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# Lifting the Veil of Secrecy

**Perspectives on International  
Taxation and Capital Flight  
from Africa**



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## About the book

This book is produced as a part of the research project *Taxation, Institutions and Participation* (TIP). TIP investigates the effects of tax havens on domestic revenue systems, institutions and on citizen participation in African countries.

The project aims to generate new, contextualised evidence on the political economy of domestic revenue mobilisation, institutional development and state legitimacy in countries exposed to large scale capital flows. TIP is led by Chr. Michelsen Institute (CMI), and funded by the Norwegian Research Council.

The book is based on research and interaction with colleagues in research institutions, civil society organisations, tax administrations and the private sector in Africa. It is developed in close collaboration with Tax Justice Network - Norway (TJNN).

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# Tax havens, capital flows and Africa – an introduction

Increasing domestic revenue is a priority for most African countries. An effective tax system is central to sustainable development. African governments need to mobilise revenues to finance public spending. Tax is key to growth and redistribution. Mobilising the domestic revenue base is crucial for African countries to escape from foreign aid or natural resource dependency.

Widespread tax avoidance and evasion undermine the domestic tax bases in most African countries (IMF 2011). It limits the amount of resources available for the government and undermines economic efficiency, income distribution, and the government's legitimacy.

It is estimated that African countries, relative to the size of their economies, lose more in corporate tax evasion than countries anywhere else in the world (Crivelli et al. 2015). The international tax system facilitates tax avoidance and evasion. There are a number of examples of multinational companies, particularly in extractive sectors, that pay little tax by transferring profits to tax havens. Similarly, there are major challenges in the taxation of renewable natural resources, such as fisheries, forestry, and wildlife. In these cases, only limited revenues reach the treasury in many African countries. Recent information leaks also show that Africans with great wealth hide it in tax havens beyond the reach of their national tax and judicial authorities. In 2015, a list of clients of the HSBC bank with secret accounts in Switzerland became public. The Swiss leaks revealed that residents in sub-Saharan Africa held huge amounts of money in secret accounts.

It is a global network of offshore financial centres (OFCs) – popularly known as 'tax havens' or 'secrecy jurisdictions' – that makes it possible for rich elites and large multinational companies to drain large amounts of wealth out of Africa. Tax havens include both small tropical islands such as the Cayman and the British Virgin Islands which feature in popular images of 'tax havens', and rich OECD countries such as Ireland, the Netherlands, Luxembourg, Singapore, Switzerland, the United Kingdom and the USA.

Tax havens are legal jurisdictions that offer a combination of low tax rates, limited regulations, and secrecy about the ownership of registered corporations and individual assets. National bank secrecy laws are designed to prevent the sharing of information about clients, thus facilitating secrecy about account ownership and registration of "shell corporations" – legal corporations that have few or no substantive activities in the country (Sharman et al. 2012). Designed to attract foreign wealth and corporations, these mechanisms disguise the identities of their owners, conceal transactions, and

move the assets beyond the reach of national authorities while maintaining an appearance of a respectable business environment.

Estimates of the magnitude of wealth held in tax havens remain imprecise, as most of it is hidden and scattered across a vast network of secrecy jurisdictions. Gabriel Zucman (2014) estimates that USD 8 trillion of the personal financial wealth is in offshore accounts. This figure captures only financial wealth, and excludes tangible assets like property, jewellery and artwork. Other estimates of total wealth held overseas are as high as USD 32 trillion (ICIJ and CPI 2013). That figure would imply that roughly 20% of the total global wealth is held offshore. Zucman argues that the share is even higher for Africa. He estimates that Africans hold USD 500 billion in financial wealth offshore, amounting to 30% of all financial wealth held by Africans. But what does this mean in terms of tax revenues lost by African governments? Based on standard assumptions about the rate of return on financial assets held abroad, Zucman (2015) estimates that African governments lose roughly USD 15 billion annually. The inclusion of non-financial wealth, or higher estimates from available literature, could push this figure as high as USD 60 billion annually.

## African countries need a tax base to fund public services and good institutions to keep governments accountable in their use of public funds.

Loss of tax revenue is just one of the damaging impacts of this system. We are faced with a very complex international system, where structures that are legal, are tailored to facilitate tax evasion and other criminal activities. Tax havens facilitate the concealment of money from organised crime, money laundering and corruption. They damage markets and distort competition by increasing the profitability of unproductive sectors and activities that have a negative impact on society. They can also destabilise financial markets and increase risks for investors because they allow crucial information to be disguised or kept secret.

Several African countries are among the fastest growing economies in the world. However, capital flows to tax havens are one factor limiting the benefits of economic growth for ordinary Africans. The region is likely to continue to grow relatively quickly and thus become increasingly attractive to international and domestic investors and international financial industries. However, institutions, legislation and regulations remain weak, benefiting the interests of ruling elites, transnational companies and other stakeholders. To improve the living standards of their citizens, African countries need a tax base to fund public services and good institutions to keep governments accountable in their use of public funds. Tax havens undermine these objectives.

In recent years, there has been a significant expansion of research on illicit financial flows, largely focusing on estimating the scale of flows (Zucman 2014; Boyce and Ndikumana 2012; Kar and Cartwright-Smith 2010; Kar and Spanjers 2015) and the role of international tax havens in facilitating tax evasion and other illicit activities (Palan et al. 2010). However, our understanding of the ways tax havens affect taxation, political institutions and citizen participation is less developed. How is the taxpaying behaviour of domestic taxpayers affected by the elites' and transnational companies' use of tax havens? How do large scale (illicit) capital flows affect domestic tax policies and practices, and what role do international accounting firms play in this process? How do tax havens affect institutions in developing countries, government accountability, citizen participation and citizens' views of the state? Until recently, there has been little firm evidence on how the use of tax havens affects tax compliance, how it influences lobbying activities towards the domestic tax system, and how tax havens shape elite and citizen incentives to inhibit or promote institutional change. The research project *Taxation, Institutions and Participation* (TIP) has researched some of these questions.

In this book, we introduce new and policy-relevant research findings on key challenges tax havens pose for development in Africa. We explore the extent of the problem, the actors, effects and policy measures. By lifting the veil of secrecy, we aim to enable contextualised and evidence based policies at country and regional levels to complement current international initiatives.

This is a new field of research. We supplement our findings with the voices of leading international scholars. Each section includes a presentation of the topic and a selection of short articles by prominent researchers and tax experts elaborating the topic. Challenges are context specific and differ between countries in Africa. There are, however, common denominators across the continent. We try to show this through examples from various countries and with articles by experts on the different African countries.

We hope the book will be useful for policy makers, tax officers in revenue administrations and private sector tax practitioners, journalists, civil society organisations, researchers and university students.

**The structure of the book**

The book has five main sections:

**Section 1** explains concepts of tax and tax justice, state obligations, tax havens and the global secrecy industry and what the international community does to ensure a fair tax system.

**Section 2** takes a closer look at the consequences of the services offered by tax havens and the global financial secrecy industry. How much money are governments losing? What are the effects?

**Section 3** gives an overview of the facilitators – auditors, accountants, lawyers, banks, multinational companies and governments in tax havens – the professionals in the financial secrecy industry who have contributed to the creation and use of tax havens.

**Section 4** explores the extraction of natural resources such as gas, oil and minerals. Natural resources is one of the largest economic sectors in Africa, and it differs in many ways from other businesses. Therefore, governments should take particular care when designing tax systems for this sector.

**Section 5** provides an overview of the current work of international and African organisations like the OECD, the United Nations, the African Union, the European Union and the World Bank. For many years, they have been active in developing and voicing solutions for a more sustainable and equitable international tax system. In addition, you will find brief descriptions of other actors, including relevant African civil society organisations, working on these issues.

At the end, there is a glossary explaining relevant concepts and expressions.

# 1. Tax and tax justice



# 1. Tax and tax justice

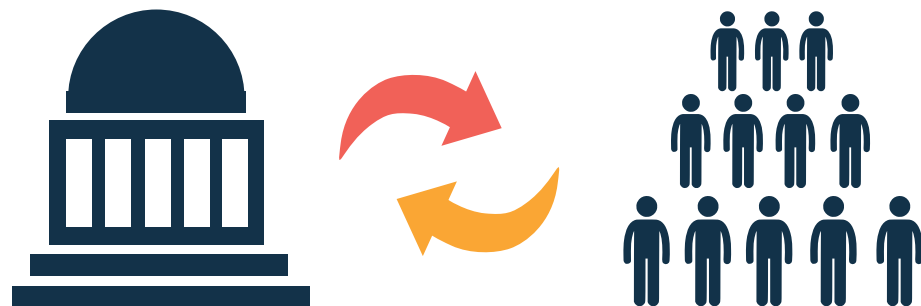
Tax is a payment made to the government, without the government providing a specific benefit in return. A tax is different from a fee, which is directly linked to the provision of a service, such as the payment of tolls to access a bridge or road. We will examine what the creation of a fair tax system requires of taxpayers, the state and the international community.

## Tax and the fiscal contract

Tax revenues enable the government to finance public goods which the market would otherwise not be able to provide in an efficient and fair manner. Military defence, a functioning judicial system and institutions that ensure public order and protection of property rights can be viewed as the very minimum state service provision. Coordinating the proper provision of such core functions is very difficult without delegating a clear authority to a state. State protection of the fundamental rights of citizens, and citizens' duty to finance state tasks through tax, is the basis of the "social contract" on which modern states are based.

There is a growing recognition that taxation and state-building are linked (Braütigam *et al.* 2008). State-building can be broadly defined as 'increasing the capacity of governments to interact constructively with societal interests, to obtain support and resources from those interests, and to pursue consistent lines of action' (Moore 2008). There are strong arguments in the literature that a substantial governance 'dividend' can be gained from mobilising domestic financial resources through the tax system.

The tax system may contribute to improved governance through three main channels. First, fiscal bargaining and negotiation between the state and citizens over taxes is central to the development of a social fiscal contract. Taxpayers have a legitimate right to expect something in return for paying taxes and are more likely to hold their government to account if it underperforms. Second, governments have stronger incentives to promote economic growth when they are dependent on taxes and the prosperity of taxpayers. Third, dependency on taxes requires states to develop a bureaucratic apparatus for tax collection. It is expected that this leads to broader improvements in public administration.



Although tax-governance linkages are complex and context-specific, and much of the evidence is anecdotal, it is clear that there are strong synergies between tax reforms and governance (Prichard 2015). If tax reform is undertaken in a way that promotes greater responsiveness and accountability, alongside improvements to the state's institutional capacity, then tax reform can become a catalyst for improvements in government performance. Seen in this light, taxation is more than just an administrative task for governments and citizens. It is also about politics and power, and the way a country exercises its authority through formal and informal institutions.

## Concerns about fairness, equity and reciprocity are pervasive among African taxpayers.

An effective tax system is essential in strengthening the state's legitimacy, accountability and responsiveness. It matters that governments tax their citizens, and it matters how they tax them. While effective enforcement is important in ensuring tax compliance, so too is perceived fairness, reciprocity and accountability in the collection of taxes, and in the spending of tax revenues (Moore *et al.* 2018). The Afrobarometer surveys, covering more than 30 countries, find that most Africans believe governments have the right to collect taxes and that citizens have a duty to pay them (Aiko and Logan 2014). However, there is a widespread mistrust of the claim that taxes will directly translate into public services, or that citizens' opinions affect how the money is spent. Concerns about fairness, equity and reciprocity are pervasive among African taxpayers.

In this book, we refer to the concept of tax justice. What justice is, and what constitutes a just society, are both important and difficult questions. However, we do not wish to approach the concept of tax justice from a philosophical perspective of justice, or on how tax should work in a hypothetical society. Our intent is to describe what we consider a pragmatic response to a tax system that unfairly creates winners and losers. We take no position on what level of tax a country ideally should have.

We understand a fair tax system as consistent and comprehensive – a system that does not have loopholes or discriminate arbitrarily based on types of income, nationality, or between individuals and companies. We understand it as a system that balances the rights and privileges of people and companies with their duties. To achieve tax justice, the legislation, such as the tax laws of a country, must work as intended. A tax system based on widely agreed-upon principles and that is generally perceived to be fair, will contribute to the taxpayers' willingness to pay tax. This is also referred to as the "tax morale" in a society.

To elaborate, we will describe the duties required to create a comprehensive and equitable tax system. The duties come in three main forms: the obligation of the taxpayer to the state, the duties the government has to the taxpayer and the obligations states have towards each other.



### The taxpayer

From the perspective of the taxpayers, tax justice means that they perceive the distribution of tax responsibilities in their society as consistent and fair. The primary responsibility of the taxpayer is to state her income and pay the due taxes to the national tax administration (and in some cases, also to the revenue administration of other countries). In practice, this means that it is the responsibility of the taxpayer not to engage in tax evasion or tax avoidance.

There are (at least) four different tax territories in Africa. One is the international tax system, involving a limited number of large corporations, multinational companies and wealthy individuals (Zucman 2014). It generally implies engagement with foreign tax jurisdictions. Second is the national tax system, which is formal and standardised, though often permeated by corruption, tax evasion and extra-legal exemptions (Fjeldstad 2005, 2009). It engages relatively few citizens directly. The third is less formal and composed of a diversity of smaller sub-national taxes, fees and charges. It affects many people directly (Fjeldstad and Semboja 2001; Fjeldstad and Therkildsen 2008; Fjeldstad 2016). The fourth is composed of informal taxes paid to a variety of state and non-state actors (Jibao et al. 2017). It often involves substantial in-kind labor payments, bribes, extortions, protection and goodwill payments. Informal taxation is widespread, particularly in rural areas and in urban slums. In much of Africa, the implications for fairness and equity are found not only in the formal tax legislation and regulations, but also in the ways they are implemented by revenue administrations at national and sub-national levels (Moore et al. 2018). Personal income taxes are only redistributive if wealthy people actually pay them. In practice, wealthy people in Africa simply do not pay tax. Larger corporations often benefit from excessive tax exemptions granted by governments, and from their ability to exploit international tax rules to their own advantage. Meanwhile, sub-national and informal taxes appear to fall disproportionately on those with lower incomes. People question why the government gathers taxes from its poor citizens, but collects little or nothing from the wealthy and the multinational companies with a much greater capacity to pay.

### Governments

The government is responsible for creating a tax system where everyone pays their fair share, and where it is not unnecessarily difficult or costly to comply with the laws. The government must ensure that taxpayers know, with reasonable certainty, what they owe in taxes and that there is a system for accessing information and settling disputes if the law is unclear. Taxpayers are both natural persons and so-called legal persons (for instance a company, institution, foundation etc.).

In most African countries, there is a need to build capacity and expertise in tax administration, particularly related to the development of taxpayer services and e-tax systems. There is also a need for expertise in areas such as specialised audit functions of large taxpayers in growing sectors, such as natural resource extraction, telecommunications, banking and finance (Fjeldstad 2014). Capacity building should also aim to strengthen taxpayers' rights and improve taxpayer outreach.

An important element of administrative accountability is the right of the taxpayer vis-à-vis the tax authority. Though still in their infancy in most African countries, tax appeal boards and tax tribunals are potentially important institutions for securing taxpayers' rights and establishing fair and transparent procedures to address tax disputes. However, to make these institutions accessible for a wider segment of taxpayers, there is a general need to simplify and communicate the procedures for appeals to the general public. Similarly, the roles and functions of the appeal board should be explained to the taxpayers. 'Tax literacy' in Africa is low as a large proportion of the economic active citizens in Africa belong to the informal sector, and the technicality of paying taxes is quite complicated that they are difficult to understand. Although revenue administrations in some countries, including Rwanda, South Africa and Tanzania, have undertaken vigorous taxpayer education interventions, they had a limited outreach as they have been mainly concentrated in the urban centres.

It is important that tax administrations are transparent about the methods they use for tax collection. Transparency can foster greater confidence around tax collection and make it easier to uncover corruption. The same applies to the use of tax revenues, i.e. to government spending. The government's budget must also be determined through an understandable and transparent process.

Ineffective tax administration is one of the main constraints on the ability of states to collect revenue in general, and direct taxes in particular. Corruption is part of the problem. Data from the 2013 Global Corruption Barometer shows that the percentage of citizens who reported paying a bribe to officials in tax and customs administration in selected African countries, is much higher than the global average. For instance, approximately 60% of citizens in Liberia, Senegal and Sierra Leone who encountered tax and customs services, reported that they had to pay bribes. The corresponding figure for Cameroon and Uganda is 46%, compared to the global average of 15% (Transparency International 2013). The Afrobarometer surveys, covering more than 30 African countries,

## Tax Inspectors Without Borders

In 2013, the OECD launched the pilot project Tax Inspectors Without Borders (TIWB). The aim of the project is to provide technical assistance to tax administrations to increase the capacity of developing country governments to collect taxes from multinational companies.

In 2016, Eurodad, a European network of 47 civil society organisations published a report highlighting the weaknesses of the TIWB-project (Eurodad 2016). The report found that in the three TIWB pilot projects in Rwanda, Ghana and Senegal, leadership came from the donor countries (the Netherlands, the UK and France, respectively). This was contrary to the design of the initiative, as formulated in the TIWB Toolkit. Furthermore, serious conflicts of interest have occurred. The UK-supported project in Rwanda was managed in part by PWC, one of the key players in the global tax planning industry with multinational corporations amongst their most important customers (see Section 3 on the "Big Four"). Eurodad also states that very little information has been made publicly available about the projects.

repeatedly show that Africans perceive tax administrations as one of the most corrupt public institutions.

Tax evasion and tax avoidance by multinational companies and wealthy individuals are important aspects of the corruption problem. International tax rules have mainly benefitted wealthy individuals and multinational corporations (Moore et al. 2018). They have thus contributed to reinforcing and deepening existing inequality, distorting economic competition in favour of international companies (Alstadsæter et al. 2017). Through the complex structures of transnational enterprises, tax havens, secret bank accounts, and secretive legal arrangements obscuring the real ownership of assets, these rules have generated new opportunities for corruption. A revealing illustration of the level of tax evasion and avoidance by wealthy Africans came in early 2015, when a list of clients of one of the world's largest banks, HSBC, who had secret accounts in Switzerland became public. These, and other similar stories, are a reminder that this is not only a story about tax evasion. These are also stories about the ways secrecy in the international system reinforces inequality, facilitates political corruption, and undermines democracy.

### The international community

A fair international tax system depends on equality in the relations between states. The right of states to enact their own laws is enshrined in the principle of sovereignty. However, international tax rules have contributed to undermining the public finances of low-income countries (Fuest et al. 2011; Keen and Mansour 2009; Oguttu 2016, 2017; Picciotto 2016, 2017). It is increasingly difficult for national tax authorities to tax mobile wealth (Baker 2005; Palan et al. 2010; Zucman 2014). The most striking manifestation of this system is the growth of a global system of offshore financial centres which have offered a destination for both wealthy individuals and multinational corporations seeking to minimise their tax payments and disguise their wealth. While governments all over the world find that their potential revenues are hijacked through tax havens, the outflows are especially high from Africa and other low-income regions. Here, there is limited capacity to effectively implement the complex rules and procedures that might stem the leaks. Gabriel Zucman

**“Financial opacity is one of the key drivers of rising global inequality. It allows a large fraction of top income and top wealth groups to pay negligible tax rates, while the rest of us pay large taxes in order to finance the public goods and services (education, health, infrastructures) that are indispensable for the development process.”**

**Thomas Piketty**, French economist, author of *Capital in the Twenty-First Century* (2014).

## “Either this is the largest building in the world or the largest tax scam”

**US President Barack Obama, Jan. 5, 2008**

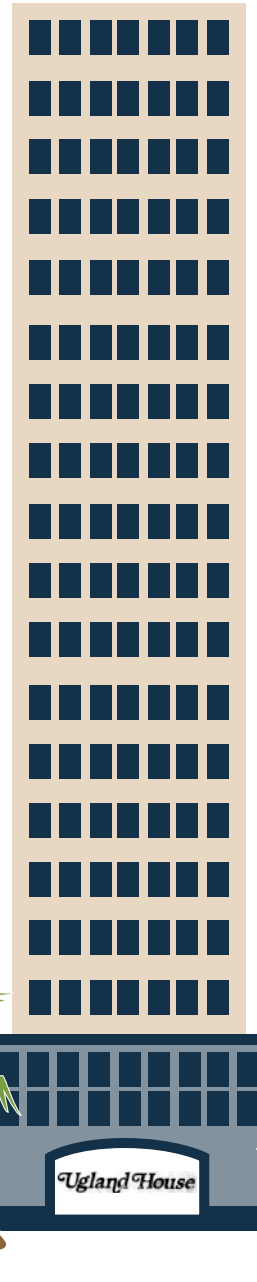
...about Ugland House, a small building on Cayman Islands, where 12,748 companies are registered and supposedly conduct their business (among them Coca Cola and Intel Corp.). No real activity is going on.

estimated the total financial wealth owned by foreigners in Swiss banks in 2015 to be USD 2300 billion. Of this, more than USD 150 billion came from African countries – making Africa the continent that is hardest hit by tax evasion.

Taxing international economic transactions faces special challenges because of the complexity of the global tax system. International tax rules have generated new opportunities for corruption through the complex structures of transnational enterprises, tax havens, secret bank accounts, and secretive legal arrangements to obscure the real ownership of assets. For wealthy people and companies, harmful tax competition creates an opportunity for a sophisticated type of ‘lawlessness’ where complicated structures of ownership and control of assets and companies make it possible to ‘rise above’ national laws.

### Tax havens

International rules, however unequal, do not directly authorise tax abuse. Instead, they create spaces for potential abuse. Since the 1960s, this space has been filled by an ever more complex network of offshore financial centres (OFCs) – popularly known as ‘tax havens’ – designed to facilitate secrecy, tax avoidance and evasion (Palan 2003; Dharmapala and Hines 2010; Reuter 2012). OFCs are legal jurisdictions that offer a combination of low tax rates for foreign individuals and companies, limited regulations, and extreme secrecy about the ownership of registered corporations and individual assets. Secrecy is a result of national bank secrecy laws, designed to prevent the sharing of information about clients, even with national authorities. The laws make it simple to register ‘shell corporations’ – legal corporations that have few or no substantive activities in the country. These policies are explicitly designed to attract ‘offshore’ investments from foreign individuals and corporations by disguising the identities of their owners and moving wealth beyond the reach of national authorities. While tax havens often have very favourable tax regimes to foreign companies and wealthy individuals, their own citizens often have far less favourable tax rules (Palan et al. 2010). Such arrangements are called ring fenced tax systems. They attract foreigners not only by offering low or no taxes, but also by offering easy, quick and flexible rules and bureaucratic practices. This is especially the case for tax havens that specialise in certain niche sectors, such as hedge funds in the Cayman Islands, or ship registry in Liberia.





