human rights. It enacts the permanent State sovereignty over natural resources, citizens' right to a healthy environment and the need to protect the environment for both present and future generations (LEX Africa, 2019).[44] Constitutional law also governs the distribution of power among different government entities and agencies. For example, the constitutional law of Ghana requires parliamentary ratification of all mining contracts involved in the granting of rights or concessions on behalf of the Government. Finally, FDI projects in extractive industries are also governed by the enabling framework for investment, including the tax code, and environmental and foreign exchange regulations. Despite the wide array of legislation, as shown in figure 12, most countries lack implementation and enforcement capacity, especially in assessing IFFs (Musselli and Bürgi Bonanomi, 2020).

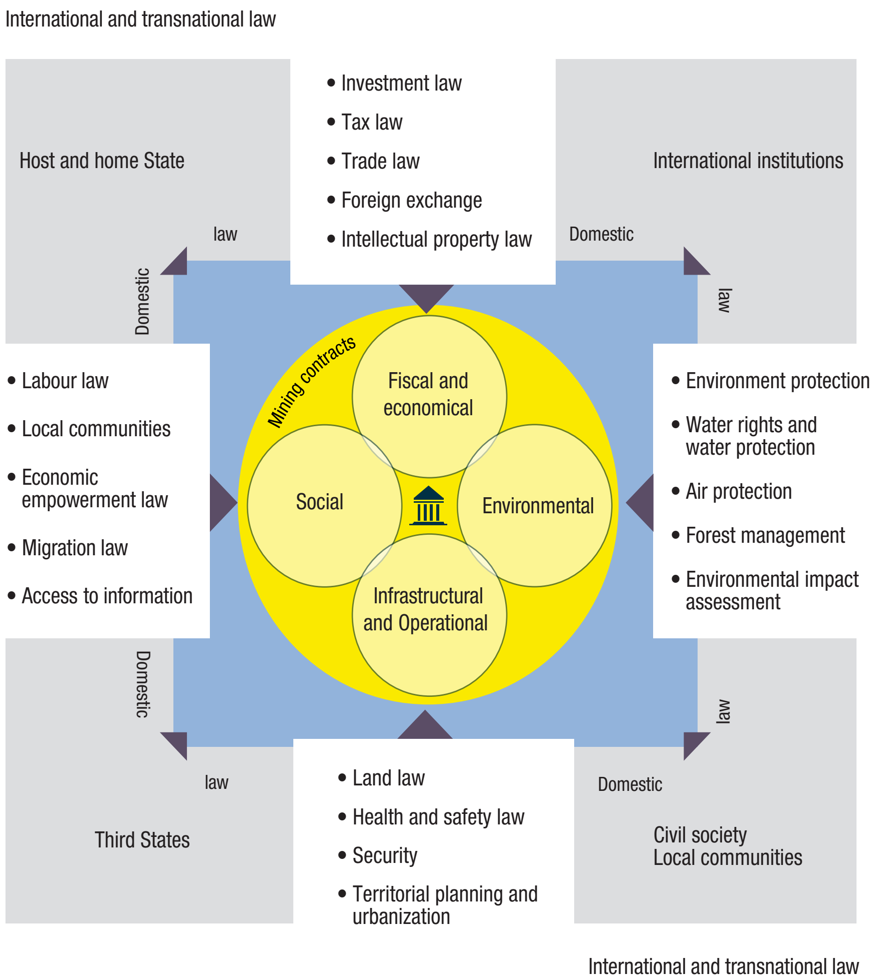
A comprehensive analysis of transfer pricing legislation in Africa by the World Bank found that most African countries do not have an appropriate transfer pricing framework (Guj et al., 2017). Transfer pricing is addressed either in the general tax law or a financial act. Examples of countries in which some of these acts address anti-avoidance include Côte d'Ivoire, Madagascar, Mali and Sierra Leone (Guj et al., 2017:94). Although most countries have a mining code, despite the adoption of AMV, aimed at making the African mining sector an engine for the transformation of the continent, several analyses show that even during commodity booms, many mineral-rich countries have not improved their socioeconomic performance (UNCTAD, 2017). Growing concerns for the sector's poor development record, evidence of the magnitude of IFFs and the emergence of civil society organizations working on transparency issues, contributed to a trend leading to the review of mining codes in Africa (Bridge, 2004).

[43] For a summary of the mining law regime in about 15 African countries, including on the relevant authorities and legislation, acquisition of rights, rules on indigenous peoples' rights, disposal of rights, the environment, health and safety, royalties and taxes, see DLA Piper (2012) and LEX Africa (2019).

[44] Constitutional law of Mozambique, Namibia and Nigeria (LEX Africa, 2019).

Figure 12

Legal and regulatory framework in the mining sector in Africa



Source: UNCTAD secretariat.

Mining contracts

Mining contracts are widely used across the mining sector as a complement to domestic legislation.[45] An examination of contracts covering gold, copper and cobalt, aluminium and bauxite across a sample of three countries (the Democratic Republic of the Congo, Ghana and Guinea) reveals a high level of variance in their fiscal clauses (table 7). Royalties, for example, can range from, in Ghana, 5 per cent of the revenue on gold, as prescribed in the mining code to, in Guinea, 0.075 per cent on bauxite and 3 per cent on iron ore. Mining contracts also vary in terms of the treatment of affiliated company transactions. For example, in Guinea, different companies have different contractual provisions on the obligation to comply with the best transfer pricing practices and that of the pre-emptive right of the State to purchase the mineral products when it considers the transfer price too low. In contrast, in the Democratic Republic of the Congo, contracts do not make any mention of such transactions. Rather, the 2018 Mining Code stipulates that transactions between affiliates be conducted on an arm's length basis.