Many tax havens also provide anonymity and secrecy, making it nearly impossible to trace assets, property and companies back to their real owners (Sharman 2010). Thus, in many respects 'secrecy jurisdiction' is a more fitting term, rather than tax haven.

However, if the focus is on countries that use secrecy and particular benefits to attract foreign companies and wealth, the primary culprits are not small islands in the sun, but members of the OECD. The largest recipient of offshore financial wealth is Switzerland, with London, New York, Luxembourg, and Singapore close behind. Globally, the easiest place to create a secretive corporate entity is the U.S. state of Delaware (Findley et al. 2014).

There is no internationally agreed definition of a tax haven. Nevertheless, there is broad consensus that a tax haven has one or more of the following characteristics:

- No, or very low, effective taxes
- Ring fenced tax systems
- No effective exchange of information to other governments
- Lack of transparency on ownership, accounting and other essential business information
- Companies do not need to do real business in the country to be registered there

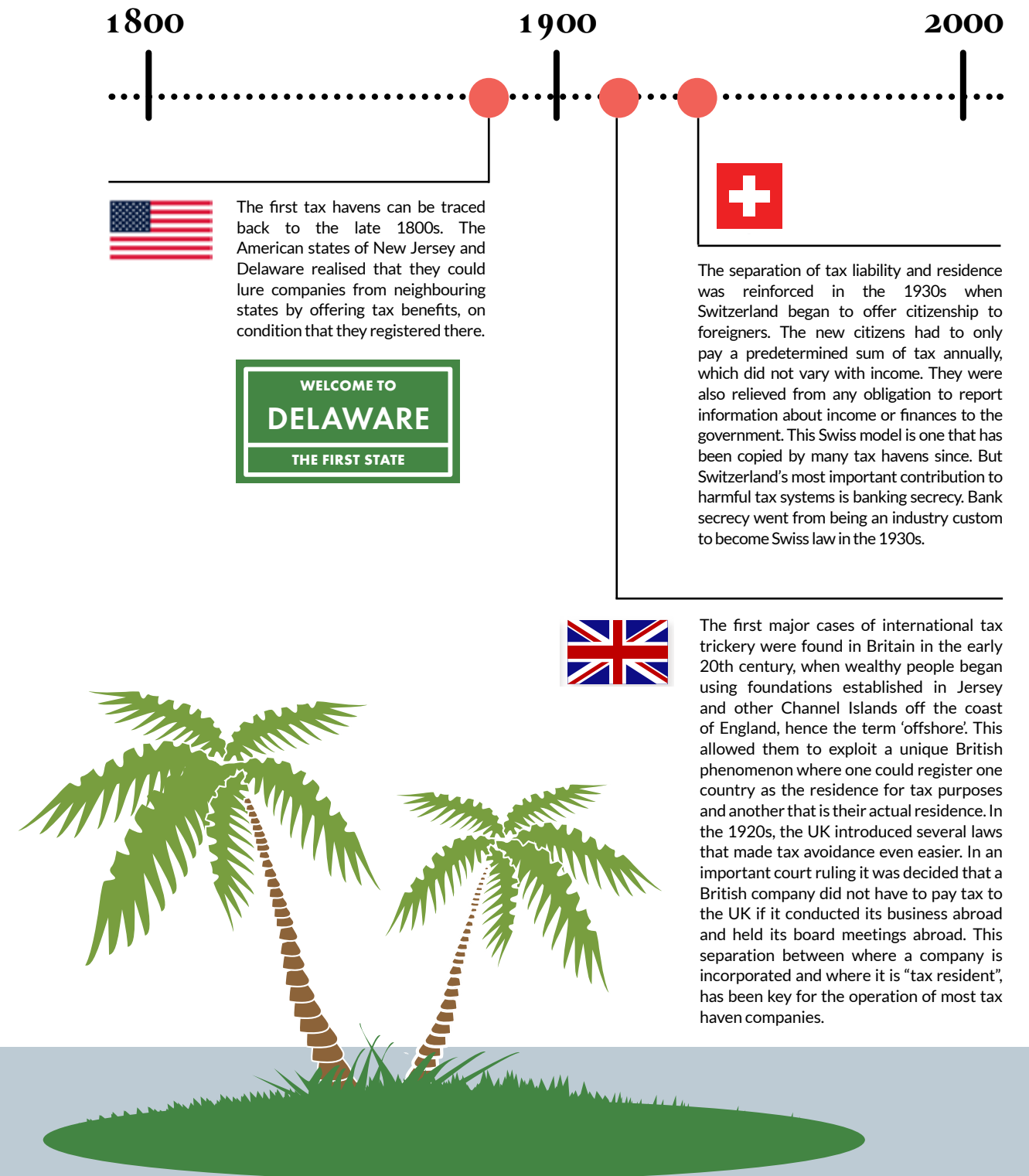
Most tax havens allow companies to register in the country without requiring an audit, annual accounts or any other financial reporting; the companies are not even required to disclose their ownership. In cases where companies have to report the names of shareholders and management to tax haven authorities, this information is rarely made publicly available.

Tax havens also usually allow companies to be owned in the names of nominee owners, a person who is paid to be registered as a director or owner of a company, even though in reality, they have no involvement in the actual business activities of the company. Thus, even if the recorded information becomes available, it will not necessarily contain reliable information about who manages or owns the company.

The British Virgin Islands (BVI) in the Caribbean illustrates the extent of 'sham' companies in tax havens (2008 data):

- 19 000 inhabitants (low level of education)
- 830 000 registered companies
- Authorities claim that these companies run and/or manage their business from BVI and thus are tax residents there
- There are 43 (=830 000/19 000) companies pr. capita
- Some BVI residents are board members (and directors even) of hundreds (and in some cases even thousands) of companies

## The origins of tax havens



## The end of bank secrecy?

The Panama Papers confirm an argument made by scholars for years that the announcement of the end of banking secrecy is very premature:



### The global secrecy industry

When the media cover tax havens, it is usually in connection with a revelation of a scandal of tax evasion or corruption where the money has flowed through one or several tax havens. Through media coverage, it is easy to get the impression that tax havens are the true architects of the shadowy side of the world's economy. On this basis, it is tempting to assume that the leaders in places like Panama or the Cayman Islands are the 'evil geniuses' behind the problems of tax havens. Consequently, one may think that if we can deal with these few, small and politically weak states, we can solve the problem.

The reality is more complex. Panama and the Cayman Islands are only parts of a larger system we call the global secrecy industry. Multinational corporations in banking, finance, audit, as well as tax advisors, asset managers and law firms, such as Mossack Fonseca in Panama, are the real architects of the system (ICIJ and CPI 2013). The global financial secrecy industry relies on governments and jurisdictions, such as the Cayman Islands, that are willing to allow the tailoring of their laws to offer specialised 'products' to customers. Legal experts within large companies or tax advisor companies with headquarters in major OECD countries, often write laws in tax havens in their entirety. If one specific tax haven is forced to tighten its rules, the industry quickly adapts, and finds another tax haven or specialised legal product to

take over the same market. Therefore, achieving more transparency in one tax haven does not necessarily mean that the global secrecy industry as a whole has become more transparent.

The bank and financial sector have proven to be experts in adapting to new laws and regulations, supplying their clients with ways to evade taxes and hide their money. As Shaxson and Christensen (2011) argue: "The initiatives leave considerable scope for bank secrecy and brings negligible benefits".

### Onshore tax havens in Africa

An increasing number of African countries have established, or plan to establish, International Financial Services Centres (IFSCs) that offer a combination of low or zero tax rates, limited regulatory standards and anonymity as an incentive for international capital and businesses. The proliferation of such tax havens on the African continent has so far attracted limited attention in the literature. Current and previous research primarily focuses on small island states, including the Bahamas, Cayman Islands, British Virgin Islands, Mauritius and the Seychelles. For instance, Dharmapala and Hines Jr., in a paper published in the prestigious *Journal of Public Economics* in 2010, argue that "[t]ax havens are small countries, they are affluent countries, and they have high-quality governance institutions", and, further "poorly run governments do not even attempt to become tax havens". These arguments do not reflect developments in Africa. Botswana, for instance, established an IFSC in 2003. Kenya has recently established the Nairobi International Finance Services Centre. Plans for an Offshore Financial Services Centre in Ghana has been on the policy agenda for several years, though recently put on temporary hold.

## Financial Secrecy Index

The Financial Secrecy Index (FSI) is a tool for understanding global financial secrecy (Tax Justice Network 2015). The index measures the degree of secrecy in 102 countries and has been published biannually since 2009. A country's position on the index is determined by the degree of financial secrecy, based on an assessment of the financial laws of the country and weighted with the proportion of the global financial sector taking place in the country. Switzerland tops the list in the 2015 edition of the FSI, ahead of Hong Kong and the United States. If you include all British Crown Dependencies and British Overseas Territories, Britain would top the list by far.

The index is based on the largest systematic survey of global financial secrecy that exists. The FSI is a response to previous attempts at "blacklisting" tax havens by organisations such as the OECD and the IMF. These attempts have repeatedly failed to include obvious tax havens, and the processes for deciding which countries to include on the list have been unclear and politicised.

In general, IFSCs are set up by means of legislation in a given country (the host country) with a view to encourage foreign or local financial institutions, companies or trusts to establish resident corporate entities with the purpose of investing funds in the IFSC (Palan *et al.* 2010; Amediku 2006). Corporate entities can be banks, fund management organisations or insurance companies, amongst others. A favourable tax and industry-friendly regulatory environment are necessary attractions of an IFSC. Thus, they are commonly categorised as tax havens or secrecy jurisdictions. The IFSCs rely on ‘ring fencing’ to separate the IFSC-facilities from the domestic economy. In principle, residents cannot establish accounts or businesses in the IFSC-jurisdiction, while those listed in the IFSC jurisdiction cannot engage in transactions with resident individuals or businesses. Those using the tax havens rarely relocate their institutions to an IFSC; instead, they pay for the privilege of ‘renting’ a residence in the IFSC host country. Meaning that they take advantage of the juridical facilities offered to them for reducing tax liabilities (also referred to as ‘effective international tax strategy’). However, with increasing numbers of both tax havens and users of tax havens, competition has reduced the cost of license fees and liberalised the character of the legal protection that tax havens offer. To a greater extent, tax havens tend to compete, not only on the level of taxes, but also on issues of residency and sovereignty. This may imply that states sell the rights to set key areas of policy to the financial sector. Palan (2002) refers to this as the ‘commercialisation of state sovereignty’.

# 1. ARTICLES: Tax and tax justice

# Capital flight and poverty reduction in Africa

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This short chapter, based on Nkurunziza 2015, discusses the potential effect of capital flight on poverty reduction in Sub-Saharan Africa (hereafter Africa), the region with the highest level of poverty in the world. According to the latest World Bank data, poor people, namely those with a daily income per person below USD 1.9 measured using 2011 purchasing power parities, represented 42.65 per cent of the population in 2012 in Africa. The corresponding proportion for South Asia, the second poorest region, was 18.75 during the same year. Africa's high level of poverty has been coupled with a very high incidence of capital flight (Ndikumana, Boyce and Ndiaye 2015).

Capital flight could affect poverty reduction efforts through several channels. First, capital flight results in a loss of resources that could be invested in national economies. This could have a negative effect on income per capita and poverty reduction, particularly in capital-starved Africa. Second, many African countries have been allocating an important part of their scarce resources to the repayment of odious external debt, crowding out resources that could be spent on poverty-reduction programmes and projects. Third, the appropriation of aid by powerful elites could fuel capital flight while at the same time robbing the poor of resources that could ease his hardship. Fourth, capital flight deepens inequality which, in turn, has been found to increase poverty. Fifth, capital flight goes hand in hand with poor governance. This discourages investments that could have a poverty-reduction effect. Moreover, poor governance and capital flight reduce investment in social services such as education and health as the elites have access to such services in foreign countries using the resources stashed abroad. There are many examples of African leaders and their family members who systematically seek healthcare abroad and send their children to study in foreign countries as a result of the poor provision of these services at home.

The potential effect of capital flight on poverty is assessed under the assumption that Africa has a financing gap between available and required investment and that the resources that leave a country as flight capital, could help to fill this gap. The procedure used to calculate the potential effect of capital flight on poverty identifies, first, the growth in GDP per capita that would be attributed to the investment of flight capital. In this regard, the Incremental Capital-Output Ratio (ICOR) and the

capital stock to GDP ratio are the two concepts used to calculate this effect. Then, in order to determine how much poverty would decline as a result of the increase in income per capita, time-varying country-specific income-growth elasticities of poverty are multiplied by the potential increase in income per capita.

The results based on the ICOR methodology suggest that if flight capital were invested in national economies with the same efficiency as actual investment, income per capita in Africa as a whole could increase by 1.46 percentage points per year, adding 1.94 percentage points to the current average annual rate of poverty reduction. These values imply that the rate of poverty reduction in Africa would have increased from about 3 per cent per year to about 5 per cent per year, between 2002 and 2012, on average. This means that had flight capital been systematically invested in national economies since 2002, poverty in Africa would affect 34 per cent of the population instead of the current 43 per cent.

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Poverty reduction would be even faster if we consider the stock of capital instead of investment as the channel through which capital flight may affect poverty reduction. Investment in a given year produces output in the same year and in subsequent years, taking into account its rate of depreciation. Hence, using the stock of capital, investing flight capital domestically would reduce poverty by an additional 2.5 percentage points per year on average. This finding suggests that the rate of poverty reduction between 2002 and 2012 would have been about 5.5 per cent. This faster process of poverty reduction would have decreased the proportion of poor people from 57 per cent of the population in 2002 to 32 per cent of the population in 2012, ten percentage points lower than the current poverty headcount.

Two main conclusions emerge from these findings. First, capital flight is depriving countries of resources that could have helped them to meet the first Millennium Development Challenge (MDG1) goal of halving poverty by 2015. Indeed, several countries, including the Republic of Congo, Lesotho, Mauritania, Sierra Leone, and Togo that did not meet MDG1 would have met it had they invested the resources they lost to capital flight. Many other countries that failed to meet the goal would have been closer to meeting the target. Second, the aggregate values provided above hide important country differences. This implies that for policymaking purposes, the analysis of the potential effect of capital flight on poverty reduction should be carried out at the country level. This analysis would identify country specificities that could be important in the process of framing poverty reduction policies. Such specificities could help to understand why, even with the same level of capital flight,



some countries accumulate capital faster than others, or why economic growth reduces poverty at a faster rate in some countries than others.

Finally, there are important questions that could not be answered through the analysis discussed in this chapter but which require dedicated analysis. For example, knowing the effect of capital flight on non-monetary aspects of poverty such as politically-induced poverty could shed more light on the relevance of some non-traditional aspects of poverty reduction policies. It would also be important to assess the interaction of capital flight with external aid and what is the effect of these two factors on poverty, particularly in highly-poor and aid-dependent African countries.

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# The Financial Secrecy Index: A policy application to address country-level vulnerability to illicit financial flows

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The Financial Secrecy Index provides a comprehensive evaluation of the transparency failures of more than 100 jurisdictions worldwide, which are exploited (and often deliberately designed) to facilitate tax abuses and corrupt flows from elsewhere. The index is the leading global ranking of 'tax havens', increasingly used in both academic research and in policy analysis – from money laundering risk assessments by financial intelligence units and central banks, through to investor tools for company evaluation. This article sets out how the index can be used for detailed analysis of countries' vulnerability to financial secrecy, supporting policy prioritisation and specific counter-measures against the most important illicit flow risks faced by individual countries.

First envisaged at a meeting in Nairobi in 2007, the Financial Secrecy Index (FSI) has been published by the Tax Justice Network every two years since 2009. Established as the global ranking of 'tax haven' secrecy, the FSI is not only a tool for high-level advocacy and campaigning, but is increasingly widely used and cited: in academic research; in policy analysis published by national and international organisations such as UNCTAD, the World Bank, the Parliamentary Assembly of the Council of Europe, the Banca d'Italia and the OECD; and in rankings of various kinds, including as a component of public policy indices and in rating tools.

Knowledge of beneficial ownership	Key aspects of corporate transparency regulation	Efficiency of tax and financial regulation	International standards and cooperation
1 Banking Secrecy	4 Public Company Ownership	7 Fit for Information Exchange	11 Anti-money Laundering
2 Trust and Foundations Register	5 Public Company Accounts	8 Efficiency of Tax Administration	12 Automatic Information Exchange
3 Recorded Company Ownership	6 Country-by-country reporting	9 Avoids Promoting Tax Evasion	13 Bilateral Treaties
		10 Harmful Legal Vehicles	14 International Transparency Commitments
			15 International Judicial Cooperation

Figure 1  
Source: Tax Justice Network, Financial Secrecy Index 2015.

### Key Financial Secrecy Indicators

The FSI is based on a ‘secrecy score’, which is constructed from 48 variables reflecting transparency in areas from corporate reporting to banking and beneficial ownership, largely based on the assessments of relevant international and multilateral organizations. These are then compiled into 15 Key Financial Secrecy Indicators, grouped into four thematic areas as figure 1 shows. The resulting secrecy score provides the basis for assessing countries’ trading and financial partner jurisdictions. It ranges in theory from zero (perfect financial transparency) to 100 (perfect financial secrecy); in practice, no jurisdiction has scored less than 30.

A central result of the FSI approach is that it does not make sense to divide jurisdictions into ‘good’ and ‘bad’, or tax havens and others. Rather, there is a spectrum of financial secrecy on which all jurisdictions sit (and where at present all jurisdictions have progress to make). Little progress could be made by ‘shutting down’ some of the smaller jurisdictions most commonly thought of as tax havens, when the great majority of potentially risky flows go through some of the biggest economies. Global progress requires that the biggest secrecy threats, such as the USA, are subject to greater scrutiny than less systemically important jurisdictions.

For individual countries, however, it is more important to consider the most secretive jurisdictions with which there are trade, investment or other economic relationship. Because the common feature of illicit financial flows (IFF) is that they are hidden; and because it is financial secrecy that allows IFF to be hidden; the IFF risk is higher in bilateral relationships with more secretive jurisdictions.

As pioneered for the High Level Panel on Illicit Flows out of Africa, it is possible to construct measures of the extent to which any given country is exposed to financial secrecy jurisdictions. Consider a particular flow: say, exports from Zambia. For each trading partner, we allocate the partner’s secrecy score (which ranges from zero to 100) to its share of Zambia’s exports. The results can be summed up to give an overall level of secrecy for all of Zambia’s exports, and this score reflects Zambia’s vulnerability to IFFs in its exports.

If we multiply this vulnerability score by the share of exports in Zambia’s GDP (a measure of their importance or intensity for Zambia), we obtain a measure of Zambia’s exposure to IFF risk, which can then be compared across other stocks or flows. A vulnerability of 50, for exports equal to 10 per cent of GDP, would give an exposure of 5 per cent. This is equivalent to Zambia carrying out exports valued at 5 per cent of its GDP with a pure secrecy jurisdiction (that is, one scoring 100 out of 100), and all other exports with completely transparent trading partners. The exposure can then be thought of as Zambia’s pure secrecy-equivalent economic activity, as a ratio to its GDP. (Note: Where no secrecy score was available we applied the lowest observed score of 33, which will bias scores downward.)

Vulnerability	Intensity	Exposure
$V_i = \frac{\sum F_{i,j} \cdot SS_j}{F_i}$	$I_i = \frac{F_i}{Y_i}$	$E_i = \frac{\sum F_{i,j} \cdot SS_j}{Y_i}$
$i: \{1, \dots, I\}$	$j: \{1, \dots, J\}$	
$F_{i,j}$	$F_i$	$Y_i$
$SS_j$		

Country of interest  
Partner country  
Flow between reporter *i* and partner *j*  
GDP of country of interest  
Secrecy Score of partner country. Ordinal scale, 0-100.

Figure 2

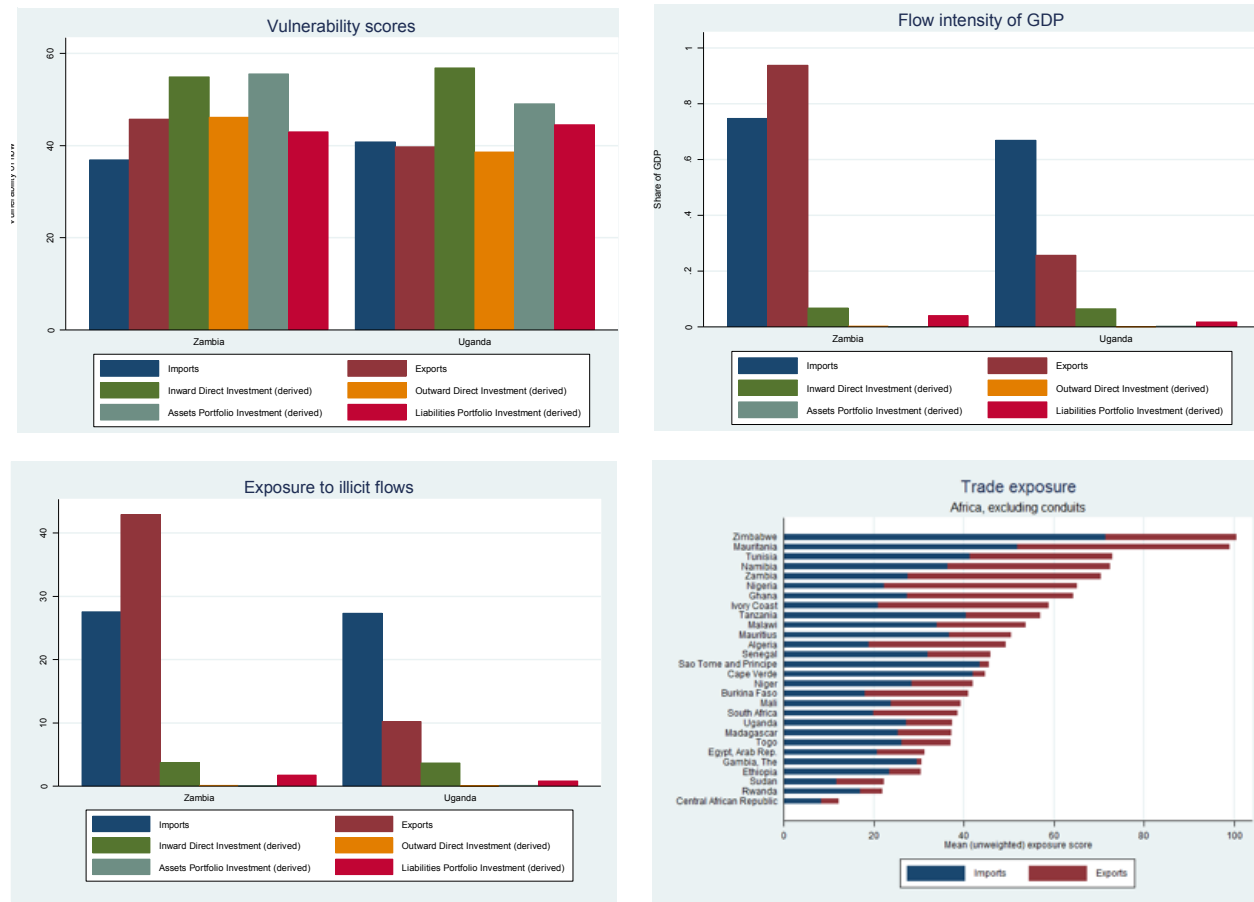
### Pilot study results, African exposure to IFF risks

The first three panels of Figure 2 provide a comparison of results for Zambia and Uganda, from a pilot study using bilateral data on trade and on direct and portfolio investment, for 2009-2011, for African countries. Bilateral data on banking positions could also be used. Note that we use stock data on investment, so exposure here should not be compared directly with that in trade flows, to assess relative importance. Nonetheless, the pattern when African countries are compared with one another, or with their peers elsewhere, will still indicate relative importance. The final panel compares a range of African countries, in terms of their exposure in exports and imports only. Even excluding the conduit jurisdictions of Mauritius, Seychelles and Liberia (which have much higher exposure in general), the range of variation is clear – in terms both of overall exposure to financial secrecy, and in terms of the relative concentration in either imports or exports.

The granular identification of IFF risks in each type of economic and financial relationship provides a much more detailed basis for policy prioritisation than currency estimates of the total scale of IFF, and with a much lower degree of uncertainty. The analysis can also indicate which secrecy jurisdictions are responsible for the greatest IFF risks in each country and each region, allowing policy prioritisation in reflect of the ultimate drivers of IFF as well as domestic defensive measures.

In addition, a full global panel of such risk measures could provide the basis for regression analysis of economic and political outcomes associated with higher IFF risk and of policy measures associated with lower IFF risk.





Source: High Level Panel on Illicit Flows out of Africa (2015).

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# Panama Papers

## — what did we learn?

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“Panama papers” refers to the leak of 11.5 million documents from the law firm and corporate service provider company Mossack Fonseca in Panama. The leaked documents revealed how companies and the super-rich use Panama and other tax havens for tax planning purposes and to hide income and wealth. However, the use of these methods has been known for a long time. What is new about the “Panama papers” is that the leak put the spotlight on a practice many thought had been largely eliminated in the wake of the OECD initiative against tax havens and, not least, that the current use of tax havens is far more extensive than many had thought.

Panama became independent from Colombia in 1903. The young country’s history as a tax haven began in 1919 when it saw income opportunities in offering American shipowners the use of Panama as a flag of convenience. This was due to the introduction of a new legislation in the United States in 1915, relating to seafarers’ rights and safety at sea. This “Seamen’s Act” meant that ships had to invest in lifeboats, and that the wage agreements and working conditions of sailors were more tightly regulated. The new law increased the costs for American shipowners sailing under the American flag and Panama saw an opportunity to undermine the new law by offering ship registration in Panama. Panama hardly put any requirements on the ships sailing under their flag, so American shipowners could continue as they had done before.

The path was short towards a more comprehensive law targeted towards foreigners because Wall Street investors quickly understood that countries like Panama could be used to bypass regulations and save taxes. In 1927, new legislation was implemented that facilitated both tax planning and tax evasion, aimed at foreigners and their companies. However, it was not until 1970 that Panama really took off as a tax haven. The 1973 oil crisis caused shipping to be less profitable and Panama therefore developed a legal framework that made them very attractive to foreigners who wanted to conceal wealth and income, due to a combination of confidentiality and minimal laws and regulations.

The business model of Panama was similar to what we see in other tax havens, namely to offer very favorable legislation with minimum requirements for investors, the use of bearer shares etc., as well as secrecy. In exchange, investors and their companies must pay annual fees to maintain registration in the company registry and cannot operate locally under this favorable legislation. Furthermore, local businesses can profit by offering local nominees that act as shareholders or board members to ensure that the foreign-owned companies are tax resident in Panama. Many of these nominees hold positions in thousands of companies. Such rules contribute to concealing who actually makes decisions and who really owns the companies. Today, Panama's tax haven industry represents a significant part of the country's value creation.

Panama is especially known for offering foreigners the possibility to establish trusts in Panama. A trust is a mass of wealth in which the formal and legal owner of the assets (the 'trustee') is committed to manage the assets through an agreement for the benefit of those who, according to the trust agreement or trust deed, are designated to benefit from the trust assets ("the beneficial owners" or beneficiaries). One can say that the managers are trusted to formally hold the property rights of the assets under trust (on trust), and for the benefit of the beneficiaries.

A trust is fundamentally different from a limited liability company. The owners of a company control and manage the company as beneficial owners, as stated in corporate law. The peculiarity of a trust as a legal instrument is that it distinguishes between "legal (title) ownership" owned by one or more trustees and those entitled to enjoy its assets ("equitable ownership", "beneficial ownership" or "interests"). The trustees' ownership rights are therefore not exercised on their own behalf, but "on trust" – in accordance with the founding requirements – on behalf of beneficial owners. Those who have the right to benefit from the trust funds are normally (but not always) someone else than those who have the formal legal authority over the funds. In Panama, information about who the beneficiaries are and how the trust operates, is hidden from the public. Those who manage the trusts in Panama face high fines and imprisonment up to 6 months if they violate the confidentiality rules.

The cases of misuse associated with trusts have sprung out of the opportunities that arise. The formal distinction between the trustees and beneficiaries, hinges on the assumption that the beneficiaries cannot exert control over the trustees. If the beneficiaries directly or indirectly control the trustees, the beneficial owners are considered as the owners of the trust funds. Secrecy rules usually prevents the ability to uncover the underlying realities of trusts. Those who have legal claims against the beneficial owners of a trust generally do not have any knowledge of the assets hidden in the trust or the ability to gain access to information about the underlying conditions. In some cases, companies are owned by a trust. Who can be held responsible for actions which are, for instance, prescribed by the trustees?

Panama has also earned a reputation for contributing to money laundering related to drug crime, weapons smuggling and terrorism amongst other things. The American Internal Revenue Service (IRS) found that in the period 1978-1983, 28% of the cases of money laundering of drug money were connected to Panama. In 2014, the IMF reacted to the problems associated with money laundering through Panama. The IMF pointed out that money laundering of criminal proceeds was illegal under Panamanian law. However, very limited resources were put into enforcing these rules. In addition, there were a number of loopholes in the legislation that needed to be corrected, according to the IMF. In retrospect, little was done prior to the before the "Panama Papers" leak to close the loopholes or enforce the rules. This might change in the wake of the "Panama papers".

### Important questions

- To what extent do tax havens comply with measures such as the ones pointed out by the OECD or the IMF to be necessary to comply with international rules and regulations? What sanctions exist for the international community against tax havens that do not follow up on their obligations?
- To what extent do we know that company registers in tax havens are up to date?
- Why are nominees allowed to act as shareholders and board members in tax havens?
- "Windowdressing": What are the realities when it comes to differential treatment of foreign investors and their companies that do not operate locally and those who live and have economic (physical) business in the tax haven. Is it true that this differential treatment does not exist anymore, as some tax havens claim?

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# The tax dilemma: How to create legitimate tax systems in Somalia

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Somalia is not commonly seen as a ‘tax paradise’. The country has little foreign investment, and most investors continue to shy away from Somalia due to the recent 26-year civil war. Regardless, Somalia’s economy has been growing steadily since 1997. Somali companies have been technologically innovative, they even created mobile money transferring systems long before the US. They also provide banking services outside Somalia, mainly due to a growing export sector of livestock. However, all the main actors in the growing Somali economy have avoided paying taxes to the government.

For the first 13 years of the civil war, Somalia, or at least southern Somalia, had few existing state structures. Some structures were established in the wake of the Arta conference of 2000, but only within enclaves controlled by Mogadishu. The Eldoret and Nairobi conferences of 2002 and 2004 resulted in new government structures. However, the government only established limited presence in one city, Baidoa. Following the fall of the Sharia courts, the government established itself in Mogadishu.

With the expansion of the militant group Al-Shabaab, the government lost control over large parts of Mogadishu, and by 2010 only controlled a small enclave in the city. In 2012, the federal government of Somalia, together with autonomous local governments, re-established some control over the urban areas of southern Somalia. Even after 2012, ‘normal taxation’ and service provision have been limited. Some forms of ‘taxation’ did exist before 2012. For example, at airports, larger markets and ports taxes were paid on commodities. Renegade militias and the Somali army established checkpoints where you had to pay a fee to pass and factions sometimes demanded “protection money” (Hansen 2007).

However, normal taxation did not exist. The commercial sector was not used to paying ‘normal taxes’ at all. Nor did they receive services from a state. Ordinary state functions, such as courts, simply did not exist. The commercial sector paid nothing, and got nothing in return. The absence of a state naturally supported an environment that

lacked a tax ‘culture’. The business community was simply not accustomed to paying taxes to a government. In 2013, the government introduced new measures, which had the potential to expand into a more full-fledged tax system.

## What mechanisms are there for taxation in Somalia today?

The 2017 IMF Country report for Somalia, estimates that Somalia has a tax potential of between USD 81-119 million. The report mentions that due to the slow development of the sector and government institutions, several revenue sources are excluded, including mobile money service fees, telecommunication services and property taxes (IMF 2017). In 2013, a year after the reestablishment of the Federal Government of Somalia a new deal compact was endorsed. The once failed state, now categorized as fragile, signed the compact that aimed to align peacebuilding and state building goals (PSG). Public financial management reform is based on priority four and five of the PSG goals: economic foundations (PSG4), and revenue and services (PSG5). By aligning its reforms to the goals, the Federal Government of Somalia (FGS) embarked on a number of initiatives to establish adequate procedural and control systems to ensure the legality, accuracy and timeliness of fiscal information in the areas of planning, budgeting, accounting, reporting and auditing (Federal Government of Somalia 2016).

While these systems are still in the early phases of implementation, one of the most important is the Somali Financial Management Information System (SFMIS), piloted and implemented in 2015. SFMIS is an instrumental source for confidence building as it enables transparency of public finance information. In a government report of March 2016, SFMIS is described as “a computer based financial management information system focusing on core public finance management (PFM) functions of budgeting, treasury management, payroll processing, tax collection, and financial processing, as well as a vital source or providing vital financial information on both execution and accounting and reporting” (Federal Government of Somalia 2016).

SFMIS was developed in 2013, and has now been piloted in a member state, Puntland, with the intention of expanding to the other states in the future. The revenue department, which is part of the Ministry of Finance (MoF), acknowledges the importance of SFMIS and hopes to make it the cornerstone of revenue collection, budget management and audit control in the near future. It is expected that the system will contribute to transparency and accountability, and help resolve issues related to fiscal federalism in Somalia. It may also help with taxing local, international and multinational enterprises operating in the region, such as telecommunication and money transfer companies that are among the major income generators in the country.

Estimates on the potential for revenue generation are, however, speculative. The absence of a population register and lack of access to many regions due to hostilities

are part of the problem. Further, corruption in federal institutions contributes to distrust in government bodies, including tax-collecting agencies.

Another issue of concern is the contracting of foreign companies for revenue collection at the airport and ports, which are among the largest revenue sources for the Somali government. Somalia's former auditor general accused two Turkish firms running Mogadishu's airport and seaport operations of resisting financial accountability. The firms rejected an audit in 2015. In 2016, Somalia awarded multi-million dollar contracts to the two Turkish firms to upgrade and run the operations of Mogadishu seaport and airport. Nur Farah, former Minister of Ports and Marine Transport of Somalia, accused the two companies of obscuring the actual proceeds from the airport and sea port through resisting an audit and accountability attempt by his office. A popular Somali news site, Hiraan online, writes that the audit general told Somali legislators that: *"There's no way we can close the annual fiscal book as long as these foreign firms that have taken over the airport and seaport's operations are evading the accountability."* This demonstrates major concerns related to tax avoidance and evasion.

### What are the consequences?

Somalia adopted the SFMIS system, which has contributed to improving accountability and transparency at the government level, and also to improving the transparency of the central bank. There are many remaining challenges, including in personal and tribal networks, capacity constraints, and lack of expertise in completing the implementation of these measures. In Somalia, the vibrant economic actors who filled the void caused by the lack of a state before 2012 have managed to, not only influence policy development in the post conflict rebuilding of Somalia, but also to create obstacles for establishing new tax legislation and financial regulations. Interest groups, such as the business community in Mogadishu, have, on multiple occasions, obstructed the implementation of new tax laws to avoid paying taxes. This is a very problematic issue since the government needs to collect revenues to finance its development expenses.

Reforming the public finance management system is essential for strengthening good governance in Somalia. Good governance is crucial in fostering service delivery, and thereby in improving revenue generation. However, the implementation of government projects faces challenges including security, absence of relevant legislation and an undeveloped federal fiscal system, which have created rifts between the central government and its member states in an environment characterised by high level of distrust among citizens and people in different regions, due to decades of clan warfare and militant rule. A major challenge facing the Somalian government is building confidence in state institutions and operations; confidence needs to be built in order to promote willingness to pay tax.

In the transition period, the lack of tax systems served the interest of stabilisation, making it more profitable for the then heavily armed commercial sector to support

state building. No formal taxes were demanded. Lack of tax payments meant that even potential obstructers of the peace process supported it because they were not expected to pay anything.

Experiences in the pre-war Somali state, as well as institutional weaknesses and corruption, have contributed to hostility towards taxing schemes. The Somali federal system complicates the sharing of information on potential tax evaders operating in different states. This further contributes to undermining the willingness to pay taxes.

Now, public service delivery is improving. Today, civil courts in Mogadishu are functioning and are used by the population. The police, although corrupt, grow in importance with respect to fighting crime. Taxation might become easier as institutions grow, and as the relationship between the federal and state levels is determined. Yet, taxpayers remain hesitant in paying taxes because there are low expectations on what the state can deliver. People simply feel that they do not get much in return for the taxes they pay.

Somalia cannot exist as an independent state in the long run without a sound tax regime. Today, the Somali army is totally dependent on foreign funding to pay salaries to soldiers and officers. If salaries are not paid, the soldiers and officers will simply walk out, meaning that the army can literally be 'switched off' by foreigners. Poor service delivery makes individuals resist paying taxes. It is a vicious circle where people do not pay taxes because of poor services, and where improved services require tax revenues. Breaking this cycle will be a major challenge for the government in the years ahead.

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## 2. The scope and consequences of capital flows from developing countries

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Tax havens facilitate illegal capital flight, harmful tax competition, money laundering, grand corruption and economic crime. Tax havens create market distortions and obstruct fair competition in markets.

### Increased debate on measurement and methodologies

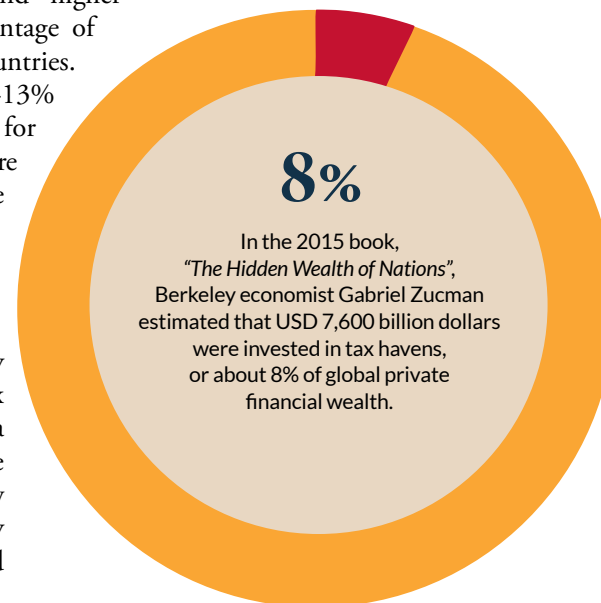
The ability to hide wealth, income and company ownership in secret bank accounts and shell companies in tax havens both facilitates and encourages individuals and enterprises to evade tax.

This is especially a problem in developing countries where government institutions tasked with detecting and deterring such activities usually are understaffed and underfunded. Tax administrations often have limited legal and auditing expertise with which to challenge powerful multinational companies.

According to estimates from the IMF, OECD countries lose as much as USD 400 billion annually through corporate tax evasion, while developing countries lose about half as much, around USD 200 billion. However, this has a much more dramatic effect on the budgets of developing countries. OECD countries have much larger economies and higher tax revenue (measured as a percentage of GDP) compared to developing countries. Tax evasion constitutes between 6-13% of the potential tax revenue for developing countries, while the figure for OECD countries is, on average 2-3% (Crivelli et al. 2015).

### The size of the problem – how big are the tax havens?

Secrecy and lack of transparency about economic activities make tax havens attractive. Access to data represents an obvious challenge for researchers in determining how much money and assets are actually stored in tax havens and channeled through them.



Despite these challenges, several studies in recent years have provided estimates on the scale of the problem. One of the first comprehensive studies was "The Price of Offshore" by James Henry of the Tax Justice Network (Henry 2012). He used data from the World Bank, IMF, UN, the Bank for International Settlements, central banks and other available domestic data sources from 139 countries. The study estimated that high net worth individuals placed between USD 21 000 and USD 32 000 billion in private assets in tax havens. This did not include non-financial assets, such as art, real estate and yachts.

Estimates on how much developing countries lose in illicit financial flows (IFFs) on an annual basis are an important contribution to lifting the issue of IFFs high on the political agenda. In particular, efforts have been made to estimate the tax loss incurred through trade mispricing by multinational companies that shift profit from developing countries where they have an economic presence to low tax jurisdictions. Early contributions in this field include the Christian Aid report "Death and Taxes" (2008). More recently, Boyce and Ndikumana (2012) have made key contributions, as have the Washington based non-profit organisation Global Financial Integrity (GFI), that have released a number of reports estimating the scale of IFFs worldwide.

The study of illicit financial flows is still a very young subject, but is now at a point where it is arguably healthy for it to mature through methodological debate. Recently, Maya Forstater has raised critiques (see Forstater 2016, 2017, and contributing article in this section), as have Erskine and Ndiaye (see contributing article). They highlight weaknesses in the methods applied to estimate IFFs. They question whether the estimates help us understand the reality of illicit economies and networks, and whether the data the estimates produce are suited to inform policy decisions.

Methodological debates will help improve the efforts to better understand the mechanisms of tax evasion, tax avoidance, grand corruption and financial fraud. New research approaches are needed, including in-depth studies and country-based research that are better suited to inform policy decisions for both governments and campaigners.

### Profit shifting in multinational companies

Economic research has found that multinational companies have a lower effective tax rate than domestic companies. Multinational companies use trade mispricing as the primary method to achieve a lower tax rate (Fuest et al. 2011; Palan et al. 2010). Trade mispricing is the strategic mispricing of goods, services and transactions between affiliated companies within the same corporate group to shift profits from high-tax jurisdictions to low-tax jurisdictions, and transfer costs in the other direction.

A large amount of global trade is not taking place in a competitive market because much of the world trade takes place between closely affiliated companies. In 2011, trade within multinational companies, and between companies in the same value



## Karuturi cut roses — and cut taxes

Karuturi Global Ltd. produces 580 million roses per year from its operations in Kenya, Ethiopia and India. It is the world's biggest producer of cut roses. One out of nine roses bought in Europe comes from a Karuturi farm. The flowers it produces in Kenya are shipped to Europe through a subsidiary in Dubai. By underdeclaring the value of the merchandise shipped to its warehouse in Dubai, the firm saves costs on its tax bill.

In late 2012, the Kenya Revenue Authority ruled that the India-based multinational company used transfer mispricing to avoid paying the government of Kenya nearly USD 11 million (EUR 8 million) in corporate income tax. Karuturi appealed the ruling in 2013, bringing the proceedings into the public domain. This is the first time an African government has brought a large multinational company to court for transfer mispricing through a fully public process (Pambazuka News 2013; International Trade Centre 2014).

chain, amounted to 49% of the global border-crossing trade in goods and services (WTO 2015).

The most common method for determining prices in these situations is the OECD standard for arm's length pricing. This method provides a guide to tax and customs authorities, and dictates that the price of a good or service shall be equal to the price it would have if the trade took place between non-affiliated actors on the open market. Determining such a hypothetical price is, however, extremely difficult for tax authorities, since there is rarely any market price to compare with on the open market (Picciotto 2013; UNECA 2015). This is particularly challenging for the pricing of patents and other intellectual property rights. Internal transactions and trade within large corporate groups thus provide huge opportunities for multinational companies to avoid tax by shifting profits and costs across borders.

Another common method of profit shifting is through so-called 'thin capitalisation' (Picciotto 2017; Reuter 2012). Rather than financing an investment in a high-tax country through equity, the investment is financed through debt to a subsidiary in a low-tax country. By transferring interest payments, often at high rates, from the high-tax country to the low-tax country, profits shift and tax owed in the high-tax country is reduced.

While these profit-shifting methods are well understood in principle, experience has revealed that combatting them is difficult, particularly for low-income countries (TUAC Secretariat 2015). OECD governments and tax administrations have invested heavily in strengthening policy and enforcement practices to curb the worst abuses (Moore et al. 2018). Despite these advantages, curbing tax abuses has been problematic. Research finds that such abuses expanded through the 1990s and 2000s (Cobham and Jansky 2015). The problems experienced by OECD tax administrations highlight the challenges faced by much less capacitated tax administrations in African countries. Generally, they lack the technical expertise and resources enjoyed by OECD governments. They also often struggle to gain access to data from tax authorities in other countries.

Thus, the problems created by the complexity and secrecy of the international system are amplified for low-income countries.