The examination of publicly available contracts in a sample of African countries shows that mining contracts play a significant role in mining investments on the continent.[46] State participation varies and includes either shares to be held by State-owned companies or shares held by the Government. Mining contracts also increasingly include provisions on their development contribution. In the contracts examined in table 7, these range from 20 per cent of royalties as required by domestic legislation in Ghana to 0.5–1 per cent of the revenue and subject to the Community Development Agreement between the company and the local community in Guinea.

It is also common for such mining contracts to include a stabilization clause, which freezes the applicable domestic law during the period of the project. While contracts are normally concluded under and subject to domestic law, mining contracts are often internationalized and apply international law or provide recourse to international dispute settlement mechanisms, a provision that is also readily available in the bilateral investment treaties between the home country of most investors and the African host country in which the project is located.

[45] Confidential interviews by a member of the present report's team with partners from two law firms with offices in mineral-rich countries in Africa.

[46] Ibid. See https://resourcecontracts.org/.

Table 7
Selection of fiscal clauses in mining contracts in the Democratic Republic of the Congo, Ghana and Guinea

	Democratic Republic of the Congo	Ghana	Guinea
Resource	Copper and cobalt	Gold	Aluminium and bauxite
Year of signature	2005–2010	2008–2015	2010–2018
Payment recipient	Government and State-owned enterprise	Government	Government and State-owned enterprise
Royalties	2–2.5 per cent of the revenue, less certain costs under most contracts	5 per cent of the revenue, as prescribed by the Mining Code	0.075 per cent on bauxite, 3 per cent on iron ore and other non-ferrous minerals, as prescribed by the Mining Code
Bonus	Either a one-off payment or a combination of a fixed fee and a monthly fee or extra fees determined by the production capacity of the mine. The amount of the payment ranges from \$100,000 to \$100 million, depending on the size of the project and the terms of the contract	\$30,000–\$50,000 as consideration of the granting of the mining lease	Applicable law
State participation	17.5–30 per cent shares to be held by the State-owned enterprise, 10 per cent shares to be held by the Government, subject to further increase	10 per cent free carried interest for the Government as prescribed by the Mining Code, subject to further participation in the mining operation	5–15 per cent non-contributive shares held by the Government or State-owned enterprise, either with or without the right to purchase additional shares
Rental fees	Most contracts do not have such a clause; therefore, the Mining Code 2018 shall apply: \$0.2–\$0.4 per hectare per year during exploration; \$0.4–\$0.8 per hectare per year during exploitation	From 8.5 to 260 Ghanaian cedi per half year	\$10–\$20 per square kilometre during exploration, \$75–\$300 per square kilometre during exploitation, depending on the type of licence and times of renewal
Corporate income tax	30 per cent, the same rate provided in certain contracts and the Mining Code 2018, which shall apply when contracts do not include such a clause. Mining companies are also subject to windfall profit tax, as provided in the Mining Code 2018	35 per cent, as prescribed by the Income Tax Act 2015	35 per cent, but most contracts provide certain tax incentives, such as tax holidays (normally 5–6 years) or a lower tax rate at the beginning of exploitation

Table 7
Selection of fiscal clauses in mining contracts in the Democratic Republic of the Congo, Ghana and Guinea *(continuation)*

	Democratic Republic of the Congo	Ghana	Guinea
Development contribution	0.3 per cent of the revenue or other amount agreed in the contract	20 per cent of the royalty contributed to a development fund, as prescribed by the legislation	0.5–1 per cent of the revenue, subject to the Community Development Agreement concluded between the company and the local community
Affiliated company transactions	No relevant terms in contracts, but according to the Mining Code 2018, any business transaction between affiliates shall be conducted on an arm's length basis	Standard term in most contracts: (a) A fair and reasonable price for services and provide justifications when required; (b) All transactions on the basis of competitive international prices and upon fair and reasonable terms and conditions; (c) Notify the minister of all transactions and supply details when required	Great variance among mining contracts, which may include some of the following elements: (a) Arm's length principle and best transfer pricing practices should be complied with; (b) Obligation to declare and report affiliated transactions included in most contracts; (c) Prior approval for either the transfer pricing method or the affiliated transaction is required under certain circumstances; (d) Pre-emption right of the State to purchase the mineral products when it considers the transfer price too low
Stabilization	From the date of signature to the entire duration of the agreement, covering both fiscal and non-fiscal issues	No stabilization clause in most contracts	During the period of the mining concession, most stabilization clauses only cover taxation and custom duties

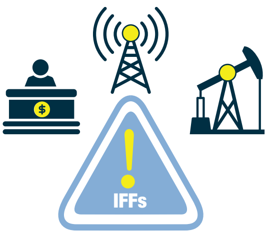
Source: UNCTAD secretariat and https://resourcecontracts.org/.
Note: In 2019, only 15 out of 27 countries in sub-Saharan Africa disclosed contracts on investment projects in the extractive sector and only six of these disclosed sufficient details for analysis.