### Money laundering and crime

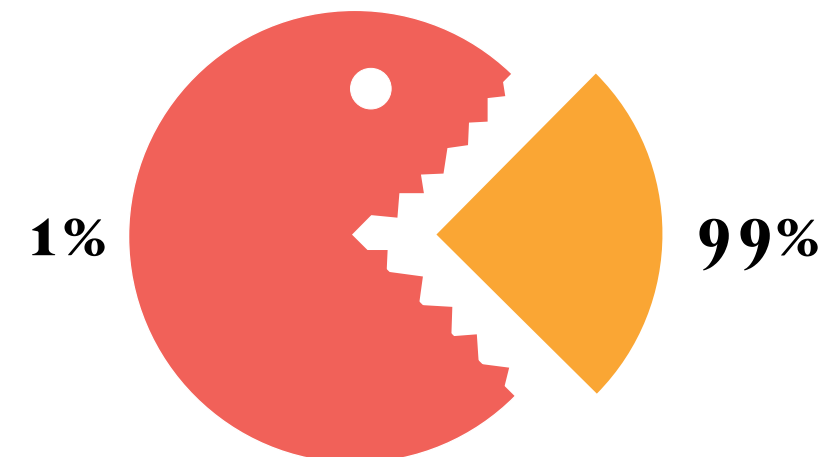
Criminals move money to where it is easy to hide and launder the money into

## Concentration of Wealth

According to the Oxfam-report "An Economy for the 99%", in 2016, the eight richest people in the world owned as much wealth as 3.6 billion people - the poorest half of the global population.



Since 2015, the richest one percent have owned more wealth than the rest of the world's population combined. Oxfam points to tax havens and tax dodging as two sources fueling this increase in economic inequality.



what appears to be legitimate commercial activity (Sharman 2010; Sharman et al. 2012). This usually means that they transfer money to where the laws, regulations and enforcement are the weakest. Tax havens have for long been a favourite hideout for criminals and others with a need to hide their activities. However, in recent years tax havens have increasingly become part of the commercial activities of major “mainstream” economic actors, especially in the financial sector.

In a globalised economic system, it is essential for the integrity of the system that the financial sector, banks, insurance companies and other providers of financial services, are subject to international standards and regulations and that these are properly implemented by the governments in the countries where they operate. According to Transparency International, however, the financial sector is the least transparent industry worldwide (Kowalczyk-Hoyer 2012). This is a major problem as it greatly increases the profitability of criminal and damaging actions. The secrecy created by the law firms and tax advisors that offer anonymous shell companies in tax havens and secret bank accounts, provides hiding places for malicious behavior, such as laundering the proceeds of political corruption, fraud, embezzlement, illicit arms trade and drug trafficking (Sharman et al. 2012).

In 2016, a major story broke in many countries: The Panama Papers leak (<https://panamapapers.icij.org/>). The leak provides a clear picture of how these worlds – the unlawful and poisonous environment of harmful tax havens and the mainstream commercial finance business sector – have become increasingly intertwined and highly integrated.

### Financial secrecy and the financial crisis

The current global financial crisis began in the United States when the housing bubble burst in August 2007. Several tax havens were deeply integrated into the US financial industry. This allowed US banks to run unregulated financial operations in bank-like companies in places such as the Cayman Islands, thus

### Panama Papers: Sierra Leone diamond cash in tax havens

The report “Panama Papers and the Looting of Africa” (Mosioma 2016) shows the many tax haven companies related to one of Israel’s wealthiest men, the diamond tycoon Benjamin Steinmetz. One of these tax haven companies is Koidu Limited, which operates diamond mines in the impoverished mining town of Koidu in Sierra Leone. The company has extracted diamonds of immense value, but without any benefit to the local population. Workers and local residents have complained about poor working conditions and extensive environmental damage. When workers protested against the poor working conditions in 2007 and in 2012, the police opened fire and people were killed.

avoiding US capital requirement regulations for banks. The debt-financed investments the banks undertook in tax havens usually were much riskier than US financial regulations allowed, with correspondingly high profit opportunities. The opportunities to engage in risky speculation for banks and finance institutions through tax havens reinforced the development of a bubble in the US financial economy and exacerbated the crisis when the bubble finally burst.

The global financial crisis initially affected advanced economies, emerging markets, and low-income countries in very different ways (IMF 2009). Advanced economies were first hit, mainly by the banking crisis in the United States and Europe. At first, emerging markets with well-developed financial systems were mostly affected by cross-border financial links through capital flows, stock market investors, and exchange rates. In financially less-developed African countries, the growth and trade effects dominated. The global slowdown in economic activity pushed commodity prices down, with negative effects on export earnings and the external current account, fiscal revenues, and household incomes. In Africa, commodity exporting countries like Angola and Nigeria faced major terms of trade deterioration.

The financial crisis is an example of how financial secrecy and weak regulations in tax havens cause problems and result in risks that others must take responsibility for. Many of the losses for banks during the financial crisis originated from derivatives and financial instruments created in tax havens. As they began to report losses, they were transferred ‘onshore’ to the banks in the US.

The banks could run huge losses, and keep the losses hidden from the public. This was possible through so-called off balance sheet investments in tax havens. As the crisis unfolded, banks ceased to lend to each other because they no longer knew the real financial situation of other banks. Eventually, US federal authorities had to inject huge amounts of money into the US financial sector to rescue it from collapse. The American taxpayers thus ended up paying the bill, and bearing the consequences of risky financial actions by the big banks.

The response to the crisis in the US and the EU has been a policy of stimulating the economy through historically low interest rates on debt, and so-called quantitative easing. This has made access to loans easy and cheaply available. Since 2008, there has been a boom in lending to the most impoverished countries. For instance, annual lending to low-income country governments more than trebled from USD 6.1 billion in 2007 to USD 20.5 billion by 2014, according to the Jubilee Debt Coalition. The coalition focuses on debt in developing countries, calling for the cancellation of unjust and unpayable debts of the poorest countries. Several years of historically low interest rates, coupled with increased lending, have dramatically increased global debt levels, and many developing countries have accumulated dangerously high levels of debt. The current economic policies that were introduced in response to the global financial crisis and the economic recession that followed in many developed economies, have therefore created conditions that might lead to a new debt crisis in the future. This would have devastating impacts on many developing countries.

### Tax competition

For the last few decades, global corporate tax rates have gradually declined (KPMG Corporate tax rates table). This is partly a consequence of companies and business

interests pushing governments to provide reduced tax levels for particular companies or entire industries. There are countless examples of companies threatening to relocate abroad unless their demands for lower taxes are met, thereby being a driving force of tax competition between countries.

In many cases, governments are the driving force behind tax competition. Tax havens are competing to offer the most “business-friendly” legal and regulatory framework to attract companies, investors and capital (TJN-A and AA 2012).

Although this may be an attractive strategy for promoting short-term economic growth in a country, at the same time it will lead to an erosion of the tax revenue base for other countries. For instance, many African countries offer generous tax incentives for many purposes to both domestic and foreign actors. Such incentives contribute to an undermining of revenues as well as the fairness and social acceptance of the tax system.

## Tax exemptions

Tax exemptions refer to measures directed at investors that provide far more favourable tax treatment for certain activities or sectors compared to what is available to the general industry (Fjeldstad and Heggstad 2011, 2012). There is a large variety of types of tax exemptions:

- 1) Tax holiday: Temporary exemption of a new firm or investment from certain specified taxes, typically at least corporate income tax. Partial tax holidays offer reduced obligations rather than full exemption.
- 2) Special zones: Geographically limited areas in which qualified firms can locate, and thus benefit from exemptions of varying scope from taxes and/or customs to other administrative requirements. Zones are often aimed at exporters and are located close to a port. In some countries, like Tanzania, however, qualifying companies can be declared ‘zones’ irrespective of their location.
- 3) Investment tax credit: Deduction of a certain fraction of the value of an investment from the liability to pay corporate income tax.
- 4) Investment allowance: Deduction of a certain fraction of the value of an investment from taxable profits (in addition to depreciation). The value of an allowance is the product of the allowance and tax rate. Unlike an investment tax credit, its value will vary across firms, unless corporate income tax is paid only at a single rate.
- 5) Accelerated depreciation: Depreciation allowances (against corporate income tax) at a faster schedule than available for the rest of the economy. This is implemented in many different ways, including higher first year depreciation allowances, or increased depreciation rates.
- 6) Reduced tax rates: Reduction in a tax rate, typically the corporate income tax rate.
- 7) Exemptions from various taxes: Exemption from certain taxes, often those collected at the border such as tariffs, excises and VAT on imported inputs.
- 8) Financing incentives: Reductions in tax rates applying to providers of funds, for instance, reduced taxes on dividends.

## Value Added Tax in Africa

Since it was first launched in France in 1948, VAT has been introduced in more than 150 countries. Currently, around 80% of the countries in Sub-Saharan Africa levy one VAT, typically raising about a quarter of all tax revenue.

VAT is a consumption tax. Key features of the VAT are that it is a broad-based tax levied at multiple stages of the production or supply of goods and services, with taxes on inputs credited against taxes on output (and refunded when the former exceeds the latter). The design and implementation of VAT differ across countries.

In theory, VAT falls on final consumption and is neutral on production decisions. Therefore, it targets a large tax base

and is growth friendly. In practice, this quality depends largely on the design features of the VAT, such as the number of rates, the prevalence of exemptions, the level and number of registration thresholds, and the limitations on refunding excess VAT credits. The productivity of the tax – the ratio of actual to potential collections – is much lower for sub-Saharan Africa than for any other continent. This is partly because the effectiveness of VAT depends on thorough book keeping and reliable self-assessment, which are in shortage in many African countries. In addition, the VAT base is often undermined by extensive exemptions and zero-ratings.

Thus, institutions like the African Union and the African Development Bank have increased their efforts to combat harmful tax competition.

If the government collects less tax revenue from corporations, it must somehow compensate for the loss in income. In many countries, we observe a relative shift of the tax burden towards taxation of consumers and employees, and a larger proportion of government revenue coming from value-added taxes (VAT) and personal income taxes on wages. Lower-income segments of the population use a greater proportion of their disposable income on consumption goods rather than, for instance, on savings. Taxing consumption is therefore, in principle, a regressive tax - those with the greatest income get taxed the least. This has also been the most widespread criticism of VAT. However, most studies find it to be distributionally neutral (Keen 2013). In some countries VAT is found to be less regressive than the trade and excise taxes it replaces (Bird and Zolt 2005). Many African countries have low or no VAT on essential goods or services such as food, healthcare, water, power and services relating to homes. Without such social reliefs, VAT would be a regressive tax, falling heavily on those who can least afford it.

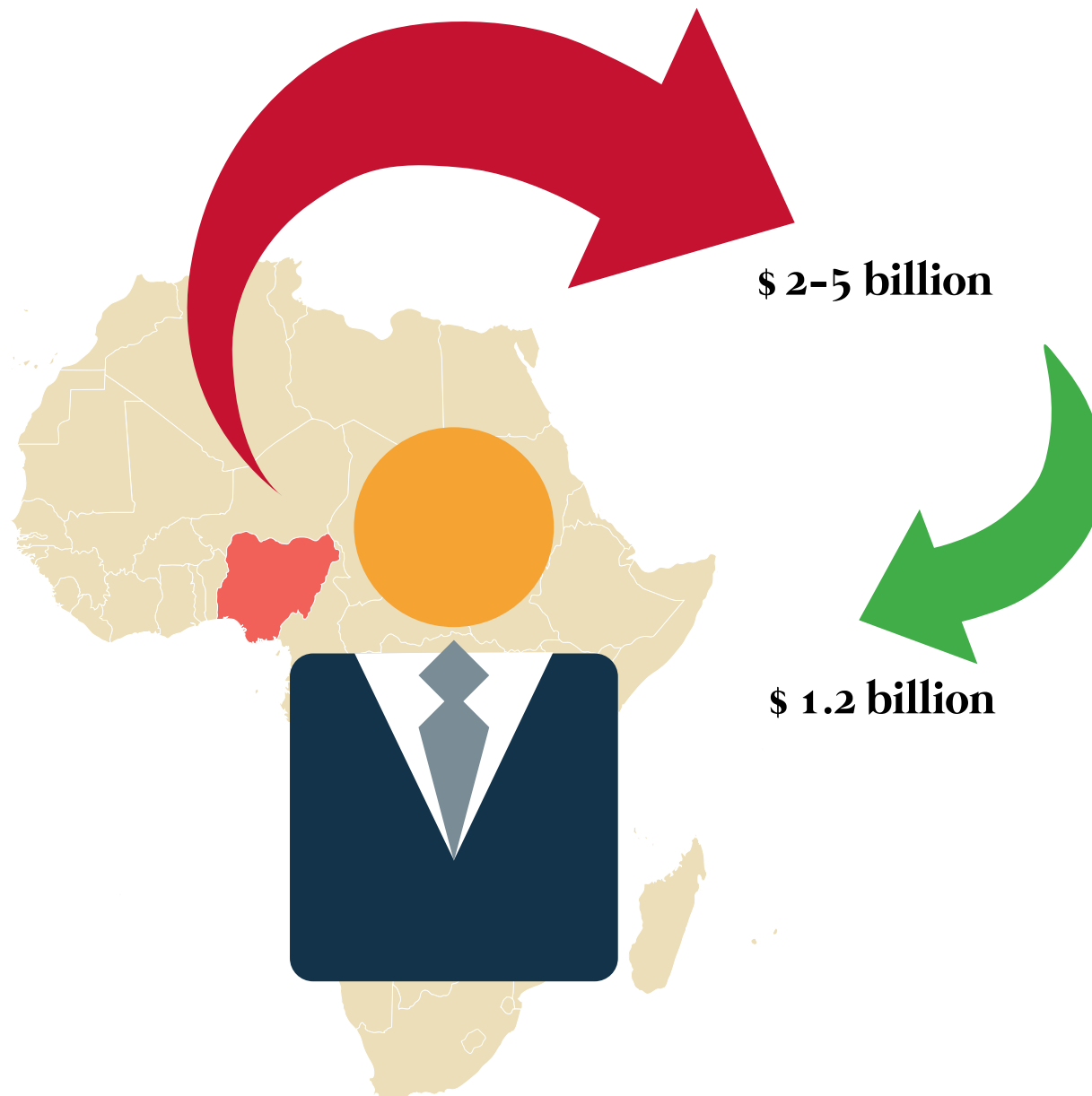
Instead of simply compensating for the loss in corporate tax revenue through other types of taxes, some states have found it necessary to cut expenses, for example by providing fewer or lower quality public welfare services. Others try to attract companies by cutting regulations on other areas than tax – such as working conditions. Unregulated tax competition may lead to a race to the bottom, not only in terms of tax levels, but also in areas such as health, security and labour rights.

## Grand corruption

One of the most serious problems with tax havens is that they host money stolen by senior officials from other countries. There are countless cases of state leaders that

## The Sani Abacha case

Tax havens played a key role when one of the world's richest non-elected heads of state, Sani Abacha, looted enormous amounts of wealth from Nigeria. During his time as head of state from 1993-1998, he secured a private fortune of between USD 2 and USD 5 billion. At the request of the Nigerian government, Luxembourg froze more than USD 600 million in assets in bank accounts in 2000. Further assets were uncovered and frozen in Switzerland and Liechtenstein. In the UK, it was revealed that 23 London-based banks had managed USD 1.3 billion worth of assets on behalf of Abacha. USD 1.2 billion has now been recovered and returned to the Nigerian government.



have looted millions (or billions) of dollars from the national coffers and placed the money in tax havens, out of reach from the grasp of investigative authorities. Only a small minority of corrupt leaders have been held to account for their actions and seen their stolen wealth confiscated and returned.

Recovering looted assets is a complicated and expensive process. Since 2000, however, the governments of the largest global economies have committed to tracking down the stolen wealth in their financial systems and returning it to the countries from which it was taken. The countries have implemented the new rules, although with varied speed and effectiveness. There are many problems facing the effective implementation of these initiatives, not least the vested interests of banks and lawyers and law enforcement agencies turning a blind eye.

### Tax havens harms innovation and productivity

In order to take advantage of the opportunities created by tax havens, you would normally need to engage specialised lawyers and professionals who can establish complex legal structures designed to minimise tax. Since these services are very expensive, wealthy individuals and large multinational companies primarily engage in this form of tax planning. The money large corporations 'save' by avoiding taxes can be used to buy up competitors, such as smaller or domestic firms, or outcompeting them because of their lower overall costs. Through such mechanisms, tax havens obstruct the proper functioning of the markets, as the companies that are better at avoiding taxes will outcompete the others.

Innovation by small, domestic companies will more easily lose out to large multinational companies, even if they may have better ideas and cheaper and better ways of producing goods and services. Profits from reducing taxes will commonly beat innovation and increased productivity. In the long term, these effects could impose huge costs to society.

### Calling Time: A sobering report on beer giant SABMiller's tax practices

SABMiller is the second largest beer company in the world, and occupies a large share of the African beer market. In the report "Calling Time" from 2010, ActionAid examined the tax structure involved in the beer giant's business in Ghana (Action Aid 2010). According to the report, SABMiller, which is behind brands such as Castle and Chibuku, reduced their tax bill in African countries by shifting profits into tax havens, particularly to the Netherlands, Mauritius and Switzerland.

ActionAid claims SABMiller achieved this through their use of the payments of royalties, management service fees, interests on loans and trading goods through subsidiaries in tax havens. This made it possible for Accra Breweries in Ghana to pay no income tax in the two years prior to the launch of the report. ActionAid estimated that the tax practices deployed by SABMiller led to tax losses to African governments of around GBP 20 million annually.



## 2. ARTICLES: The scope and consequences of capital flows from developing countries

# What do tax havens cost in terms of lost tax revenue?

**Annette Alstadsæter** • Professor, Norwegian University of Life Sciences.

**Niels Johannesen** • Associate Professor, University of Copenhagen.

**Gabriel Zucman** • Assistant Professor, UC Berkeley.

Increased globalisation and the emergence of tax havens provide large opportunities to (legally) avoid or (illegally) evade taxes, either by moving in order to change the tax affiliation, or by shifting income and / or wealth to tax havens. Because of this, governments annually lose out on up to USD 430 billion in tax revenues globally.

## Definition of tax havens

There is no official list of tax havens that all countries agree upon. However, there are some characteristics that tax havens have in common. A tax haven offers secrecy. Bank secrecy and anonymous mailbox companies (shell corporations) make it possible to hide wealth in tax havens with (up to now) little risk of being discovered. Tax havens also have low tax rates for foreigners, or no tax at all. A third feature of tax havens is weak regulatory framework with little or no efforts to enforce regulations. This is particularly appealing to banks and insurance companies who by moving activities to tax havens, may bypass financial regulations of other countries, such as capital requirements. A fourth feature of tax havens is political stability, which is a prerequisite for foreigners to be willing to place their money in the country. Some tax havens, such as Panama, may nevertheless function despite instability, because they mainly offer the ability to conceal actual ownership of companies, while the actual bank deposits are placed in other, more stable countries. The wealth is not actually located in Panama.

It is not illegal to have an account or buy services in a tax haven. However, the secrecy provided by tax havens facilitates illegal activities such as tax evasion, corruption, terrorist financing and other crimes.

## Profit shifting

Profit shifting occurs when different formal tax rates and different rules for defining the tax base between countries make it profitable to deploy various techniques to reduce taxable income in countries with high corporation tax. Either profits could be shifted out of the country or costs could be shifted into the country, or both. Methods used for this purpose are transfer mispricing, internal loans and royalties. The use of tax havens and profit shifting by multinational companies has received considerable attention in recent years.

The distinction between legal and illegal tax adjustment is blurry, and instances of aggressive tax planning has led to drawn-out legal cases in order to determine whether a certain transaction is legal or not. In addition, there is a continuous development of legislation and case law that moves the limits of what is legal and illegal.

The fundamental problem in international corporate taxation is to determine which country should receive the tax revenues from multinational companies. Today, three main principles are used to determine a single country's tax revenues from an international company:

- Source-based corporate taxation means that profits will be taxed where they are generated, and not in the home country of the shareholders or where the corporation is tax-resident.
- The arm's length principle means that affiliated companies within the same group should calculate profits as if they were independent companies, ie trading goods and services at market prices.
- International tax treaties between countries are largely bilateral, and not multilateral as for instance in trade treaties under the WTO.

Lack of consistent rules between countries (for instance in defining which type of companies should be taxed at company level and which type of company should be taxed at an ownership level and definitions on where corporations are tax residents) opens up for profit shifting between countries.

Increased economic globalisation means that such inconsistencies in principles for taxing multinational corporations have increasingly greater consequences. At the time when the principles of international taxation were established, almost a hundred years ago, less than 5 percent of the profits of US corporations were generated abroad. Today, this has increased to around 35 percent. More than half of these foreign profits are today located in tax havens, to a large extent within the EU (Zucman and Gabriel 2015).

According to conservative estimates from the OECD, governments around the world annually lose between USD 100 and 240 billion due to base erosion and profit shifting (BEPS) (OECD 2017). Developing countries are particularly vulnerable to this, with high profit shifting elasticity in terms of corporate tax rates, which reduces tax revenues and the possibilities for further development (Johannesen, Tørsløv and Wier 2016). According to estimates by UNCTAD, developing countries lost USD 100 billion to profit shifting through tax havens in 2014 (UNCTAD 2015).

## Hidden wealth

By definition, it is difficult to calculate the extent of tax evasion by hidden offshore wealth. But in the last years, new sources of data have surfaced that have opened up opportunities to do research in this area. New estimates find that the hidden wealth in tax havens accounts for at least USD 7.6 trillion, equivalent to 8% of the global



financial assets of households (EU Aid Explorer). This does not count physical assets such as property, art and gold, so the total hidden wealth is actually even greater.

The annual loss in tax revenue from this hidden wealth is USD 190 billion. Few countries have a wealth tax, so this is largely due to governments losing out on the income tax on capital income from this hidden wealth.

How much of the wealth in a society that is hidden in tax havens varies between different parts of the world, from 4% of US and Asian financial assets, 10% in Europe, 22% in Latin America, 30% in Africa and 50% in Russia.

But even if we have knowledge of the total wealth placed in tax havens on an aggregated level, this alone does not tell us who hides their wealth there.

This is the subject of our current research, where we use new data sources to estimate country-by-country offshore wealth, analyse who owns wealth in tax havens, and analysed the implications for tax evasion and inequality (Alstadsæter, Johannesen and Zucman 2017).

This chapter was previously published as 'Kor mykje taper verdas land på skatte-paradisa' in Tax Justice Network Norway's book 'SKJULT' and for the purpose of the current book updated and translated into English by the publishers with the authors' permission.

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# Illicit financial flows from Africa: Their loss; not our gain

**Raymond Baker** • President of Global Financial Integrity, and author of *Capitalism's Achilles Heel*. He has a lifetime of involvement in Africa.

We in the West have over the last half century created and expanded a shadow financial system for the specific purpose of shifting money across borders and secreting it in obscure accounts. This system comprises tax havens, secrecy jurisdictions, disguised corporations in the millions, anonymous trust accounts, fake foundations, money laundering techniques, trade misinvoicing enabling capital flows within import and export transactions, and holes left in our laws to facilitate the ultimate receipt of illicit funds into our coffers. No part of the world is so negatively impacted by this reality as Africa.

The High Level Panel on Illicit Financial Flows from Africa, headed by President Thabo Mbeki of South Africa, in its report released in January 2015 estimates IFFs from the continent at USD 50 billion. Global Financial Integrity in its latest analysis estimates that IFFs from Africa have grown to USD 75 billion. In both of these analyses, the commercial component is shown to be the largest, representing perhaps 60 to 80 percent of what can be measured using official data. All of these estimates are undoubtedly conservative, as they do not include cash movements, most criminal activities, misinvoicing of intangibles and services for which there is no data, and certain other invisible forms of trade anomalies. If data on these missing elements was available, estimates of IFFs from the continent would be considerably higher.

This is on the outflow side. Then there are illicit inflows, mostly trade misinvoicing done for the purpose of minimising customs duties and VAT taxes on imports. In GFI we estimate illicit inflows into Africa at some USD 120 billion. This seems large in comparison to the outflow numbers and suggests that, indeed, the outflow estimates may be well understated. Customs officials in Africa have repeatedly confirmed that no one in the business sector brings illicit money in without having a parallel means of taking illicit money out. Together, illicit outflows and inflows total roughly USD 195 billion.

Illicit outflows represent about 6 percent of Africa's GDP. By comparison, the same flows compared to GDPs for other parts of the world are smaller: Asia stands at 3.8 percent, Latin America at 3.6 percent, and the Middle East at

2.3 percent. Hence comes the view that Africa is the most negatively affected by this debilitating reality.

### **Tax loss**

If all of this money stayed in Africa, would it accrue to national governments? No. Governments in Africa typically collect about 15 to 30 percent of GDP as taxes. Thus, on the inflows and outflows estimate of USD 195 billion, African governments may be losing perhaps USD 29 to USD 58 billion. Think what would be the contribution of these funds to health, education, sanitation, infrastructure, and the environment if these funds remained in the continent. Think what would be the additional funds available within the private sector for investment and jobs if the rest of the money stayed in the continent.

What if the numbers are wrong? What if the total of illicit outflows and inflows, instead of USD 195 billion, are half this or double this – USD 98 billion or USD 380 billion? What measures for curtailing illicit financial flows would we change based on the most accurate of these numbers? None. The level of illicit financial flows impacting Africa are severe at whatever estimated level. It is the order of magnitude rather than the exactitude of this issue that needs to be grasped. We will never have fully accurate data, just as we do not have fully accurate data on corruption, drug trading, human trafficking, poaching, resource theft, or other realities with which we deal. But, as with these scourges, we must address the issue of IFFs with determination and tenacity in order to maximise domestic resource mobilisation for Africa and in so doing reduce poverty and inequality and enhance stability and opportunity for the continent's one billion people.

### **What can be done**

Effective analysis of and writing on the issue of illicit financial flows is aided by two sets of life experiences. First, a deep exposure to poverty. To treat IFFs as simply a statistical exercise misses the point. One ought to bring to this task a keen observation of and sensitivity to the weight of poverty limiting the lives of billions of people around the world. Second, is an understanding of how policy is set and progressed. High level policy grows out of broad appreciations much more than out of esoteric arguments. At high levels, politicians and policymakers across the globe have grasped the significance of IFFs. This is driving the agenda forward, beyond the limitations of the doubters.

As my colleague Tom Cardamone said before a World Bank audience recently, “The poor of the world cannot wait for perfection of the data.”

Can anything be done to curtail the reality of IFFs? In brief, the answer is transparency – greater transparency in financial dealings both inside and outside the continent. The shadow financial system described above needs to be steadily dismantled. We need to end tax havens by ending secrecy of ownership structures. Very simply, international banks need to know the natural persons owning accounts before

handling transactions to or from accounts. We need to end trade misinvoicing, with each nation passing laws stating that it is illegal to manipulate prices of imports and exports for the purpose of manipulating customs duties, Value-Added-Tax (VAT), income taxes, excises, or any other sources of government revenues. Customs departments should avail themselves of global trade databases enabling risk assessments of import and export pricings. We need to require multinational corporations to publish their accounts in all countries where they are authorised to do business. Every element of this is doable, a matter of political will. And every element of this has been adopted by the African Union when it approved the full recommendations of the High Level Panel. What remains is to implement what is already agreed.

We are dealing with a long-standing global reality – illicit financial flows – that depreciates the wellbeing of much of humanity. We must work together to curtail this drain on prosperity, this injury to our collective ethos.

# Are the big numbers on illicit financial flows misleading, and does it matter?

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Illicit financial flows from developing countries are commonly cited to amount to ‘a trillion dollars’ in total and USD 50 billion from Africa (GFI 2015 and UNECA 2015). These numbers have been influential in shaping international perceptions. But are they meaningful or helpful in understanding what is going on and informing the best course of action?

## How do we know?

Estimates of illicit financial flows are largely based on analyses of mismatches in official trade statistics – in other words checking whether the exports reported by one country to another are the same as the imports the second country reports from the first. If these records do not match it is assumed that this must be evidence of ‘trade misinvoicing’ (where a trader deliberately manipulates the price, quantity, or quality of the good in order to divert undeclared cash in one direction or the other).

However, the international agencies that publish the underlying statistics specifically warn against using their data in this way. The IMF says “we caution against attempting to measure [illicit flows] by using discrepancies in macroeconomic datasets... official estimates of trade misinvoicing cannot be derived by transforming trade data from the IMF Trade Statistics and/or UN COMTRADE, either by individual country or in aggregate.” (UNSTATS 2016)

It is increasingly clear that ignoring these health-warnings can lead to wildly unreliable conclusions. For example, in 2016 UNCTAD published a study estimating trade misinvoicing relating to commodities in five developing countries (Ndikumana 2016). It argued that the data revealed that South Africa was the victim of a massive smuggling scam where ‘virtually all gold exported by South Africa leaves the country unreported’. However, the South African Revenue Services, Statistics South Africa and Chamber of Mines all argued that this improbable annual heist did not happen, and that the study had drawn conclusions based on a simple misinterpretation of the way that gold is reported in South Africa’s trade statistics (Forstater 2016b; and Eunomix 2017). Similarly, Global Financial Integrity (GFI), the think tank that has calculated the trillion

dollar estimate, recently discovered that large amounts gold exported from India to Switzerland which they had counted as “misinvoiced” were in fact included in official statistics all along. In its latest report GFI reduce the estimate for illicit flow from India via trade misinvoicing by 85 percent (GFI 2017).

These problems with interpreting trade statistics are not confined to gold. It is an ordinary occurrence for internationally traded commodities to be dispatched without the final customer being known in advance, and commodities can transit through customs warehouses and other special zones before reaching their final destination. The way that trade statistics handle these trade flows tends to generate significant discrepancies in bilateral trade data in every direction, that have nothing to do with deliberate misinvoicing. Volatility in prices and transport costs can also generate mismatches (Forstater 2016a).

## How to treat estimates of illicit inflows?

Interpreting gaps and mismatches in trade data as evidence of misinvoicing suggests that there are both large illicit inflows and outflows. The popularly cited trillion dollar estimate is based on a methodology (‘Gross Excluding Reversals’) which ignores all discrepancies that could be illicit inflows to developing countries and adds up all the discrepancies that could be illicit outflows (GFI 2015). GFI has argued that this is justified because “there is no such concept as net crime”. But trade data discrepancies cannot be reliably interpreted as evidence of crime in the first place. While the latest GFI report accepts that apparent illicit outflows cannot simply be ignored, it now adds apparent inflows and outflows together (GFI 2017).

Professor of International Economics Volker Nitsch reviewed GFI’s methodology and concluded that the quantitative results have no substantive meaning and that the estimate for trade misinvoicing globally lacks evidence and is uncorroborated (Nitsch 2016).

## 10 times more than aid?

While academics are interested in methodological details, for others it is often enough to say that the numbers are huge and the problem is serious. A comparison is often made with aid. One statement is that illicit financial flows are 10 times more than aid (or sometimes even 24 times more than aid (Hickel 2017). However this involves comparing a global estimate based on 150 developing countries including major emerging economies and EU and OECD members, with aid receipts that go to fewer, poorer countries. 70% of GFI’s total relates to countries that receive no or almost no aid. The largest portion of the global estimate relates to high income countries such as Russia and Saudi Arabia, as well as major middle income countries like Mexico and India that generally rely little on aid.

Looking more closely at GFI’s estimates for each country, in 2011, only 2% of the misinvoicing total was associated with low-income countries. In countries where aid

is significant (more than 2% of the government budget) the average result is that estimated illicit financial flows are around the same magnitude as aid, not ten times larger.

Thus, the comparison with aid is a numbers game that does not tell us anything about the scale of illicit flows in relation to aid in individual countries where aid is significant. Comparisons with aid also tend to encourage the misunderstanding that illicit flow estimates indicate money diverted from public budgets, yet this is not what the estimates measure.

### **Why quibble over methodologies and magnitudes?**

Illicit financial flows are hidden and will always be difficult to measure. Is it really worth pointing out misunderstandings and myths in pursuit of a more rigorous and careful approach to evidence? Should we not just accept they are significant and just get on with tackling them?

I would argue that relying on bad numbers debases political debates and leads to weak policy analysis and ineffective action. Cases of grand corruption have been found to use wire transfers more often than manipulated trade invoices. Yet, large trade misinvoicing estimates have been used to make the case that trade misinvoicing (ascribed to multinational corporations) is a larger problem than crime and corruption. Similarly, the focus on misinvoicing tends to support the perception that international tax havens are the main way that elites in developing countries escape taxation, when in practice much tax evasion takes place domestically (Kangave et al 2016).

The big numbers are mainly a communications tool. They are used to make the case for transparency mechanisms such as public registers of beneficial ownership and country by country reporting. The hope is that access to data will inform and empowers citizens to hold governments and the powerful to account. However, for this to work there needs to be a robust chain of links between raw data, real analysis and understanding, and sustained citizen engagement on complex issues (Forstater, 2017b). It is hard to reconcile this with the argument that we shouldn't worry about looking too closely at the analysis.

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# Improving methods and data for estimating illicit financial flows (IFFs)

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In 2014-2015, the Bank of Tanzania commissioned a country study of illicit financial flows (IFFs), funded by Norway. The aim of the report was to understand the extent of IFFs, the sectors involved, the channels used and the drivers of the IFFs, and to receive recommendations for effective policy actions. Current methods for estimating IFFs require careful handling and provide little of the insight sought. This note draws out lessons for future country studies of IFFs, especially on the research challenges regarding the main types of IFFs.

The problem of IFFs and related policy issues has been receiving increasing attention from world leaders, most prominently in the Mbeki Report, the Addis Ababa Action Agenda and the United Nations Sustainable Development Goals and the actions agreed in 2016 by the G20 (Leaders' Communique Hangzhou Summit, 4-5 September 2016).

Countries are increasingly coming together to encourage domestic resource mobilisation, tax information exchange and tax enforcement skill sharing, ownership registries, asset recoveries and sanctions compliance, and to discourage secrecy, tax havens, money laundering, terrorist financing, transnational organised crime, trafficking crimes and corruption. This is now beginning to be seen in country-level policy measures and in development assistance (DFID Tender Notice 2016). There are prospects for more, even the coherent and whole-of-government policy actions that have been called for (OECD 2016).

To reach this point, there has been a sustained campaign. Credit must go to the advocates for action, including to the researchers whose estimates have raised the profile of IFFs. But for such a young subject, an unhelpful obsession with measuring has already developed, which is both understandable and frustrating. Understandable because “what cannot be measured cannot be managed”. But frustrating, or worse, because IFFs are hidden, the measures that have emerged cannot be proven and the current focus on controversial “big number” estimates risks rendering the IFF agenda ineffective.

**The problem is that the crimes are hidden and cross-border crimes are particularly hard to identify, report, record, prosecute and convict.**

This article explains why, seen through the prism of the challenges we faced undertaking the Tanzania country study. (Until the country study is published, we cannot recount its findings or limitations.)

A key issue is matching what has been estimated as IFFs with the actual concept of IFFs. The term “Illicit Financial Flows” is broad. The Mbeki Report describes IFFs as “typically originating from three sources: commercial tax evasion, trade misinvoicing and abusive transfer pricing; criminal activities, including the drug trade, human trafficking, illegal arms dealing, and smuggling of contraband; and bribery and theft by corrupt government officials”. However, money is fungible, and the IFF concept for consistency has to encompass all activities that involve breaking a national or international law where the flows cross a border (e.g. there must be an international element).

But the well-publicised IFF estimates in multi-country studies have a narrower view (Johannessen and Pirttilä 2016). Two closely related methods have developed for estimating IFFs, from Global Financial Integrity (GFI) in Washington, D.C. (Kar and Spanjers 2015) and the other from Ndikumana and Boyce (N&B 2015) in Massachusetts. Though they differ in detail, both are based on deriving discrepancies in databases of balance of payments and trade statistics, and depend on assumptions that the discrepancies are illegal flows. Their headline estimates are split between two components, a residual in the balance of payments (described by N&B as “capital flight” or by GFI as “hot money narrow”) and a mismatch between the international trade a country has recorded and what its trading partners have recorded (which is described by both as “trade misinvoicing”, which is one type of IFF).

This paper is not the setting for analysis of the differing approaches (we prefer and use variants of the N&B articulation). Both require care at a country level: the data for one country is much more fragile than it appears in a full dataset of countries. Instead, this paper is an opportunity to encourage researchers to find new approaches that add insight for policy makers.

The chief problem is policy relevance. Annual estimates based on statistical discrepancies are volatile. Nevertheless, they may be useful to policy makers if they can be related over decades to specific changes in the economy, for instance a switch in policy regimes (e.g. from socialism to capitalism, from a tightly-controlled exchange rate regime to a more flexible regime or from taxing exports to taxing imports) or structures (e.g. from oil-importing to oil-exporting). But estimates based on discrepancies say almost nothing about the underlying actors or activities, their importance or drivers, let alone how IFFs might be contained.



A second problem is distraction. Providing an estimate of one type of IFF (“trade misinvoicing”) leaves aside, unseen and potentially buried, all the other types of IFFs listed as “typical” by Mbeki.

At this stage, at the level of a country, researchers addressing the other types of IFFs face real difficulties: so few have tried that there are no developed methods in use (Haken 2011). The problem is that the crimes are hidden and cross-border crimes are particularly hard to identify, report, record, prosecute and convict. There are often statistics or media on reported crimes and court outcomes, but there is no systematic compilation of the events, especially those that escape detection or reporting. In addition, there is risk of double-counting, or worse. Almost every crime leading to an IFF also involves tax evasion and money laundering: some activities such as poaching may involve multiple crimes.

**This will be difficult and estimates will lack precision, but it will be better to be broadly right than precisely wrong**

Valuation issues abound. It is easy to consider theft through corruption or fraud and transfer of proceeds abroad as an IFF involving theft, tax evasion and money laundering. But the IFFs resulting from trafficking in ivory are more complex: an externality has to be attributed to the nation’s loss of animals killed by poachers, but how should this be valued? And what about damage to the environment, pertinent when considering the SDGs?

It is essential to broaden research from the current narrow focus on one type of IFF (“trade misinvoicing”), but also to stop before the estimation process becomes too difficult to explain.

Another issue will be assessing progress. Can researchers distinguish between changes in IFFs resulting from data collection changes or from behavioural changes? Or prove effectiveness given how little is known about how IFFs would have changed in the absence of policy actions?

### Conclusions

The quest to make country estimates of IFFs will not subside, even though the UN expert group for SDG measurement has not yet found an acceptable methodology (United Nations Department of Economic and Social Affairs Statistics Division). It is time for new research approaches to country studies, moving beyond what have come to be the most prevalent (yet unofficial and unendorsed) measures for estimating IFFs. It is vital to broaden the research on IFFs to cover the full range of criminal activities that generate IFFs. These include tax-based, theft-based and

trafficking-based crimes and will have to cover undetected crimes. This will be difficult and estimates will lack precision, but it will be better to be broadly right than precisely wrong.

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# 3. The tax avoidance industry and law enforcement

## 3. The tax avoidance industry and law enforcement

Ownership structures and wealth is transferred to tax havens because they have laws that are attractive for companies and individuals. There has been a surge in ‘tax haven laws’ all over the world. Powerful interest groups have succeeded in creating legal systems tailored for their needs and wishes. Auditing firms and accountants, lawyers, banks, multinationals and governments are key facilitators in tax avoidance and evasion. We present examples of large tax evasion cases brought to court by law enforcement agencies, both in Africa and internationally.

### Accounting firms and the ‘Big Four’

Accounting and auditing firms primarily perform two main services for their clients. Firstly, they offer accounting services, including keeping accounts and providing systems for accounting, and provide a broader set of consulting services, which may include tax planning. Secondly, they perform auditing or accounting controls, which involve verifying that records and financial information is correct. In the first role, one can say that the firm is primarily an agent for its customers’ interests. Their auditing role can be considered an agent for the interests of society – to ensure businesses follow the rules and are trustworthy and credible.

Audits have gradually evolved, and are now performed by international corporate groups to meet the needs of an ever-growing customer base of multinational companies. Currently, four international firms dominate the industry. Commonly known as ‘The Big Four’, they are (ranked based on the size of their turnover): PricewaterhouseCoopers (PwC), Deloitte, Ernst&Young (EY) and KPMG. In 2012, they had a combined turnover of USD 112 billion, 2800 offices and over 700 000 employees worldwide. All four companies have businesses in over 150 countries, including in all the major tax havens (Annual reports from PwC, Deloitte, EY and KPMG).

The ‘Big Four’ have all promoted tax haven activities:

- A whistleblower from PwC exposed the content of hundreds of secret deals that PwC had negotiated with the tax authorities in Luxembourg on behalf of the multinational companies, in a leak known as ‘LuxLeaks’. These ‘sweetheart deals’ helped multinational companies avoid large amounts of tax. LuxLeaks highlights the problematic dual role the ‘Big Four’ have: as auditors, they are supposed to ensure that companies act ‘correctly’. As tax advisors, they assist companies to exploit loopholes or operate in legal gray areas (Tax Justice Network-Norway 2016).
- PwC, EY and KPMG in particular, faced strong criticism in the early 2000s for marketing and selling ‘tax products’ in the USA. These tax products involved the use of tax havens, and were promoted primarily to American citizens.

A US Senate investigation found that these illegal products cost the US tax authorities billions of dollars in lost tax revenue (United States Senate 2005). EY paid USD 123 million in a settlement in 2013 (Rapoport 2013), while KPMG paid USD 456 million after having admitted helping US taxpayers avoid USD 2.5 billion in taxes (IRS 2005).

- Deloitte, and the now terminated Arthur Andersen company, were criticised by the US Senate for their involvement in the Enron scandal. Between 1996 and 2000, Enron declared billions of dollars in profits, but only paid corporate income tax in one year. They accomplished this by creating a complex web of hundreds of shell companies in tax havens, of which nearly 700 were registered in the Cayman Islands (New York Times 2002).
- In 2005, the European court of justice ruled that KPMG had sold products to circumvent VAT in the UK. Their promotional materials for the products even said that KPMG was aware that UK tax authorities would consider the structures they sold as “unacceptable tax avoidance” (Wall Street Journal 2005).
- A report from the British Parliament’s Public Accounts Committee referred to PwC’s activities as ‘nothing short of the promotion of tax avoidance on an industrial scale’ (British Parliament Committee on Public Accounts 2015).

The ‘Big Four’ are not alone in facilitating tax dodging and use of tax havens. However, they have a special responsibility for several reasons:

The ‘Big Four’ international accounting and auditing firms are so large that they dominate the world market of accounting and auditing services (Sikka and Hampton 2005; Mitchell and Sikka 2011). Together, they audit 99 of the 100 largest companies on the London Stock Exchange. When so few actors occupy such a large part of the market, the chances of collusion dramatically increase and it becomes very difficult for governments to regulate them. If one of them collapsed, it would lead to a crisis in the audit market because there are no real alternatives.

When financial actors are as large as the ‘Big Four’, they are in practice “too big to fail.” This gives them tremendous bargaining power towards governments, which they regularly take advantage of to obtain special privileges.

Audit firms provide advisory and consultancy services to governments and government agencies, and have used this position to promote their own and their clients’ interests. It is common for managers and senior staff from the ‘Big Four’ to take on positions in the OECD or national governments only to return to the auditing companies later. This is known as ‘revolving doors’ and can cause conflicts of interest between regulators and those the regulators are tasked to monitor. Members of the British Parliament have been alarmed by how this allows audit firms to get detailed information on the British tax authorities’ strategies, information that they in turn can use to customise tax planning strategies for their clients (Sky News 2016).

## Lobbying versus corruption

There is no single widely used definition of lobbying, but it is often defined as any legal attempt by an organisation to affect the actions and decisions of the government. Corruption, on the other hand, is generally defined as the abuse of entrusted power for private gain. To citizens in many countries the words “lobbying” and “corruption” are essentially synonymous. Lobbying and many forms of corruption have the same basic goal – to influence policy decisions by the government (Campos and Giovannoni 2007). However, there are three principal differences between lobbying and corruption:

- 1) Corruption is illegal and generally illegitimate, while lobbying is legal and legitimate.
- 2) Corrupt practices tend to benefit one person or a small group of people, while lobbying is usually conducted on behalf of a larger group of organisations who share a particular interest (for instance, to lowering taxes and granting tax exemptions).
- 3) While corruption often entails the provision of bribes or favours, lobbying most often entails the provision of information, as lobbyists provide government decision makers with information they can use as basis for government officials’ decisions.

Nevertheless, lobbying and some forms of corruption have something important in common; both are ways of obtaining help from the public sector in exchange for something. A better understanding of how lobbyism is conducted in developing countries could therefore also improve our understanding of corruption patterns.

### Lawyers and wealth managers

Lawyers and legal professionals are essential for a country’s legal system to function properly. Most people associate lawyers’ roles with providing services to those who need assistance with legal matters, for example in connection with a lawsuit. However, a large component of the activities of law firms today are related to financial affairs, in particular financial transactions. This is an area in rapid growth. Lawyers are involved in large transactions by multinational companies. The World Bank identified the abuse of lawyers’ professional secrecy in the financial area as one of the major threats to effective countermeasures against corruption and money laundering (de Willebois et al. 2011).