4.3 Other selected sectors with high risks of illicit financial flows

Telecommunications and private equity

The other two sectors in which tax avoidance issues have received attention due to their high-profile nature are telecommunications and private equity. Sub-Saharan Africa is the world's fastest growing market for mobile telecommunications. The total number of subscribers is expected to increase from 456 million in 2018 to over 600 million by 2025, half of the continent's population (GSMA, 2019). A common tax evasion practice known as "SIM[subscriber identification module] box fraud", for example, involves operators making false declarations of incoming international call minutes to reduce the tax payable to the Government (UNECA, 2015).

The telecommunications sector is also prone to market concentration as it is dominated by a small number of multinational corporations and contributes to an estimated 8.5 per cent of GDP at the continental level and raises about $15.6 billion in taxes. This relatively limited competition has allowed companies to generate significant rents (Matheson and Petit, 2017). As shown in box 4, the telecommunications sector has also been subjected to several tax disputes. These disputes have uncovered the complex interactions between the establishment status of affiliates, tax treaty shopping and the implications of the application of the domestic tax code.



Sectors most vulnerable to IFFs
and tax disputes
include extractives, financial services and telecommunications

With regard to private equity, in addition to publicly owned direct investors, there are also high-profile cases in the area of social impact investors. Private equity investment structures typically involve a pooling vehicle located in an intermediate jurisdiction. Mauritius is often the chosen location in Africa (Hearson, forthcoming). This provides a number of tax and non-tax benefits that investors argue are crucial to the business model (Carter, 2017). However, the tax treaty networks of Mauritius and other pooling jurisdictions can reduce the ability of the country in which the investment takes place to tax dividends and interest payments and capital gains. Investors argue that eliminating such taxes allows them to invest more widely in Africa, that the economic burden of withholding taxes would ultimately fall on the recipient of the investment and that the alternative to pooling offshore would be to use an onshore jurisdiction in an OECD country that had an advantageous treaty with the recipient country (Carter, 2017).

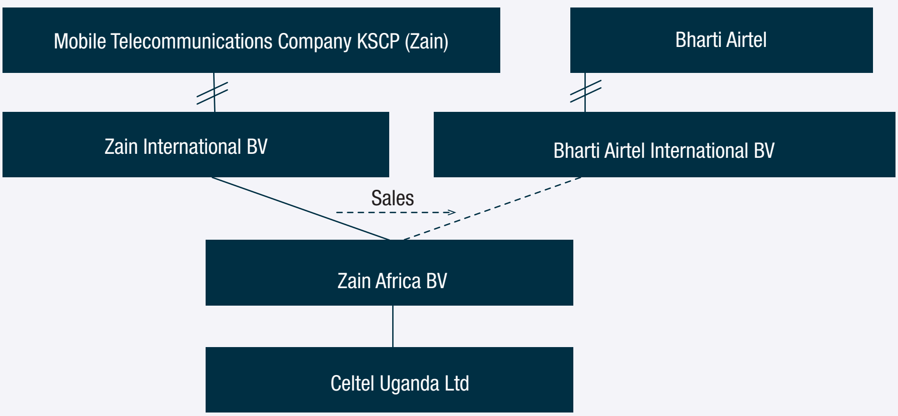
Box 4

Tax dispute on capital gains: The case of mobile telecommunications from Kuwait in Uganda

An ongoing dispute exists between the Uganda Revenue Authority and the mobile telecommunications company Zain, from Kuwait. The dispute concerns the sale of the latter's subsidiary in Uganda. At the time, Zain International owned Zain Africa BV, which had equity in 26 companies, all registered in the Netherlands. As a result, the sale took place through the transfer of shares in a holding company based in the Netherlands. At stake is a tax assessment of $85 million. The Uganda Revenue Authority states that Zain is liable to pay capital gains tax on the transaction, although it took the form of an offshore indirect transfer in the Netherlands. Indirect transfers of companies whose value derives primarily from immovable property (in this case, telecommunications infrastructure) are taxable under the domestic tax code of Uganda, but not under the tax treaty between the Netherlands and Uganda.

Zain declined to pay, stating that the Uganda Revenue Authority had no jurisdiction to levy tax on Zain Africa BV because it was resident in the Netherlands and did not source the income from Uganda. The Uganda High Court in Kampala initially ruled in favour of Zain in December 2011. The case attracted attention across the 26 countries in which Zain operates in Africa. However, the tax law of Uganda includes an anti-abuse rule designed to prevent treaty shopping. In its ruling in favour of the Uganda Revenue Authority in 2014, the Court of Appeal only covered a procedural matter. It is therefore unclear whether the Revenue Authority or Zain would be successful with regard to the content, as Zain has not appealed further. The Revenue Authority cannot enforce its tax assessment without assistance from the Netherlands, which the treaty provides for, since Zain no longer has any assets in Uganda.

The indirect transfer can be illustrated as follows.



Source: Hearson and Kangave, 2016.

New technologies and the digital economy

The emergence of new business models stemming from the digital economy has given rise to a number of challenges related to IFFs in both developed and developing countries. With regard to taxation, an OECD paper points to three ways in which digitalized businesses are harder to tax under existing rules: the ability to generate value in a country without a physical presence; the importance of data, a new and different type of commodity; and the importance of intangible assets (OECD, 2018c; UNCTAD, 2019b). Nonetheless, digital business models also allow firms to avoid tax liabilities that Governments intend them to pay. For example, intangible assets are hard to value and easy to move, which makes them an important tool in profit-shifting strategies; the minimal physical presence needed for digital business models allows firms to design business structures that circumvent existing permanent establishment rules.