Lawyers may also be involved in tax dodging in other ways. For example, by drawing up laws in tax havens tailored for tax avoidance purposes and by establishing and

## The Paradise Papers

In November 2017, a window to the world of offshore law firms was opened, as the Paradise Papers leaks exposed millions of leaked documents from the Bermuda-based law firm Appleby. The firm is more than 100-years old, with a well-protected reputation. Founded in Bermuda, it has offices in Hong Kong, Shanghai, the British Virgin Islands, and the Cayman Islands. The Paradise Papers disclose how the offshore financial system is deeply entangled with the overlapping worlds of politicians, private wealth and corporate giants, including Apple, Nike, and other global companies that avoid taxes through increasingly creative maneuvers. The leaked files show how law firms such as Appleby are instrumental in spinning the webs of financial secrecy that are at the core of offshore finance. Read more here: [www.icij.org/investigations/paradise-papers/about/](http://www.icij.org/investigations/paradise-papers/about/)

administering trusts. Law firms often organise the use of nominee owners and directors to anonymise the real beneficial owners of assets or companies.

A professional group of wealth managers commonly services the super-rich. According to Brooke Harrington (2016a, 2016b), there are about 20 000 practitioners of wealth management located in 95 countries. They help their clients violate the intention of the laws while remaining formally compliant. The super-rich and elites do not simply want tax avoidance, but law avoidance. For ultra-mobile private capital, national laws are just a set of ‘shopping’ opportunities. Why do not governments stop this? The answer is that there are massive conflicts of interest at the personal level, as well as institutionally. Wealth managers have access to the highest levels of government, and in tax havens they literally write the laws.

### Banks

There is growing evidence that subsidiaries of the world’s major banks have been heavily involved in facilitating capital flight and money laundering (Fjeldstad and Heggstad 2014). The Panama papers identified 500 banks as enablers of capital flight. In particular, three of the world’s largest banks are identified as major players in this ‘market’: HSBC Holding PLC, UBS Group AG and Credit Suisse AG.

Banks facilitate the creation of shell companies and hidden accounts for thousands of their clients in different tax havens that have secrecy jurisdictions, such as the British Virgin Islands, Panama, Bahamas and others. The Panama Papers confirm that illicit capital flight is a global issue (ICIJ and CPI 2016). Banks with subsidiaries all over the world are represented in the leak as active facilitators for global clients.

## Credit Suisse

In 2014, the Swiss bank Credit Suisse became the first bank to admit guilt in a criminal case in the US in more than a decade. For years, the bank had helped wealthy American clients to avoid US taxation through setting up anonymous trusts and shell companies in tax havens. The bank accepted a fine of USD 2.5 billion. Since 2014, the bank has also been under investigation in several European countries for complicity in tax evasion, money laundering and hiding assets for politically exposed persons. In 2017, Credit Suisse have come under heavy criticism and is facing possible legal action in the UK, due to their role in facilitating secret loans totalling more than USD 2 billion with three firms in Mozambique (Jones 2017). The firms were secretly and illegally granted government guarantees, which have caused a political and economic crisis in the country. A large portion of the loans were transferred to bank accounts in tax havens, with secret owners.

Large-scale tax abuse would be much harder if well-known banks and financial institutions were not present in tax havens. Tax havens usually house clusters of banks close to the main region in which they operate. For example, the Cayman Islands have been very popular with South American banks, while many banks from the United States are present in Bermuda and the Bahamas. The Channel Islands, including Jersey and Guernsey, are a popular location for banks from the UK and Europe, while banks from Australia and New Zealand often use Pacific islands for



specific tax related purposes. Banks that operate all over sub-Saharan Africa use Mauritius for their transactions. A bank in Mauritius does not operate in isolation, but as a part of a financial system that often has direct links to mainstream banks in major economies.

Individuals and companies that use services in tax havens usually enter through an intermediary that they know and trust, for instance a mainstream bank that they already have a customer relation with. The 50 largest banks in the world manage USD 12 100 billion dollars in tax havens on behalf of wealthy individuals. In 2010, the three largest banks UBS, Credit Suisse and Goldman Sachs, managed respectively USD 1.789 billion, USD 932 billion and USD 840 billion in assets in tax havens (Henry 2012).

### The Swiss Leaks

The Swiss Leaks revelations showed how the Swiss subsidiary of HSBC helped 106 000 clients from 203 countries, including many African countries, to set up bank accounts in Switzerland holding a total of USD 100 billion (ICIJ 2015). The source of the data was an HSBC employee, Hervé Falciani, who gave information to French tax authorities in late December 2008. A non-disclosed source passed the data on to the French newspaper Le Monde in January/February 2014. After analysis by the International Consortium of Investigative Journalists (ICIJ), international news media published the case on 8 February 2015. The Swiss Leaks sparked considerable public debate on the role of tax havens in the international financial system, and the role of multinational banks in facilitating tax avoidance and evasion. The leaks provide a glimpse into the secretive world of private wealth held in tax havens, estimated to represent a substantial 8% of private wealth globally. Some of HSBCs wealthy clients are Africans. They come from a variety of backgrounds, from businesspersons to entertainers – who have made their wealth legitimately – to politicians and a hostage negotiator (Spooner 2015).

### Tullow loses tax case in Uganda

Tullow Oil is an oil and gas exploration and production company. The company has operations in both West and East Africa. In 2012, Tullow Oil completed a 66.7% sale of its Ugandan licences to CNOOC Limited and TOTAL for USD 2.9 billion. Uganda Revenue Authority estimated that Tullow should pay USD 473 million in income tax. Tullow contested the assessment and filed a suit in the Tax Appeals Tribunal.

In 2014, the Tribunal ruled in favour of the government and ordered Tullow to pay the full amount of USD 473 million. Tullow contested the ruling and said it would appeal to the High Court and go to International Arbitration. The Government and Tullow reached a settlement, and Tullow agreed to pay USD 250 million and withdrew all capital gains tax related cases against the government (Bwire 2014).

Several banks that had knowingly financed transactions that contributed to tax evasion were involved in the cases of large-scale tax fraud in the US, as described in the previous section on audit firms. Among these was Deutsche Bank who financed illegal tax products constructed by KPMG. JP Morgan Chase and Citigroup were also criticised for the role they played in the Enron fraud scandal, including assisting Enron in accessing financing through tax haven companies.

### Multinational companies

Many of the largest economies in the world are multinational companies, rather than countries (Khanna 2016). With a turnover of USD 486 billion in 2015, the economy of the US multinational Walmart is about the size of the gross domestic product (GDP) of Nigeria (USD 481 billion). Apple's revenue is four times the size of Kenya's GDP (USD 234 billion against USD 63 billion).

Multinational companies have become increasingly important in the global economy. A social responsibility to pay fair and correct taxes to the countries in which they operate should have accompanied this increased importance. It is an important ethical principle that a company's right to earn money in a community is tied to a responsibility to society in the form of tax payments. For a company to be able to earn money, it needs to operate in a society that has a rule of law, infrastructure, and an educated population. All this is funded by tax revenues. However, many multinational companies hardly pay any tax to the societies from which they earn their profits. In the US, companies have gone from contributing more than 30% of federal tax revenues in the 1950s, to only about 10% today (Tax Policy Center 2016).

Many multinational companies seem to consider tax as a cost that must be minimised. Managers of these companies tend to explain the need to avoid taxes wherever possible as an integral part of their responsibility towards the shareholders.

### MTN – South African cell phone giant under offshore profit shifting allegations

MTN, a South Africa-based multinational mobile telecommunications company, has almost a quarter of the African mobile market with more than 150 million subscribers. The company has recently been confronted with allegations of shifting profits to offshore destinations, and thereby dodging tax bills in many African countries. Investigative journalists questioned the transfer of funds from Ghana, Uganda, Nigeria and Cote d'Ivoire to MTN companies in Dubai and Mauritius. MTN claims that these are payments for management and technical services, as well as royalty payments for the use of the MTN brand. The Uganda Revenue Authority (URA) froze more than USD 90 million of assets held in MTN bank accounts, awaiting the legal outcome of what the tax authorities claim are under-declaration of earnings by MTN (McKune and Turner 2015).

## Zambia Sugar criticised for tax dodging by Action Aid

In a 2013 report, Action Aid examined the tax practices of one of the world's largest multinational food companies, the Associated British Foods (ABF) group, in Zambia. ABF is behind brands like Silver Spoon sugar, Kingsmill bread, Ryvita, Patak's, and clothing chain Primark. In the report "Sweet Nothings", Action Aid looked into the ABF's Zambian subsidiary, Zambia Sugar Plc.

Based on the findings in the report, ActionAid claimed that Zambia Sugar was dodging taxes from the Zambian government. Looking at data starting from 2007, the report claimed that Zambia Sugar had generated profits of USD 123 million, but paid "virtually no corporate tax" in Zambia. The company was also found to have taken over USD 83.7 million (USD 13 million a year) - a third of pre-tax profits - out of Zambia into tax havens, including Ireland, Mauritius and the Netherlands. ActionAid estimated that Zambian public budgets were deprived of USD 27 million because of the company's tax avoidance schemes and special tax breaks.

This contradicts corporate law in most countries. Often, the law states that a company must be managed for the interests of the company. Obviously, this includes shareholders, but it also implies that the company should pay attention to other stakeholders, including employees.

There is reason to question the notion that the maximisation of short-term dividends is in the shareholder's best interests. Many shareholders have a much broader set of interests and a longer time perspective. For example, it is reasonable to assume that many people who have savings through pension funds or mutual funds, and therefore are indirect shareholders in multinational companies, do not see it in their interest that the companies minimise tax contributions and seek maximum short-term profits. Many pension savers would abstain from extra earnings if the extra earnings were earned by companies dodging tax. In addition, pension savers are usually wage earners and taxpayers. They are the ones who ultimately have to pay more tax if companies do not contribute.

One of the largest shareholders in the world, the Norwegian Sovereign Wealth Fund, which holds shares in almost 9 000 companies in 77 countries, issued an expectation document on responsible taxation to the companies they have invested in. In the document, they explicitly question the notion that the companies have an obligation towards shareholders to minimise tax (Norges Bank Investment Management 2017). They also ask companies to publish public country-by-country reports, and for boards to develop company tax policies, according to the principle that taxes should be paid where economic value creation takes place.

## The governments of tax havens

The governments in tax havens must bear much of the responsibility for the many opportunities for tax and financial abuses that exist in their jurisdictions. They have all contributed to a system that increases inequalities and creates obstacles to sustainable development for the world's poor.

Those who defend tax havens often refer to their right as sovereign states to independently design their own tax system. This independence is shallow, as tax havens often are 'captured states'— an interest group dominating a political entity and shaping legislation to their advantage by influencing a country's politicians and other decision makers. The political culture in many tax havens makes substantial democratic debates practically impossible. Those in power are generally satisfied with "business as usual" and there is no real climate for political discussion. In 2016, for instance, the island of Jersey only had one political party, Reform Jersey, which had three of 49 representatives in the island's government. All other representatives formally had status as independents. In reality, the majority are representatives of business as usual and cater to the interests of the tax havens' financial industry.

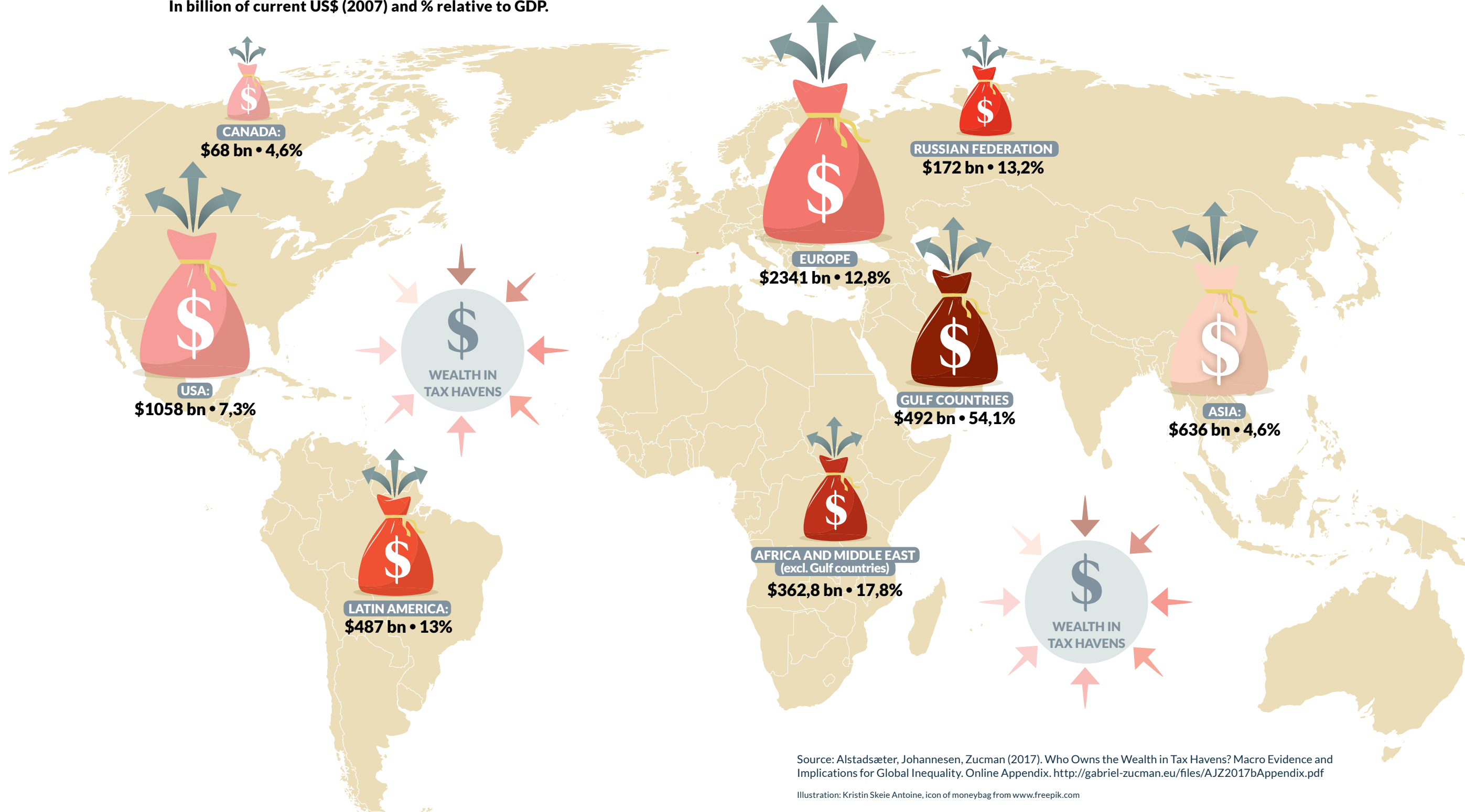
An extreme case is the City of London. City of London is in many ways an autonomous sovereign jurisdiction, even though it is located in central London and is considered London's financial district. The City can write its own laws which are independent from the laws of the United Kingdom government in many areas – particularly laws related to business and finance. "The City" is the only democracy in the world where companies are entitled to vote. Since mainly companies are located there, outnumbering citizens, companies have the majority of votes (Shaxson 2011).

## "Bid-rigging" scheme in the construction of an airport in Trinidad and Tobago.

The government of Trinidad and Tobago was defrauded more than USD 100 million, as a criminal organisation used a number of tax haven shell companies to engage in a bid-rigging scheme (FATF 2010). Unknown to government officials, the international construction and architectural firms that participated in the tender were all owned by the same people, allowing the manipulation and control of the bidding process by a criminal organisation. The real ownership of those behind the scheme was hidden and the money from the construction contract was laundered through a series of shell companies in tax havens. "We do not think we will ever know just how much money was stolen from the public", said the prosecutor in Trinidad and Tobago, John Jeremie. However, through handwritten notes kept by foreign bankers, investigators from U.S. Immigration and Customs Enforcement later identified the real beneficiaries of the funds. Six of the eight persons involved were found guilty of money laundering and fraud in a court in Miami, USA.

## Wealth in tax havens per continent:

In billion of current US\$ (2007) and % relative to GDP.



If we are to combat the global problem of corruption, it is vital to understand the essential role tax havens play as providers of secrecy. Many will associate corruption with bribery of officials in developing countries and corrupt politicians. However, companies and facilitators in the financial secrecy industry contribute largely to corruption. They are the ones who enable corruption, making it easy and low risk to hide the proceeds of corruption.

The secrecy industry represents the supply side of corruption. Corrupt public officials are examples of the demand side. Corruption must be combated through measures addressing both the supply and demand sides – not only by strengthening institutions in corrupt countries, but also by increasing transparency in tax havens.

# 3. ARTICLES: The tax avoidance industry and law enforcement



# Above the law? Offshore and the politics of libertarian anarchy

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Discussions about offshore finance tend to focus on its role in tax evasion, but the real story is much worse. The offshore world is about *law avoidance* by the super-rich: taxation is just the tip of the iceberg. If a wealthy person does not wish to pay their debts, or wants to flout the laws that govern everyone else – whether it be a matter of inheritance laws or trade embargoes – offshore makes it possible (Harrington 2016).

The American writer Joan Didion once observed that “the secret point of money and power is neither the things that money can buy nor power for power’s sake...but absolute personal freedom, mobility, privacy” (Didion 1968). This is part of a philosophy of libertarian anarchy shared by many contemporary billionaires (Mayer 2010): a radically anti-government stance which advocates “freedom from democratic restraint” for the richest members of society (Monbiot 2012). Offshore is the creation of this politics of lawlessness for the rich, creating “a world without rules” for those who wish to “take the benefits from society without paying for them.” (Shaxson 2011)

By now, the role of offshore in facilitating massive, systematic tax avoidance is well-known. At least USD 200 billion is lost to governments worldwide each year, just from private individuals’ use of tax havens (Zucman 2015). Another USD 500 billion in tax revenues are lost annually due to corporate tax avoidance (Cobham and Jansky 2017). Supporting this massive transfer of wealth away from the public good and into private hands is an industry of experts, without whom the offshore world could not function. For corporations, the key players are the Big Four accounting firms (Pricewaterhouse Coopers (PwC), Deloitte, EY and KPMG), and – to a lesser extent – some international law firms. For private individuals, tax avoidance is facilitated by wealth managers: a profession of expert lawyers, accountants and others who specialise in protecting the fortunes of ultra-high-net-worth clients (Harrington 2012).

With the explosion of the Panama Papers scandal in 2016, wealth managers and their significance in the offshore world became far better known to the public than ever before (Obermayer and Obermaier 2016). It revealed, for example, how Mossack

Fonseca – the firm whose client data was exposed in the Panama Papers leak – helped make the law in several offshore jurisdictions, tailoring it to the desires of their clients to escape the “sovereign national cage” of their home countries (Palan 2002). Offshore, what was forbidden back home suddenly became possible, without criminal or civil penalties. This aspect of the Panama Papers, the bigger picture surrounding tax evasion, has received less attention than it deserves.

Consider just one offshore jurisdiction: the Cook Islands. As a tiny archipelago in the South Pacific, the Cook Islands has developed a crucial niche in the offshore world by enshrining the asset protection trust in its national law. This tool is tax neutral, meaning that it does not help anyone evade taxes. However, it does help individuals get around other laws, such as the requirement to pay court-ordered fines or to abide by trade restrictions.

Cook Islands law has prevented the U.S. government from collecting the USD 37.6 million judgement it won in 2007 against author Kevin Trudeau for fraudulent business practices, as well as the USD 8 million judgment it won the same year against an Oklahoma property developer who defaulted on loans from the U.S. federal government; both Trudeau and the property developer put their assets in Cook Islands trusts (Brief for Appellant Fannie Mae 2011). The same structure was used by Baroness Carmen Thyssen-Bornemisza of Spain to get around UNESCO trade restrictions on her private art collection, valued at billions of dollars (Cabra and Hudson 2013). And it was used by American financier Marc Rich to protect his fortune – made by violating the US trade embargo with Iran – from government seizure (Martin 2013).

## To date, no effort to break a Cook Islands asset protection trust has been successful.

To date, no effort to break a Cook Islands asset protection trust has been successful. Many governments and creditors don’t even try, since pursuing a claim against a trust based there requires litigating in the Cook Islands; this means sending a legal team on a long and costly journey – fifteen hours of flight time from New York, plus billable hours (Wayne 2013). As a result, “many creditors will settle for cents on the dollar, rather than face the expense of a long and difficult lawsuit halfway across the Pacific” (Wayne 2013).

As a result of the country’s role in facilitating law avoidance, the Cook Islands have been blacklisted twice – first in 2000 by the intergovernmental Financial Action Task Force, and then again in 2015 by the European Union’s Executive Commission – for being an “uncooperative jurisdiction” within the world financial system (Kumar 2015). In spite of this, the asset protection trust business continues to thrive. The country’s unbroken track record of stonewalling the legal authority of other nations has led to its asset protection law being imitated in 25 other jurisdictions worldwide (Hofri 2015).

Such cases can only illustrate a problem that is global in scope. The facilitation of lawlessness among the rich is one of the most important, but least understood phenomena of the offshore world. Going forward, this suggests the following implications:

- For researchers, the study of offshore should acknowledge not just tax avoidance, but the larger context of law avoidance – with the attendant political, economic and social implications
- For policy-makers, one of the few effective tools at their disposal is the kind of naming-and-shaming of law avoiders made possible by leaks like the Panama Papers; governments and NGOs must make it possible for whistleblowers to follow the model of John Doe, who leaked the Panama Papers data without breaking anonymity and destroying his or her life

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# International financial centres in developing countries

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This article examines the main drivers behind the establishment of international financial centres (IFCs) in Africa. Kenya was meant to have established an international financial centre in Nairobi by December 2013. However, when this article was finalised in February 2017, the process was still ongoing.

### An international financial centre or a tax haven

The concept international financial centres (IFCs) is often used interchangeably with tax havens or secrecy jurisdictions. Tax havens and secrecy jurisdictions have a negative connotation while IFCs refer to financial service provision. Most authors label tax havens as countries and territories that offer favourable tax regimes like low or zero corporate tax rates, low or zero withholding tax rates, and bank secrecy laws (Hines Jr. 2013). The OECD states that a tax haven has no or very low nominal tax rates, in combination with one or more other factors like lack of effective exchange of tax information with other countries, lack of transparency in the tax system, and no requirement to have substantial activities in the jurisdiction to qualify for tax residence.

A financial centre, on the other hand, is found within a tax haven. It can be defined as the clustering of financial intermediaries and service providers in one location, usually a city, allowing for easier coordination of financial transactions and settlements of payments.

### Advantages and disadvantages of IFCs

IFCs have a certain number of characteristics that can be both negative and positive depending on how they are managed by the constituting state.

First, IFCs attract and host large-scale international lenders. This raises the natural borrowing limit of a country thus making it possible to finance larger projects. In the long run this can increase government revenues in two ways; (i) tax breaks are removed, or (ii) high license fees for setting up and maintaining companies in an IFC. However, this hypothesis has not been substantiated by any research or data.

Second, the concentration of financial intermediaries in financial centres reduces transaction costs and creates economies of scale, thus benefitting investors and other financial sector stakeholders.

Third, IFCs may provide a cushion from economic crisis. For instance, during the 1997 East Asia crisis, Singapore and Hong Kong, two main regional IFCs were able to avoid contagion from other Asian countries, thanks to their large and dynamic financial service sector.

Fourth, the inflow of foreign investors may lead to higher administrative costs, but the state will not obtain revenue from the companies in the IFC.

Fifth, the establishment of an IFC can undermine democracy and increase corruption because IFCs may assign a disproportionate level of influence to corporations and financial actors, legally through lobbying, and illegally through corruption.

### **The Kenyan IFC: The Nairobi International Financial Centre**

The Ministry of Finance and Treasury developed the idea of the Nairobi International Financial Centre (NIFC) as a flagship project under the financial services sector, but also as a critical component to finance all the other projects envisioned under Kenya's Vision 2030 development plan. Consultations have resulted in agreement on a hybrid model used in Qatar where locals as well as foreign investors will be able to use the IFC. NIFC was planned to be set up by December 2013. Areas such as banking, insurance and reinsurance, and the stock market were identified as the priority areas for the NIFC. However, several issues still remain unclear, including: Which users will be attracted to the NIFC? Will there be any increase in state revenues? There are no legal and regulatory frameworks, no designated agency responsible for managing the IFC, no agency with specialised courts and a dispute resolution system, no corporate registry and no registry of securities. Kenyan law does not allow for the setting up of a separate authority with broad powers and independence.

The NIFC also plans to grant tax incentives to investors. These are likely to include a 10-year tax holiday maximum with no VAT, customs duties and work permits for expatriate workers with the potential of an additional 10 visas or work permit waivers based on the size of the investment or company.

### **Future research questions**

- Why are African countries still considering IFCs and tax incentives?
- Who is driving the process? Is it domestically driven or does it involve foreign actors?
- Is there reason to believe that individual policy-makers benefit personally from pursuing an IFC agenda?
- What are the possible/likely implications for key institutions like the tax administration if a country introduces policies and institutions that facilitate and encourages a no-tax regime for foreign companies/individuals?

# Beware: Accountancy firms at work

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No country will be able to effectively combat tax avoidance without shackling the Big Four accountancy firms. Profits from tax avoidance are a major part of their business model. Governments should take a number of steps.

The world economy is going through a major crisis. Income and wealth inequalities are rising and, due to lack of tax revenues, governments are inflicting cuts and austerity programmes on people. At the same time corporations and wealthy elites are avoiding taxes through schemes that shift profits across border, convert profits to losses, transform income into capital gains and shunt billions to secretive low/no tax jurisdictions that ask no questions.

One estimate (Henry 2016) is that USD 24 to USD 36 trillion of wealth has been hoarded in tax havens to enable some to dodge taxes in their home countries. This hoard is protected by a highly paid bevy of professional enablers in the legal, accounting and investment industries, taking advantage of the increasingly borderless, frictionless global economy (Henry 2012). An investigation by the US Senate Permanent Subcommittee on Investigations (2005) concluded that “the tax shelter industry had moved from providing one-on-one tax advice in response to tax inquiries to also initiating, designing, and mass marketing tax shelter products ... They had become big business, assigned to talented professionals at the top of their fields and able to draw upon the vast resources and reputations of the country's largest accounting firms”.

In this context, the focus on the Big Four accounting firms (PricewaterhouseCoopers (PwC), Deloitte, KPMG and Ernst & Young) is very appropriate because they have the organisational structure and financial resources to arbitrage and exploit domestic and international tax systems. They operate through numerous countries and cities. Their combined global revenue of around USD 125 billion dwarfs the GDP of many a nation state, though the firms remain silent about the profits from tax avoidance.

The firms' claims about ethical conduct are routinely punctured by revelations of involvement in malpractices. In 2013, the firms became the subject of a hearing by the UK House of Commons Committee of Public Accounts (2013). Just before the hearing the Committee received evidence from a senior former PwC employee stating that within the firm the policy was that it would sell a tax avoidance scheme

which had only a 25% chance of withstanding a legal challenge, or as the Committee chairperson put it “you are offering schemes to your clients – knowingly marketing these schemes – where you have judged there is a 75% risk of it then being deemed unlawful”. The other three firms happily admitted to “selling schemes that they consider only have a 50% chance of being upheld in court”.

## The partners responsible for promoting the illegal schemes should be personally liable to pay at least 50% of the fine.

PwC is credited (Bloomberg 28 October 2013) with developing Ireland as a tax haven and with refining a scheme known as the Double Irish Dutch Sandwich (International Monetary Fund 2013). It uses complex corporate structures to arbitrage global tax systems. The essence of the scheme is to shift profits to low/no tax jurisdictions through royalty payments for the use of intellectual property, transfer pricing techniques, intragroup loans and other internal transactions. Variants of the Double Irish have enabled Apple, Google, Starbucks, Amazon, Facebook, Microsoft and others to avoid taxes in many countries.

The colonisation of governments enables the Big Four firms to operate with impunity. Evidence for this was provided in November 2014 by Luxembourg Leaks or Luxleaks. Some 28 000 pages of information leaked by a whistleblower showed that with the collaboration of Luxembourg government, PwC crafted avoidance schemes which enabled multinational corporations to avoid taxes in their home countries.

Many of the tax dodging schemes designed by the firms, when challenged, have been found to be unlawful. The US case of *Salem Financial Inc. v United States*, No. 10-192T (Ct. Fed. Cl. Sept. 20, 2013) showed that the firms collaborate with others to market phony schemes. In this example, KPMG collaborated with Barclays Bank to mass market a tax avoidance scheme to several global corporations, including AIG, Microsoft and Wells Fargo. The main objective was to generate USD 892 million in foreign tax credits through a series of paper transactions which could then be offset against the US tax liability of the companies. The tax avoidance scheme was thrown out by the court and the judge said that the scheme was “driven solely by the sham circular cash flows” and described the conduct of Barclays and KPMG as “nothing short of reprehensible”.

Deloitte designed a scheme to enable the London-based staff of Deutsche Bank to avoid income tax and National Insurance Contributions (NIC) on bonuses adding up to GBP 92 million. More than 300 bankers participated in the scheme which operated through a Cayman Islands registered investment vehicle. In 2011, the scheme was declared to be unlawful by the courts. The judge in the case of *Deutsche Bank Group Services (UK) Ltd v Revenue & Customs* [2011] UKFTT 66 (TC)

said that “the Scheme as a whole, and each aspect of it, was created and coordinated purely for tax avoidance purposes”.

Ernst & Young designed and marketed a scheme involving intragroup loans. The aim was for one company to claim tax relief on interest payments whilst the other would pay no tax on the income it received. The scheme was declared unlawful by the courts in the case of *Greene King Plc & Anor v Revenue and Customs* [2016] EWCA Civ 782.

### What to do

When a firm’s avoidance scheme is found to be unlawful, it should face a fine of ten times the tax which would have been avoided. The partners responsible for promoting the illegal schemes should be personally liable to pay at least 50% of the fine. Persistent offenders should be shut-down. Big accounting firms advise government departments and enjoy publicly funded contracts. This should be ended and as a matter of principle no one involved in tax avoidance should receive any publicly funded contract. The firms should be required to reveal the fees generated through the sale of tax avoidance schemes. Their advice to large companies on tax avoidance should be a matter of public record. This can be achieved by expanding the requirement to file company accounts to also include corporate tax returns and related data. There should be a complete ban on accounting firms selling non-auditing services, including tax avoidance, to their audit clients. Currently, firms are able to sell tax dodging schemes to audit clients and then pretend to have audited the same. Unsurprisingly, company accounts provide little meaningful information about taxes or tax avoidance strategies.

The above may not fully check the addiction of accountancy firms to tax avoidance, but it will provide some food for thought.

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# With a little help from the banks

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In the foreword to a book published in 2011 on the global financial system and ethics, Daniel Lebéque, former director of the French Public Treasury wrote: "Banks are expected to behave in a socially responsible manner and to keep a close eye on the impact of their activities (...) Governments and professionals are jointly responsible for ensuring that the globalization of trade does not go hand in hand with an exponential increase in fraud and financial crime including money laundering, corruption and tax havens." (ICIJ and CPI 2013:112)

The actual behaviour of the banking sector has proved to be far from this ideal. There is growing evidence that subsidiaries of the world's major banks have been heavily involved in facilitating capital flight and money laundering (Palan et al. 2010; Reuter 2012; US Senate Permanent Subcommittee on Investigations 2012). Despite making illegal capital flight and money laundering possible, the role of banks is often underestimated in discussions on how to curb capital flight from developing countries.

## Lack of international unity in legislation opens for abuse

National laws regulate the kind of services a bank can offer its clients in a particular country. Some countries have laws that require complete confidentiality regarding any information about the client or account. In other countries, banks are required to inform the tax authorities about their clients' accounts and, if necessary, inform the authorities about any suspicious transactions. The use of tax havens effectively limits the tax authorities' access to information, and facilitates money laundering and tax evasion.

An example from the USA demonstrates the serious problems caused by disparities between different countries' legislation. The US Senate Permanent Subcommittee on Investigations found that banks aggressively marketed methods for hiding money from national tax authorities. For example, bankers from UBS, Switzerland's

largest bank, travelled to the US in search of wealthy individuals and promoted their services to them (US Senate Permanent Subcommittee on Investigations 2003, 2006, 2008). Even though the products the bank offered were legal in Switzerland, they posed a high risk of violating the US Secrecy laws in Switzerland and would make it virtually impossible for US authorities to discover tax evasion. In 2009, the US Department of Justice successfully brought a criminal case against UBS for assisting offshore tax evasion, forcing the Swiss bank to pay USD 780 million to settle allegations that it had helped Americans dodge taxes (ICIJ and GFI 2013). The UBS may have been put into checkmate, but there is scarcely any knowledge about what services other providers offer to clients in developing countries. It is likely that the practices revealed in the US have been prevalent in other countries too, including in Africa. Authorities in developing countries have limited capacity to follow up on and sanction such activities. In countries with high levels of corruption, it is also a matter of political will. It is usually not in the interest of the political elite to put an end to it.

## Banks outside tax havens are also involved in capital flight

The use of tax havens has received a lot of attention, but banks in well-regulated Western financial centres can also be actively involved in hiding or laundering money. Banks that are subject to comprehensive regulations may, for various reasons, have internal practices that allow payments to go through the system, even when they should have been stopped or reported. This could be because, for example, (i) the actual owner of the values is unknown to the bank's employees, (ii) suspicious activity goes unreported, (iii) upon notification, the activity continues without any further investigation, or that (iv) there is no routine for sanctions once violations of guidelines are detected, hence the bad practice continues.

## Big money to earn from violating the regulations (but not without a risk)

Different considerations can cause banks to have different practices, even in cases where the formal legislation is the same. The banking sector has strong financial incentives to manage wealth, regardless of who owns it. However, this is combined with a connected risk of not having a full overview of the customers and the origin of their funds. Firstly, if a bank's involvement in shady activities is exposed, they risk a loss of reputation. Secondly, unpredictability and the possibility of an expensive court case adds a legal risk. Thirdly, the bank becomes vulnerable if it depends on only a limited number of customers. Such a situation can arise if the bank has done a poor job checking its clients' background, and if only a limited number of persons turn out to be the real owners of the wealth the bank manages.

## More research is needed

If we are to stop illegal capital flight from Africa, we need more in-depth and detailed knowledge on how banks are involved:

- How do political elites, their partners, companies, individuals, organised crime and terrorist networks use the banking system to channel money illegally out of developing countries?

- What incentives do banks have to facilitate or curb illegal capital flight?
- Which measures can effectively assist in limiting the role of banks in facilitating illegal capital flight from developing countries?

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# Capital flight, tax policy and lobbyists in Africa

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We know little about how the use of tax havens affects tax moral and lobbying, and how tax havens form elites' and other actors' incentives to block or promote tax reforms in African countries. The research project "Taxation, Institutions and Participation (TIP): the dynamics of capital flows from Africa" aims to contribute to better understanding of these issues. This article summarises findings from one of the studies conducted as part of the project.

African countries need to mobilise domestic revenues to finance public services and good institutions to hold the authorities accountable for the use of public funds. It is often argued that tax havens undermine these efforts. However, how tax havens affect the domestic tax system, political institutions and citizen participation in the developing countries have been subject to little research.

### How lobbyists affect tax policy in poor countries

A central theme in the TIP-project is the role that the international accounting and consultancy firms play in shaping tax policies in poor countries. The four largest companies in this industry, PricewaterhouseCoopers (PwC), Deloitte, EY and KPMG, are often referred to as the 'Big Four'. These companies dominate the world market for accounting, audit and tax advisory services. In 2012, they had a total turnover of USD 112 billion, over 700 000 employees worldwide and 2800 offices in over 150 countries – many of these located in tax havens. In Tanzania – one of the world's poorest countries – PwC has over 200 employees and offices in several cities.

In Western countries, it is documented that the Big Four actively lobby in favour of laws and regulations that reduce transparency and against legislation that aims to curtail bank secrecy. They are advisors for both multinational companies and governments. They are also engaged in international forums whose purpose is to establish global standards for international taxation. This happens despite the fact that they repeatedly have been levied huge fines by OECD countries for facilitating tax avoidance and evasion. However, there

is very little documentation on how the Big Four operate in poor countries. The TIP-project has investigated this.

In Tanzania and Zambia, we find that the Big Four actively lobby to influence tax policies and legislation on behalf of their clients. There are also indications that they are even more active in this field in poor countries due to weaker domestic institutions and inadequate regulation of lobbying than they are in developed countries. Initially, our working hypothesis was that the Big Four mainly lobbied for multinational corporations to influence tax policy for the benefit of these companies, for instance by lobbying for tax incentives and tax exemptions. We found, however, that many domestic firms and business organisations also are on their customer list.

We have conducted detailed studies of the processes behind the development of specific tax legislations. In one of these cases, we studied the process behind the new VAT Act in Tanzania. Value Added Tax (VAT) was introduced in 1998. The law was at the time referred to as a model for other developing countries: simple and transparent, with very few goods and services exempted from VAT. In the course of the next decade, the VAT act was repeatedly amended. Many tax exemptions were introduced, partly based on discretionary exemptions granted by the Minister of Finance; where discretion and corruption certainly went hand in hand. In some cases, individual enterprises in one business sector were granted exemptions, while others in the same sector had to pay tax.

## The study shows that the Big Four international accounting and consultancy firms play an important role in influencing and changing tax policies – also in African countries.

Gradually, the VAT legislation became cluttered and very difficult to manage. In 2013, the Ministry of Finance decided, based on advice from the International Monetary Fund (IMF), that there was a need for a new VAT act, instead of repeated revisions of the old one. A technical committee was appointed, composed of staff from the Ministry of Finance and the Tanzania Revenue Authority, with the support of experts from the IMF. In May 2014, the drafted new VAT Bill was presented to the Parliament. Here, most of the tax incentives were removed and it was suggested that the Minister of Finance should no longer have the power to grant tax exemptions. The draft also suggested that tax exemptions should be approved by the Parliament and that all new exemptions had to be rooted in legislation. This led to massive resistance. Private companies and business organisations mobilised to restore tax exemptions. The Big Four were engaged by the private sector to lobby towards parliamentarians and ministry of finance staff against the drafted act. In addition, a former deputy commissioner general of the national tax administration, who was considered the country's foremost expert

on VAT, was recruited as lobbyist. The ministry responsible for tourism and the Ministry of Agriculture also lobbied against their own government to reinstate tax exemptions for their respective sectors. The lobbyists argued that the removal of the tax incentives would make the country unattractive for foreign investors and be a competitive disadvantage for Tanzanian companies in the domestic and regional markets. This was despite the fact that the same companies said in interviews that such incentives were not vital for their investment decisions. But, in contexts where the level of tax incentives is extensive, and many of these are assumed to be given on a discretionary basis, this creates its own momentum and demand for more tax exemptions. It can be described as a 'race towards the bottom'.

The lobbyists succeeded in turning the parliamentarians. In December 2014, the new VAT Act was signed by the President. Many of the old tax exemptions had been reintroduced and the power of the Minister of Finance to grant discretionary exemptions was partly restored. A member of the technical team behind the drafted VAT bill, said to us: "the new law is completely diluted". This study shows that tax incentives do not exclusively benefit multinational companies. In Tanzania, the tax exemption regime includes both international and domestic companies. When these companies have common interests, they mobilise together to change (or retain) the legislation by using professional tax consultants and lobbyists to promote their positions to parliamentarians and senior bureaucrats in key ministries. The study also shows that the Big Four play an important role in influencing and changing tax policies – even in poor countries.

### Political measures ahead

- Stronger regulation of lobbyists, including measures to deal with conflicts of interest when tax consultants at the same time operate as tax advisors for both the private sector, including multinational companies, and the government.

### Questions for further research

- How, and in which arenas, do the Big Four operate to influence tax policies in developing countries? Who are their main clients?
- How does multinational enterprises and elites' use of tax havens affect domestic companies' tax behaviour?
- How to document the benefits and costs of tax incentives to businesses and sectors?

### Facts about TIP

The TIP-project is funded by the Research Council of Norway (2014-18). The researchers involved include Odd-Helge Fjeldstad (Project Director), Ivar Kolstad and Arne Wiig (all from CMI); Caleb Fundanga (IFE, Zambia); Elizabeth Kariuki (APRIL, Kenya); Prosper Ngowi (University of Mzumbe, Tanzania); Lise Rakner (University of Bergen); Alves da Rocha (CEIC/UCAN, Angola), and Ricardo Soares de Oliveira (Oxford University). The project team collaborates with TJN-

Norway to disseminate the results of the research and to help motivate researchers, students and journalists in African countries to work on issues related to taxation and capital flight.

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# 4. Natural resources and capital flight from Africa



## 4. Natural resources and capital flight from Africa

In many countries, wealth from natural resources falls into the hands of the few: politicians, elites, foreign investors or multinational companies. Over time, scandals have emerged. They show how grand corruption and large tax evasion and avoidance schemes rely heavily on the use of tax havens. We will take a closer look at the natural resource sector exploring public perceptions and political responses.

### Big money – and big poverty

Investigative journalist Nicholas Shaxson travelled to Libreville in Gabon in 1997. There, he found both extreme wealth and extreme poverty. The political and economic elites he met were so eager to charm him and show him around in an air-conditioned bubble of splendour, that he became very curious about what they wanted to hide. This marks the beginning of the book “Treasure Islands” (Shaxson 2011), a book about tax havens.

It is no coincidence that he starts his book about tax havens in an oil-rich country. Hidden in the former French colony Gabon was a combustible cocktail of grand corruption, westernised political elites, tax haven accounts, and lots of oil money greasing the system. This would later blow up in France as the Elf corruption scandal (Henley 2003). The Elf scandal, which came to light in 1994 in France, was according to The Guardian, “the biggest political and corporate sleaze scandal to hit a western democracy since the second world war” (Henley 2003). Elf became a private bank for executives. The never-ending stream of cash was used to buy political favours at home and abroad, and to fund some extravagant lifestyles in the form of mistresses, jewellery, fine art, villas and apartments. Huge amounts of money were paid out in illegal “royalties” to various African leaders and their families.

During the 1960s and 70s, resource abundant countries in Africa vastly outperformed other African countries, scoring about twice as high on income per capita. Since then, the advantages of having rich natural resources have evaporated. In Africa today, there is hardly any difference in the income levels between resource rich countries and countries with limited natural resources. A comprehensive economic and political economy literature suggests that resource rich countries do not perform any better in terms of social and economic development than countries that have less natural resources (Ross 2015; Venables 2016). Natural resource wealth is associated with less democracy (Andersen and Aslaksen 2013; Ramsay 2011), more corruption (Leite and Weidmann 2002; Brollo 2013), and a higher likelihood of violent conflicts (Collier and Hoeffler 1998). These phenomena are commonly referred to as the “Resource Curse”.

More than 1.5 billion people live in countries that are rich in natural resources, but are classified as low-income countries (less than USD 2 per day per person on average). For instance, the Democratic Republic of Congo (DRC) has some of the richest mineral deposits in the world. Yet, it is ranked among the poorest and least developed countries. In many developing countries, the natural resource sector is the primary export sector. Technical expertise needed for the extraction of petroleum and minerals is under high demand. This demand implies that specialised multinational companies often dominate resource extraction. For tax authorities, ensuring that multinational companies pay their fair share in taxes is a very difficult task.

**“When foreign investors make extensive use of offshore companies, shell companies, and tax havens, they weaken disclosure standards and undermine the efforts of reformers in Africa to promote transparency.**

**Such practices also facilitate tax evasion and, in some countries, corruption, draining Africa of revenues that should be deployed against poverty and vulnerability ... it is unconscionable that some companies, often supported by dishonest officials, are using unethical tax avoidance, transfer pricing, and anonymous company ownership to maximize their profits, while millions of Africans go without adequate nutrition, health, and education.”**

**Kofi Annan (Africa Progress Panel 2013:7).**

## Gold mining and taxes

The London-based gold mining company Acacia Mining plc (former Africa Barrick Gold plc) is the largest gold producer in Tanzania where it owns three gold mines. Over the years 2010 – 2015, Acacia paid USD 444 million in dividends to its shareholders, despite not paying any corporate income tax in Tanzania. The Tanzania Revenue Authority (TRA) imposed 10% withholding tax on these dividends. AB G appealed, and declared to have incurred losses in Tanzania and therefore was not eligible to pay taxes. However, the Tanzanian Tax Revenues Appeals Tribunal dismissed the appeal in March 2016, stating that it was inconceivable that AB G could pay huge amounts in dividends to its shareholders for four consecutive years, while its only assets were the three loss-making entities incorporated in Tanzania that did not make any profit (Kapama 2016; OpenOil 2016). The conflict between Acacia Mining and the Government of Tanzania deepened in 2017. Much is at stake for both the Government and the company (see Forstater and Readhead 2017; Paget 2017; Woodroffe et al. 2017).