African Governments are seeking to address this problem through a variety of routes beyond simply corporate income tax. To address the main problem of low corporate income taxes, some African countries have adopted a range of innovative measures (Hearson, 2018). Kenya, for example, recently designed a proposal to expand its definition of permanent establishment, to include digital advertising platforms. Some African countries have been seeking to use other taxes to respond to the situation. This includes value-added tax, which, for example, South Africa has now imposed on sales of applications through mobile platforms. Uganda has attempted to levy value-added tax on foreign providers of digital services. Several countries, including Uganda and Zimbabwe, have also introduced taxes on digital financial transactions.

Furthermore, digital technologies have expanded opportunities for cybercrime and offered platforms to trade illegal goods and services by offering a wide range of features that facilitate the illegal transfer and use of money (Tropina, 2016), including the following the following:

(a) Automation, speed and cross-border nature, which allow money to be quickly transferred across different jurisdictions;

(b) Anonymity, which reduces the ability to perform customer checks;

(c) Complexity of online transactions, which allows for multiple activities;

(d) Insufficient or no regulation of most intermediaries operating online, which enables transactions to take place without anti-money-laundering measures.

Malhotra (2010) notes that the above features allow for the division of transactions into small amounts, below the reporting threshold, and for them to be performed rapidly through different institutions and jurisdictions. As a result, it becomes nearly impossible to detect IFFs and trace them back to their origins. They thus provide a means to distance money from illegal sources and the means to illegally transfer money from legal sources.

There are several tools associated with money-laundering and digital technologies, such as mobile banking or online non-bank payment services. Online non-bank payment services, in particular, are prone to IFFs, owing to their largely unregulated nature. These services provide a fast, cheap and anonymous means to make payments and international transfers, which makes them vulnerable to illicit transfers.

4.4 Cross-cutting regulations of relevance to illicit financial flows

Taxation standards and legislations

Transparency and cooperation between tax administrations globally is key in the fight against tax evasion and tax avoidance. In this regard, the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, established in 1988 and originally limited to OECD and Council of Europe members, has, since 2008, been open to all interested countries. By joining this agreement, countries can obtain the right to request information on their taxpayers' affairs from all other signatories. The Convention also offers the legal framework through which to cooperate when investigating multinational taxpayers, without the need to negotiate dozens of bilateral deals. To date, 10 African countries have joined the convention (Hearson, forthcoming). However, the need for compliance with this Convention has been underlined as not adequate to African countries due to capacity constraints (UNECA, 2015). Similarly, the Global Forum on Transparency and Exchange of Information for Tax Purposes conducts peer reviews of countries' compliance with OECD information-exchange standards and is backed by the threat of "defensive measures" from the Group of 20 (Hearson, forthcoming).[47] After ATAF, it is the tax body with the most African members, namely, 31.[48]

By joining, countries agree to be peer reviewed, but they also have more leverage if they seek access to tax information from another Global Forum member.

Most sub-Saharan African countries established a domestic transfer pricing regime only during the last decade; there are a few exceptions, such as South Africa in 1995 and

47 See https://www.oecd.org/tax/transparency/.

48 For the list of members, see www.oecd.org/tax/transparency/about-the-global-forum/members/.

Kenya in 2006. As at March 2019, about half of the countries in sub-Saharan Africa still did not have any form of domestic transfer pricing rules and therefore could not challenge MNEs through local judicial authorities (AndersenTax, 2019). Indeed, when domestic transfer pricing rules are available, they are the superior legal source and international instruments such as the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations can only be used as secondary sources; if no transfer pricing rules are available under the domestic regime and no guidance has been provided by the authority, the tax administrators cannot choose the rules ex post to the detriment of taxpayers. In effect, the few transfer pricing cases published in Africa suggest that most of the countries concerned did not have their first transfer pricing judgment until recently, for example, Zimbabwe in 2017, and Ghana, Malawi and South Africa in 2018. As a result, the transfer pricing methods and the applicability of the OECD Transfer Pricing Guidelines were at the centre of the debate in several of the cases.[49]

In Malawi, domestic transfer pricing regulations were already available at the time of a landmark dispute in 2016.[50] However, the audit report produced by the Malawi Revenue Authority did not refer to domestic regulations, but instead relied on the OECD Guidelines and directly quoted article 9 of the OECD Model Tax Convention to define the arm's length principle. In response to this, the judges stated that "where local legislation provides for the law, it is always imperative to apply that law" and international instruments can be used "in interpreting that local law". The tax administrator should "strictly follow the dictates of the law as enacted by the legislature" and "any slight departure from the law is not allowed". Therefore, the court of Malawi ruled the application of the OECD Guidelines and not the domestic transfer pricing regulations to be illegal.

In the other two cases, respectively in Kenya and Zambia, the courts ruled that the OECD Guidelines can be used by taxpayers for transfer price calculation, although these rules are not part of the domestic legal system. The court in Zambia, for example, acknowledged the use of the OECD Guidelines and the United Nations *Practical Manual on Transfer Pricing for Developing Countries* when there is a lacuna in domestic legislations at the time of the case. However, the court pointed out that the domestic transfer pricing regulation was issued in 2018 and should now become the first reference point for transfer pricing practices.[51] Interestingly, the court in Kenya expressed its concern about the lack of relevant transfer pricing rules in the judgment and said that while "unfortunately our Act is silent on such methods to be employed or

[49] For the first transfer pricing case in South Africa, see Brink (2018).
[50] See https://www.africataxjournal.com/wp-content/uploads/2018/08/TP-MALAWI-JUDICIAL-REVIEW-Eastern-Produce-MW-Ltd-vs-MRA-Transfer-Pricing-Applicability-of-OEC...-2.pdf.
[51] Nestle Zambia Trading Ltd v Zambia Revenue Authority, Tax Appeals Tribunal, 2018/TAT/03/DT, available at https://www.africataxjournal.com/wp-content/uploads/2019/04/Nestle-vs-ZRA-TP-Case-2019.pdf.

used", the court hoped that the Kenya Revenue Authority would "lead in the initiative to make rules in this regard".[52]

Corruption and money-laundering

Several international instruments have established legal obligations of relevance to the regulation of IFFs. The following conventions criminalize either the origin of IFFs, corruption, money-laundering or the use of flows, such as in the financing of terrorism: United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances, 1988; International Convention for the Suppression of the Financing of Terrorism, 1999; United Nations Convention against Transnational Organized Crime, 2000; United Nations Convention against Corruption, 2003; and a number of United Nations Security Council resolutions establishing targeted financial sanction regimes applied to terrorist groups.

With regard to corruption, the United Nations Convention against Corruption covers five main areas, namely, preventive measures, criminalization and law enforcement, international cooperation, asset recovery and technical assistance and information exchange. In addition, as part of their anti-corruption initiatives at the domestic level, a majority of countries globally have enacted laws that require officials to disclose their financial information (assets, income and liabilities) through financial disclosure frameworks. According to Guj et al. (2017), 176 countries have enacted respective laws, including all high-income OECD countries, 89 per cent of countries in sub-Saharan Africa and 61 per cent in the Middle East and North Africa.

Anti-money-laundering laws and regulations are critical in the fight against corruption as they criminalize a type of conduct that is related to the corrupt act itself (World Bank, 2004). In terms of money-laundering, the set of global standards on the fight against the laundering of the proceeds of crime that has become the main reference is the 40 recommendations of the Financial Action Task Force (2003). While not binding, these recommendations set out several requirements for combating money-laundering. Critically, they recommend that countries should criminalize money-laundering so that these actions can be prosecuted. Financial institutions should be obliged to keep records of all transactions and perform customer due diligence. This entails knowing company ownership, or the beneficial owner of a customer that is a legal entity. Additional due diligence is required for politically exposed persons as, typically, these are particularly at risk of large-scale corruption. However, definitions of politically exposed persons differ across countries.

[52] Unilever Kenya Ltd v Commissioner of Income Tax [2005], Income Tax Appeal No. 753 of 2003 at 15, available at https://www.africataxjournal.com/wp-content/uploads/2018/08/Unilever-Kenya-Ltd-v-Commissioner-KRA-Income-Tax-Appeal-753-of-2003.pdf.

In countries with anti-money-laundering legislation, both financial institutions (banks, insurance companies and currency exchange services) and designated non-financial businesses and professions (for example, lawyers, accountants and casinos) are required by law to notify a public agency when they find a suspicious transaction report. These agencies are mostly financial intelligence units. While almost all countries have a financial intelligence unit, their institutional set-ups and capacities in terms of mandate and resources differ widely. As in all other countries, it is critical that financial intelligence units in African countries be shielded from political pressure so that they can perform their functions independently (IMF, 2004).

4.5 The prevalence of bilateralism

Investment treaties, taxation and dispute settlement mechanisms

IFFs from commercial activities are operated within an environment framed by international investment agreements, notably bilateral investment treaties, regional treaties and others. In addition to bilateral investment treaties, international investment agreements also comprise treaties with investment provisions. These typically consist of three types of treaties: broad economic treaties that include obligations commonly found in bilateral investment treaties (for example, a free trade agreement with an investment chapter); treaties with limited investment-related provisions (for example, only those concerning the establishment of investments or the free transfer of investment-related funds); and treaties that only contain framework clauses such as the ones on cooperation in the area of investment and/or for a mandate for future negotiations on investment issues (UNCTAD, 2018).

Bilateral investment treaties constitute the main form of investment agreements used by African countries to attract FDI. There are now over 3,000 international agreements concluded by around 180 countries.[53] Their attractiveness is such that in 2018, countries signed some 40 new international investment agreements, including 30 bilateral investment treaties and 10 treaties with investment provisions, bringing the treaty universe to 3,317 agreements (UNCTAD, 2019c). Out of these, by January 2019, African countries alone had signed close to 1,000 international investment agreements, of which around 200 were intra-African, including numerous regional agreements. Regional agreements comprise the Investment Agreement for the Common Market for Eastern and Southern Africa Common Investment Area, the Economic Community

[53] See https://investmentpolicy.unctad.org/international-investment-agreements.

of West African States Supplementary Act on Investments and the Southern African Development Community Protocol on Finance and Investment, among others. In addition, many countries are increasingly bound by extraregional agreements such as the East African Community–United States Trade and Investment Framework Agreement, the European Union–Southern African Development Community Economic Partnership Agreement and the Economic Community of West African States–United States Trade and Investment Framework Agreement.[54]

These treaties confer a series of rights and obligations on contracting parties. In bilateral investment treaties, in particular, the obligations of States include the commitment to not discriminate against foreign investors by offering them national or most-favoured nation treatment, to offer fair and equitable treatment and to not expropriate investment without compensation. In addition, bilateral investment treaties mainly include a dispute settlement clause that allows investors to sue host States, typically bypassing domestic courts and allowing investors to directly bring international arbitration proceedings, most often at the International Centre for Settlement of Investment Disputes or under the United Nations Commission on International Trade Law arbitration rules. However, originally based on a system of ad hoc confidential commercial arbitration between private parties, the legitimacy of the investor–State dispute settlement system is now challenged (UNCTAD, 2018). By mid-2019, investors had brought more than 980 investor–State dispute settlement cases against 118 countries, including 117 cases against at least 30 African countries.[55] With more than half a century having passed since the first bilateral investment treaty was concluded (between Germany and Pakistan in 1959), international investment agreements have gone through a significant evolutionary process (UNCTAD, 2018:14). A system that was originally developed to foster legal predictability in investment relations between countries has today become a source of legal uncertainty, debate and controversy (El-Kady, 2016; El-Kady and De Gama, 2019:1).

Disputes over international taxation have been increasing in response to rising international trade and investment. Resolving such disputes is, however, problematic, as tax treaties generally do not provide direct access to arbitration. The main instruments for dispute resolution for international taxation issues are the mutual agreement procedures (OECD, 2007). Under such a procedure, taxpayers can submit a request to the competent authority in their resident State if they consider that the actions of the contracting States have resulted in taxation in disaccordance with the provisions of the underlying convention. If no solution is found, the case can be submitted for

54 Ibid.

55 See https://investmentpolicy.unctad.org/investment-dispute-settlement.

arbitration, which is non-binding and only imposes on the parties the obligation to negotiate (Chaisse, 2016). This highlights the limitations of the process. On one hand, the process is largely dependent on the decisions of the local tax authority and, on the other hand, the outcome is non-binding.

In light of the void in dispute settlement mechanisms on taxation, investor–State dispute settlement mechanisms were originally designed to resolve disputes on international investment issues and in some instances, investors can challenge the tax policy and tax measures of host States through this mechanism in international arbitration tribunals. This possibility arises if measures implemented by host States to address BEPS issues increase the tax obligations of investors and violate concepts for which international investment agreements offer protection to the investor, such as expropriation or violation of national treatment, most-favoured nation treatment and fair and equitable treatment. Investors therefore may claim that these measures are in breach of international investment agreements, while possibly in line with the spirit of double tax treaties and other international taxation cooperation regimes (Chaisse, 2016).

Over time, the need for systematic reform of the global international investment agreement regime has become evident. A shared view has emerged on the necessity of ensuring that the investment treaty regime works for all stakeholders. The UNCTAD publications *UNCTAD's Reform Package for the International Investment Regime* (UNCTAD, 2018) and *Investment Policy Framework for Sustainable Development* (UNCTAD, 2015b) offer policymakers more than 100 options for treaty drafting and the pros and cons of each. Concerns about the functioning of investor–State dispute settlements under investment treaties have been summarized in UNCTAD (2013). These concerns pertain to the following issues: legitimacy; transparency; consistency of arbitral decisions; erroneous decisions; arbitrators' independence and impartiality; financial stakes; and nationality planning. With regard to the latter, investors may gain access to investor–State dispute settlement procedures using corporate structuring, that is, by channelling an investment through a company established in an intermediary country with the sole purpose of benefiting from an international investment agreement concluded by that country with the host State (UNCTAD, 2013).

The UNCTAD reform package includes provisions on taxation that are of relevance to the regulation of tax-related IFFs. Key reform options, from a tax perspective, relate to carving out taxation policies (including double taxation treaties) from the scope of the treaty (UNCTAD, 2015b:94, policy option 2.3.1), from the treaty's non-discrimination clauses (UNCTAD, 2015b:96, policy options 4.1.3 and 4.2.2) or from the treaty's dispute settlement clause (UNCTAD, 2015b:106, policy option 6.2.1).

Reform of international investment agreements is also well under way in African countries, including on ways to address taxation issues. At present, African countries are taking a more active approach in the formulation of their international investment commitments, at the national, bilateral and regional levels. Africa is becoming a “laboratory for innovative and sustainable development-oriented investment policymaking” (El-Kady and De Gama, 2019). Some of the innovative reform features found in new African international investment agreements explicitly address, in different manners and to varying degrees, taxation matters. To cite a few examples, the Brazil–Ethiopia bilateral investment treaty carves out measures related to taxation from the scope of the treaty (article 3); the recently adopted model bilateral investment treaty in Morocco, in addition to excluding tax measures from the application of the treaty, further provides that in the event of a conflict between the bilateral investment treaty and a tax convention, the latter shall prevail (article 24); and the draft pan-African investment code stipulates that taxation is not subject to the most-favoured nation and national treatment principles (articles 8 and 10).

Home State, third State law and framework for mutual legal assistance

In Africa, MNEs are also subject to the legislation of their home States. Regulations from third States can play a crucial role in FDI projects, even in cases where there is no physical presence of an investor in the host country. While systematic studies on the volume of investment made through these “secrecy jurisdictions” are limited, as stated in chapter 3, a substantial share of global FDI is made through networks of offshore shell companies. Projects that involve the use of OFCs need to comply with the regulations of the corresponding jurisdictions on financing, taxation, anti-money-laundering and the like.

Furthermore, the laws of the home State can have legal effect beyond their territorial scope. For example, the Foreign Corrupt Practices Act of the United States prohibits companies issuing stock in the United States for bribing foreign officials for government contracts and other business. Breach of this Act may lead to hundreds of millions of dollars in penalty or criminal charges.[56] The examination of the list of the United States Securities and Exchange Commission enforcement actions shows that the Act has affected a wide range of sectors and has allowed the conviction of both individuals and companies.

Bilateral arrangements in the context of frameworks for mutual legal assistance play a critical role in the case of frozen assets held abroad. In Switzerland, for example, the

[56] For examples of rulings, see https://www.sec.gov/spotlight/fcpa/fcpa-cases.shtml.

Federal Council provides regular updates on the application of the 2016 Federal Act on the Freezing and the Restitution of Illicit Assets held by Foreign Politically Exposed Persons. For example, the closure of mutual legal assistance procedures reduced the prospects for the restitution of assets from Egypt held in Switzerland within the framework of mutual legal assistance and will not result in the release of assets worth approximately SwF430 million; these assets will remain sequestered within the framework of criminal proceedings in Switzerland for the purpose of determining whether or not their origin is licit.[57]

4.6 Entrenched inequalities in the international economic system

As argued in the conceptual framework of the report (chapter 1), the root causes of IFFs originate in structural inequalities in the international legal and economic system. In this section, the review of the historical attempts to address inequities in the international trading system is aimed to inform forthcoming engagement on IFFs at the multilateral level, including during the fifteenth session of the United Nations Conference on Trade and Development. The section also provides a highlight of the literature on gender inequality and IFFs.

Unequal terms of engagement in international trade

The imbalance in terms of engagement between African countries and investors in extractive industries and in most international engagements of relevance to IFFs partly originates in long-standing inequalities in international trade. The struggle of commodity-exporting developing countries for fairer rules of engagement in international trade is the most emblematic of efforts to reverse structural imbalances in the global economy. In 1947 and 1948, as world leaders met during the opening of the United Nations Conference on Trade and Employment in Havana to deliberate on a post-war economic order, concern for the "special difficulties" that developing countries faced and how these affected international trade in primary commodities was on the agenda. To address these difficulties and what has become known as the "commodity problematique" or commodity problem, the Havana Charter recognized that "a special treatment of the international trade in such commodities through intergovernmental agreement" may at times be necessary (United Nations Conference on Trade and Employment, 1948). However, the Havana Charter was never ratified.

[57] See https://www.admin.ch/gov/en/start/documentation/media-releases.msg-id-69322.html.

A confluence of factors, inter alia, the impact of the cold war and decolonization, opened opportunities for developing countries to organize themselves around issues of common interest within the United Nations and at the global level. During the 1950s, Raúl Prebisch[58] played a central role in creating a pathway for commodities on both the research and international relations agenda. Working under the aegis of the United Nations, Raúl Prebisch and Hans Singer identified the secular decline in the prices of primary goods relative to the prices of manufactured goods as the major development problem of countries dependent on the exports of primary commodities (Prebisch, 1950; Singer, 1950).

In the context of a continued downward trend in the terms of trade for commodity-exporting countries, combined with instability in commodity prices and revenues, and pressure from developing countries, the United Nations General Assembly approved the recommendation of the Economic and Social Council to convene a United Nations conference on trade and development in 1962.[59] The commodity problem was a priority item on the agenda of the first session of the United Nations Conference on Trade and Development in 1964. The Conference provided a forum for deliberations by the international community to develop a viable international commodity policy. By 1976, at the fourth session of the United Nations Conference on Trade and Development, as part of a new international economic order – a more equitable system of trading relations between the global South and North – the Conference adopted the Integrated Programme for Commodities. Negotiations were launched on a basket of commodities. The idea was to negotiate commodity agreements with economic clauses that would be able to finance buffer stocks in order to reduce price fluctuations and stabilize prices at levels remunerative to producers.

However, due to a combination of factors, including the global recession in the 1980s, falling commodity prices, scepticism regarding the efficiency of the instruments, sector-specific politics and power imbalance in the negotiations, the only new international commodity agreement containing economic clauses negotiated within the context of the Integrated Programme for Commodities at UNCTAD was the International Rubber Agreement (UNCTAD, 2003; Gilbert, 2011; UNCTAD, 2014a; Gayi, 2020). Notwithstanding, the pre-eminence of commodities in the international development discourse has not been matched by concerted action. At the global level, this situation has led to an institutional and political vacuum at worst, or a diffused and incoherent policy agenda for commodities at best (Gayi and Chérel-Robson, forthcoming).

[58] Raúl Prebisch (1901–1986) was an Argentinian economist and Secretary-General of UNCTAD from 1964 to 1969.

[59] For a detailed account of the developments leading to this resolution and subsequently to the formation of UNCTAD, see UNCTAD (2014a).

Long after the “Prebisch–Singer thesis”, most African countries are still heavily dependent on the export of primary commodities (UNCTAD, 2019d). Furthermore, it is established that power in global value chains is strongly asymmetrical, with MNEs and other private companies controlling critical points along the chains (Fitter and Kaplinsky, 2001; Gibbon, 2001; Gibbon and Ponte, 2005). Analysis based on OECD and WTO trade in value-added data shows that: OECD countries capture 67 per cent of value created in global value chains; the economies of Brazil, China, India, the Russian Federation and South Africa and a handful of economies from East and South-East Asia capture 25 per cent; and the remaining 100 plus developing, mostly commodity-dependent, countries are left to divide among them the balance of 8 per cent of value-added in global value chains (Banga, 2013). Furthermore, although primarily meant to demonstrate the benefits of integrating into global value chains, the analysis reported in *World Development Report 2020* (World Bank, 2020) also provides evidence of the inequality in rules of engagement between developed and developing country actors. The report alludes to the exacerbated market power and large profit rates that “superstar firms” benefit from due to the disproportionate bargaining power that they may have over their suppliers. The report shows that there is a negative relationship between markups and forward participation for developing countries in the same value chain. It further stipulates that “although buyer firms in developed countries are seeing higher profits, supplier firms in developing countries are getting squeezed” (World Bank, 2019:85). In addition to the expansion of global value chains, the financialization of commodity markets has increased the role of trading companies and financial institutions in global commodities trade, and increased market concentration with associated oligopolistic tendencies (UNCTAD, 2013).

Gender inequality and illicit financial flows

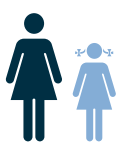
As alluded to in chapter 3, it is impossible to ascertain a direct causality link between the poor records of gender balance in institutions within which IFFs are facilitated and IFF prevalence. Yet the Goals of the 2030 Agenda for Sustainable Development suggest that reversing this trend would lead to better outcomes on all fronts. With regard to IFFs, gender inequality is prevalent across many dimensions: at the roots of the structure of economic rights that underline the dominant international economic system; at the institutional level within MNEs across sectors; at the sources of IFFs; and at the distributional impact of the development outcomes of the resulting limited public funds. These are now examined in turn.

A review by the United Nations Human Rights Council on progress on women’s human rights and participation in power and decision-making found that, 20 years after the

Beijing Declaration and Platform for Action, women still do not have equal enjoyment of the right to economic and political participation due to “deep-seated patriarchal structures” in both the public and private spheres (Office of the High Commissioner for Human Rights, 2015).

Specifically, many reports on gender equality highlight poor gender representation at the management level across all sectors (see McKinsey Global Institute, 2015, 2019; Crédit Suisse, 2019). Studies also show that women are less represented in key segments of value chains due to gender-based discrimination in access to credit and opportunities (McKinsey Global Institute, 2019). With regard to Africa, progress has stagnated across all indicators, except in legal protection and in political representation. Paradoxically, due to the excellent performance of a small sample of countries (Botswana, Kenya, Rwanda, Uganda and South Africa), Africa has the highest representation of women at the board level of any region, at 25 per cent, whereas the global average is at 17 per cent (McKinsey Global Institute, 2019). Women’s representation is also marginally higher than the average representation on executive committees, at 22 per cent.

The gender-related aspects of IFFs are also apparent in their sources. With regard to trafficking in persons and migrant smuggling, for example, 49 per cent of trafficking victims are women and 23 per cent are girls, at the global level (UNODC, 2018). The Financial Action Task Force–Asia Pacific Group on Money-Laundering (2018) uses International Labour Organization estimates to show that human trafficking and associated sexual and labour exploitation generates $150.2. billion per year. Terrorist organizations have also been shown to use human trafficking to fund their activities and organizations. UNDOC (2018) states that trafficking victims from sub-Saharan Africa were reported in 69 countries between 2012 and 2014. The harm caused to victims has many dimensions. In addition to labour bondage and sexual exploitation, for example, a case study based in Nigeria shows that victims are debt bonded to their traffickers for up to €70,000 through the use of illicit money transfer mechanisms (Financial Action Task Force–Asia Pacific Group on Money-Laundering, 2018).



Trafficking in persons and migrant smuggling
is an important source of IFFs.
Globally,
72% of trafficking victims are women and girls.

On the development outcome side, the negative impact of IFFs is also gendered. Tax evasion affects the allocation of scarce government funds and reduces budgetary allocations for public services of which women and girls are the majority beneficiaries. Governments also tend to choose to prioritize certain areas, such as security over social services, creating a further gap in services offered (Waris, 2017). In addition to the widely substantiated feminization of poverty, women also often constitute the largest contingent of victims of health crises. Up to 75 per cent of victims of Ebola virus disease in West Africa, for example, were women (Alliance Sud et al., 2016). In this report, a coalition of civil society organizations argued that budget shortfalls in the health services, exacerbated by tax abuse and illicit financial outflows, worsened the situation. Furthermore, the broadening of the tax base, in order to compensate for revenue shortfalls, is also likely to disproportionately hurt women. Consumption taxes levied on goods and services highly consumed by poor households disproportionately hurt poor women-headed households (Capraro, 2014; Waris, 2017).

4.7 Concluding remarks

This chapter discusses the most prominent features of the regulatory environment of tax-related IFFs in the extractive and other sectors in Africa. In addition to the specifics of these sectors, the discussion also uncovered the broader complex layers of legislation that both countries and investors have to navigate, with the particular dominance of bilateral investment treaties. As in the case of tax treaties discussed in chapter 3, investment treaties tend to be of greater value to investors than to host countries. Furthermore, the chapter's discussion of corruption and anti-money-laundering regulations and the evidence of various rulings on this matter also demonstrate that, overall, neither the domestic nor the international legal systems provide sufficient disincentives against illicit practices. Finally, the gendered impact of IFFs on socioeconomic indicators provide cause for concern. The association between IFFs and sustainable development indicators is further explored in chapters 5 and 6.