### Public outcry and political response

The African Union and the United Nations Economic Commission for Africa mandated the establishment of a *High Level Panel on Illicit Financial Flows from Africa*, chaired by Thabo Mbeki. In its final report from 2015 (UNECA 2015), the High Level Panel highlighted how, particularly in the area of natural resources, illicit financial flows occur mainly through corruption, illegal resource exploitation and tax evasion.

The final report estimated that illicit financial flows from Africa totalled USD 50 billion annually. Similar studies at a global level have found that slightly more than half of the illicit financial flows, around 60%, come from commercial activities, such as tax evasion and aggressive tax avoidance from multinational companies. However, due to the lack of solid data and estimation techniques, there are disputes about the quality of these figures based on trade statistics.

## Threats to journalists in Tanzania

In February 2014, the weekly Swahili newspaper *Dira ya Mtanzania*, published an investigative story on the oil company Lake Oil Ltd which was involved in tax evasion by selling transit oil, i.e. imported oil that was reported to be in transit from Tanzania to neighbouring countries. The company was suspected of evading taxes amounting to USD 6 million. Lake Oil has established a strong footprint in most East and Central African countries and is one of the five largest distributors of petroleum products in Tanzania. It has subsidiaries in every region of Tanzania and in neighbouring countries, including Zambia, DRC, Burundi and Rwanda.

Following the publication of the story, the editor of the newspaper started to receive threats. In one incident, when the editor of the newspaper, Musa Mukama, was heading home, a car blocked his car on the road and armed people invaded his vehicle. They inspected his car and took his ID and mobile phone leaving other belongings like money. They gave him a warning that if he wanted to stay alive, he should immediately stop following other people's business. He reported the matter to the police and to the Tanzania Human Rights Defenders Coalition (THRDC).

Civil society organisations (CSOs) and journalists have, over the last couple of decades, increasingly focused on exposing the harmful consequences of the activities of oil, gas, and mining companies in developing countries. One of the main concerns has been the tax contribution of extractive companies (Durst 2016; Readhead 2016). The main argument is that multinational companies extract very valuable resources, without these riches benefiting ordinary people in the countries where they operate.

Over the years, CSOs have named and shamed companies for tax dodging, and criticised governments for not taxing companies properly. CSOs have argued that both companies and governments must be held accountable. A core problem is the lack of transparency. The contracts which regulate the terms of tax payments between companies and governments, are often secret and not publicly accessible. There is also information asymmetry between companies on the one side and the government on the other. It is often the companies, not the government, that have the full picture of the commercial quantities of available natural resources, costs involved to extract them, amounts extracted at any point in time, actual sales prices and profits. Transparency can facilitate cooperation against unproductive rent-seeking and help maintain norms of integrity and trust. However, the effects of transparency on company and political elite activities depend on whether citizens have the ability to process the information, and the power and incentives to act on that information (Kolstad and Wiig 2009).

## Indaba - Mining the alternatives

The annual African Mining Indaba in Cape Town, South Africa, is the world's largest mining investment conference. The conference aims to advance mining on the continent. A wide range of civil society and faith groups organise a parallel side conference called the Alternative Mining Indaba (AMI). AMI aims to provide a platform for communities affected by the extractives industries, advocate for transparent, equitable and just extractive practices, and to provide space for the engagement of the inter-faith communities, governments, CSOs and private sector enterprises to share information and experiences.

The organisers behind the AMI are: The Economic Justice Network of the Fellowship of Christian Councils in Southern Africa (EJN of FOCCISA), in collaboration with the Zimbabwe Environmental Lawyers Association (ZELA), Publish What You Pay (PWYP), Norwegian Church Aid (NCA), South African Council of Churches (SACC), Mozambique CC, Benchmarks Foundation, Diakonia, Council of Churches Zambia, the Zimbabwe Council of Churches and Oxfam (<http://altminingindaba.co.za>).

Public pressure has paved the way for new initiatives to promote transparency in the extractive industry sectors. Three main initiatives are listed below:

- In 2002, then UK Prime Minister, Tony Blair, launched the Extractive Industries Transparency Initiative (EITI). This is a system where governments commit to publishing their tax income from extractive companies. At the same time, companies commit to publish their payments to the government. Although spearheaded by the British government, it was launched with support from the World Bank, among others.
- Shortly after, the CSO coalition Publish What You Pay was founded in London. PWYP's purpose is to make the extractive companies publish their payments to governments.
- Later, organisations such as Global Witness, Transparency International, Save the Children International, and Tax Justice Network joined forces to demand country-by-country reporting (CBCR) by multinational companies. CBCR requires multinational companies to publish annual reports to make the inner workings of companies more transparent. This means publishing key economic and financial figures, such as profits, turnover, corporate taxes, income taxes paid by their employees, etc., for every country they operate in. This may make it easier to identify when companies shift their profits out of countries to avoid their taxing obligations. Currently, 'weak' versions of the CBCR-reporting standards are underway and are being implemented in the EU and several other countries.

# 4. ARTICLES: Natural resources and capital flight from Africa

# Natural resources and tax avoidance

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Countries rich in natural resources face the risk of capital flight as multinational corporations seek to avoid taxes.

The Democratic Republic of Congo (DRC), widely considered as one of the richest countries in mineral deposits in the world, regularly sits high on various lists ranking the world's poorest countries. Each year, the country loses billions of dollars in tax revenue as wealthy individuals and local and multinational corporations take advantage of DRC's weak tax legislation and enforcement to funnel profits abroad including to foreign financial centers. A similar situation plays out again and again throughout many countries in Africa, and across other parts of the world.

Capital flight, here defined broadly as money or securities rapidly flowing out of a country, can take several forms. Illicit financial outflows constitute a form of capital flight from developing countries. Over the past decade, the democratisation process in developing countries and the subsequent increase in transparency and accountability suggest that illicit financial outflows might be on the decline.

But while governments may be seeing more constraints, globalisation of trade and finance has made multinational corporations even more powerful, leaving some critics to argue that these global corporations have unfettered access to capital, labour, and natural resources at the expense of the citizenry. In contrast to illicit financial flows instigated by political elites, the other form of capital flight brought on by multinational corporations that manipulate prices and take advantage of loopholes in tax codes has received less attention. However, the latter is surely on the rise (even so it is hard to obtain systematic evidence) with far reaching consequences for developing countries – especially the resource-rich ones where the wealth is concentrated in one sector.

## What's at stake?

Tax avoidance by multinational corporations is a serious problem for many developing countries, especially those rich in natural resources. For example, the Zambian government estimates that it loses USD 2 billion per year – 15 percent of

its GDP – to tax avoidance by multinational corporations operating copper mines within the country.

An important aspect of profit shifting is the loss of positive spillovers that natural resource exploitation can bring to the country, including through the development of the domestic financial system. Preventing capital flight that stems from multinational corporations operating in this sector would help the development of a domestic financial system, particularly an equity market with its attendant benefits in risk-sharing and liquidity provision. This in turn would aid in the financing and development of the non resource sector.

The historical development of South Africa's stock market provides a case in point of the potential spillover stemming from discoveries of natural resources. In 1886, the discovery of gold discovered at Langlaagte on the Witwatersrand was rapidly followed by the establishment of the Johannesburg Stock Exchange. The stock exchange helped raise money for the then booming mining and financial industry. Today, the Johannesburg Stock Exchange has a capitalisation of over USD 800 billion and 411 listed companies including an overwhelming majority in the non resource sector.

## Policy response and “thin capitalisation”

Several countries have put in place so-called ‘thin capitalisation’ rules. The rules essentially specify a ‘safe haven’ debt-to-equity ratio that limits the amount of deductible interest for tax purposes. Such rules are designed to counter cross-border shifting of profit through excessive debt, and thus aim to protect a country's tax base.

The thin capitalisation rule was first introduced in 1972 in Canada and is now in place in about 60 countries. It is often implemented in countries with large resource sectors in which multinational corporations operate and was most recently introduced in several resource-rich developing countries in Africa, including Sierra Leone, Uganda, and Zambia.

## A thin line

Establishing whether thin capitalisation rules promote more equity finance in the resource sector can also help determine if these rules improve prices of countries' natural resource assets (and therefore help with the development of a domestic stock market). Of equal interest is whether the sensitivity of host countries' external debt to the resource tax rate is altered by the presence of thin capitalisation rules. To get some answers, we conduct an event analysis using cross-country variation in the timing and size of large oil, gas, and minerals discoveries for over a hundred countries during the period 1970–2012. Our empirical framework controls for time invariant factors that include the quality of institutions which can play an important role in the development (or the lack thereof) of stock market. Results suggest that following a resource discovery, stock market capitalisation



## Following a large discovery, stock market capitalisation increases by up to 20 percent of GDP in the presence of a thin capitalisation rule.

decreases. This result is consistent with the work of Beck (2012), who found evidence that resource-rich countries tend to have less developed financial systems. However, in contrast, our findings show that the presence of a thin capitalisation rule allows countries to reverse the negative effect on capitalization of the resource discoveries. Our results hold for mineral, oil, and gas discoveries although the timing varies by the type of discovery. Those effects are large in terms of their impact on the economy. Following a large discovery, stock market capitalisation increases by up to 20 percent of GDP in the presence of a thin capitalization rule. We also find that the sensitivity of countries' external debt to the resource sector tax rate decreases in the presence of a thin capitalisation rule. This can be explained by the fact that the tax subsidy provided to corporations paying interest on their foreign debt is lower in the presence of a thin capitalisation rule.

### Changes afoot

The thin capitalisation rule looks to be the most viable option right now, yet other alternatives have been floated. Based on the U.S. experience, Nobel Laureate Joseph Stiglitz recently proposed taxing global profits of multinational groups and redistributing a proportion of those tax receipts to the country in which the value is actually being created. While Stiglitz's proposal is conceptually appealing, it might be impractical given the limited level of disclosure now required of multinational corporations.

The Extractive Industry Transparency Initiative, a global standard, asks governments and companies operating in participating countries to declare the amount of money received from oil exports. More recently, the 2010 Dodd-Frank Act in the United States requires public disclosure to the Security and Exchange Commission of payments made to the U.S. and foreign governments relating to the commercial development of oil, natural gas, and minerals. In October 2011, the European Commission adopted a legislative proposal that would require EU-based companies to disclose their payments to governments for oil, gas, minerals, and logging on a country-by-country and per-project basis.

The increase in the level of disclosure of multinational corporations operating in the resource sector is certainly a very important step in the right direction. However, increasing transparency is only a first step toward tax base protection and does not deter tax avoidance through tax optimisation methods such as thin capitalisation.

Another idea is using the public stage to "shame" corporations, not unlike the efforts regarding child labor or human trafficking. Judging by recent "shaming" campaigns

against large corporations, the reputational risk that multinational groups face vis-à-vis their global consumer base might prove to be a very effective means of accountability.

Overall, the concern over massive capital flight from developing economies, particularly resource-rich countries, should go well beyond illicit financial flows and consider the seemingly legitimate behavior of corporations across countries and their increasing capability in shifting profits and minimising the tax base. Thus, effective mechanisms, such as thin capitalisation rules, should be in place to deter massive outflows stemming from tax avoidance schemes.

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# Mines and tax in Africa: Fair benefit sharing or exploitation in the wake of liberalisation?

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More than 1.5 billion people currently live in countries that are rich in natural resources but poor in terms of income (<2 USD / day / person). There are various estimates on how much tax revenue governments in sub-Saharan Africa (SSA) may have lost from the inefficient taxation of the mining sector in recent times. For Zambia in the period 1998-2013, we found that the loss was more than USD 300 million a year, while in Tanzania we found an annual loss of USD 75 million due to a smaller mining sector. The following provides a short fiscal and regulatory account of mining in SSA that confirms the problem with a lack of robust tax regimes with appropriate rates, and how this dominated as an explanation of poor fiscal benefit sharing during the price boom from 2003-2013.

Today, there is no longer such a pronounced difference in income and poverty levels between the resource and non-resource rich countries in Africa. In the 1960s, the average income level in the resource rich countries in the region was almost twice as high. Much of this change reflects a downturn in the mining sector closely following widespread nationalisation from the 1970-90s, as can be seen in the falling share of the region in the global mining production from 31 to 10%. Rising budget deficits and debt levels characterised this period as the fiscal position of governments deteriorated.

Throughout the 1990s and into the 2000s the mining sector in Africa went through a significant privatisation effort. Much of the change originated from recommendations by the World Bank (WB) and the international financial institutions together with the private sector and selected domestic interest groups. A major vehicle to deliver this was 36 different projects with associated policy and program loans amounting to almost USD 3 billion. In most cases, these projects included writing a new general law for the mining sector “from scratch”, redesigning tax laws and creating new model contracts for the extractive sector, as well as including technical assistance. The main objective of these projects was to reverse a long-running trend of declining production, exports, investment and employment in the sector, as well as often large government fiscal losses in the mining sector.

**It is possible to say that the turnaround operation involving privatisation of the mining sector largely succeeded in terms of raising investment, production and export, but it seems that this happened at the expense of safeguarding the governments’ interests when it comes to increased revenue through tax and ownership.**

It is possible to say that the turnaround operation involving privatisation of the mining sector largely succeeded in terms of raising investment, production and export, but it seems that this happened at the expense of safeguarding the governments’ interests when it comes to increased revenue through tax and ownership. The large growth in the mining sector in African countries in particular after 2003 came about due to a historic price increase in minerals (500-600% from 2000-2008) combined with a turnaround in production and exports. This increase has been described as the fourth super-cycle in mineral prices over last 150 years. Few, if anyone at all, could foresee this dramatic change, but the price surge exposed a lack of robustness in particular in the fiscal regulatory framework of the mining sector.

What was exposed was the lack of a fiscal upside built into the fiscal framework in mining for the governments in resource rich African countries during price booms. As the nominal and real price as well as profits grew after 2003, 110 mining countries in the developing world entered into preparations for, or processes of, changing the regulatory framework of their mining sectors.

Similar to the oil and gas sectors, the mining sector extracts and sells a product that depends critically on a non-renewable natural resource as the primary input factor. How complex, costly and profitable the extraction and processing of this input factor is, will largely depend on the quality of the resource (quantity, purity and availability) as well as how the exploration and extraction is regulated by the Government in practice. The combination of these factors also affects investments, technology and costs as well as market prices.

The fundamental problem in mining as seen from the perspective of a Government is how the underlying value, the resources hidden underground, are transformed into a financial value, and thereafter used to generate real economic value for the benefit of the citizens of the country in question. Minerals are valuable and non-renewable resources. Therefore, in principle therefore, the mining sector should, on average over time, contribute relatively more in tax than in value added compared to the rest of the economy.

As suggested above from the stop-go trends in nationalisation and privatisation and the structural challenges over time, it is unclear to what extent mining has generated the expected levels of tax and/or rent over time including during the last super-cycle. An indication of the contrary is the fact that the turnover of the global mining sector grew by 460% from 2002-2010 while the tax payments rose only by 115% in the same period. At the same time, there was also a marked difference between the oil and mining sectors in terms of these trends. Even though the global export value of oil towards the end of the super-cycle in 2013 was only twice as large as that of other minerals, oil-rich countries had one hundred times as much wealth in sovereign wealth funds based on oil income, when compared to funds based on mining sector income.

We studied the mining sector's relative contribution to the economy (from tax and value creation) for the period 1994-2013. We found that contributions in several dominant mining countries in southern Africa (Zambia, Tanzania, Ghana, South Africa), as well as in well-known mining sector exporting countries like Australia, were significantly lower than expected. Two countries in our study distinguished themselves positively: Botswana from Africa and Chile from South America. In these, the contribution from tax-mining government revenue in relation to mining value added was 1.94 and 1.44 higher respectively (as expected due to the significant element of rent and super-profits during high prices). For the other countries, the contributions to tax-mining government revenue in relation to mining value added was only 0.34-0.78, i.e. significantly lower than for other regular economic sectors.

We studied possible explanatory factors of tax revenues such as price, production, investment, costs and tax levels. Our findings were that in terms of levels of actual tax revenues, the effect of tax rates were more than four times as large. Furthermore, we looked in more detail into the biggest mines in Zambia and Tanzania and the effective tax burden they actually faced in the period 2000-13, using their own accounts as well as official reports. In Tanzania, it was clear that the effective tax burden was relatively low and ranged between 14-30%, whereas in Zambia there were indications (with one exception) that the company accounts did not reflect the real economy of the mining operations. The latter was later also indicated through several audits including specifically one that was leaked but also a number of tax reassessments in later years.

There are various estimates of how much tax revenue governments in sub-Saharan Africa may have lost from the inefficient taxation of the mining sector in recent times. For Zambia in the period 1998-2013, we found that the loss was more than USD 300 million a year, while in Tanzania we found an annual loss of USD 75 million due to a smaller mining sector. However, some of the years in the period after 2005 saw losses much higher than these figures, and in Zambia the revenue loss was higher than net aid for several years. The IMF has also found that on average, effective taxation in the mining sector has been significantly weaker than in the oil and gas sectors. Nevertheless, higher taxation alone does not provide any

guarantee to ensure the effective development of the mining sector. An interesting example of this is Zambia where the government potentially missed USD 1 billion per year in the period 1970-2010 alone due to inefficient mining operations with under-investment and falling production.

In conclusion, we will highlight three main challenges the mining sector in Africa faces today. First, we still know relatively little when it comes to when and where and to what extent different types of tax and public ownership (directly and indirectly) are effective means to ensure a good distribution of resource rent and profits between the government and the companies. The IMF and OECD have started collecting more data, but currently this has limited coverage and suffers from a lack of accessibility to data. The ICTD, together with other research communities, have also published preliminary data and some analysis of the African oil, gas and mining sectors. Secondly, there is continued extensive misuse of tax incentives for investment and mining operations. Finally, there is the related and overarching challenge relating to the use of tax havens to shift the profits outside of the countries of mining operations. Due to the dominance of multinational companies in a liberalised mining sector, this problem is extensive.

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# Confidentiality and financial secrecy in the fisheries sector

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Since at least the 1960s, fishing companies from Europe, the former Soviet Union, and Asia have relocated some of their vessels and activities to Africa, resulting in a staggering rise of fish exports and trade. Today, several thousand fishing vessels of foreign origin operate in Africa, and their impact has long been scrutinised for causing overfishing and marine habitat destruction as well as for undermining local small-scale fishing communities and the related role fishing plays for food security on the continent. FAO estimates that around 10 million Africans are employed in the fisheries sector (90% in the small-scale sector). Investments in fish processing factories, often encouraged by African coastal states, are rarely subject to public oversight: bilateral fisheries access agreements between African states and foreign fishing nations have been kept confidential; only the EU's agreements are now being published and subject to public accountability.

In many African countries, basic information on which fishing vessels have been authorised to fish, how much they pay and how much they catch is obscured from the public. An example is in Mauritania, where in 2012 the Government agreed to a confidential 25 year deal with a Chinese state-owned fishing firm that allowed approximately 100 fishing vessels access to fishing grounds that are already fully exploited, including by hundreds of local small-scale fishing vessels. The arrangement involved an extremely generous tax holiday for the Chinese company, as well as an agreement for the company to by-pass national laws and state institutions that regulate the price paid for exported fish products, thereby allowing the company to undercut local fishers. In return, the company pledged to invest USD 100 million in the fishing sector, an investment described as being for the benefit of local fishers. Another example is the investment of approximately USD 180 million by the Carlyle Group in 2012 to help China Fishery, a subsidiary of Pacific Andes (the world's largest fishing company) to expand its businesses into Southern and Western Africa. A case which is particularly illustrative is that of the new tuna fishing company EMATUM established in Mozambique (see box on page 115), revealing foreign involvement in financing and production, grossly inflated expenses, the creation of an enormous public debt burden, the illicit state allocation of contracts to private interests, poor performance, and state absorption of the consequent financial losses.

## Subsidies and impatient capital

The fishing sector faces a structural problem, created and maintained by the world's largest fishing nations. Part of the problem is government subsidies that enable the fishing sector to continue fishing despite struggling profits and declining catches in some fisheries. Worldwide, subsidies that contribute to overfishing have been estimated at over USD 20 billion a year, but fishing nations have resisted several calls to publish information on their fisheries subsidies. Despite well-known problems of sustainability and the fact that fish catches globally have stagnated and may be in decline, the fisheries sector remains enormously attractive for private investors. Indeed, seafood is the most traded food commodity in the world, estimated to have an export value of over USD 130 billion.

In many African countries, including those in East Africa, the new frontier for fisheries investments will be in fish farming, particularly for shrimp. Shrimp farms can be highly profitable, but they are short lived, placing biological strain on the immediate environment and quickly becoming less productive and profitable. International and multilateral donors are providing financial resources and expertise to help encourage growth in investment in new farms, as has been done for decades already in countries such as Madagascar, which has the most developed commercial prawn farming operations in Eastern Africa. Commercial shrimp farms can have disastrous implications for the marine environment and local communities, as was argued by thousands of people who successfully protested over a government backed industrial shrimp farm in the Rufiji Delta in Tanzania.

## Beneficial ownership

Efforts to better regulate the fishing sector are frustrated by confidentiality of beneficial ownership. The OECD has raised concerns that in the fisheries sector it is common for the beneficial owners of vessels to be hidden, and there is widespread use of shell companies based in offshore tax havens. It is assumed that these arrangements allow fishing companies to engage in transfer pricing and tax fraud, as well as laundering illegally caught fish. We have no idea how extensive the problem is, because this aspect of the fishing sector remains bereft of independent research or audit.

The problem of beneficial ownership transparency in Africa is compounded by conflicts of interest. As is the case in other resource sectors, it seems that in many countries political elites are hidden beneficiaries of foreign fishing activities, including having financial interests in fishing companies, fish processing factories as well as fish farming ventures. Ironically, companies that were alleged to have cost Mozambique millions of dollars from illegal fishing included several joint venture prawn fishing companies that have beneficial owners which include military and political elites, as well as the former president. These conflicts of interest undermined efforts to better regulate the prawn sector, which was once the largest earner of foreign currency for the country.



Another area that seems open to abuse is the role of fishing agents, often made mandatory for foreign fishing companies to use in acquiring licenses. Politically influential people are ideal agents. Indeed, the former head of the Indian Ocean Tuna Commission, a regional management body that is set up to regulate tuna fishing, was forced to resign in 2015 when it was revealed he was simultaneously working as an agent for Asian tuna fishing vessels. Fisheries experts at the World Bank allege that fishing agents have become one of the major obstacles to achieving governance reforms in West Africa, and kick-backs between agents and fishing authorities, derived from various fees paid by vessel owners for services including licenses and inspections, are widespread and account for considerable sums of money.

### Turning the tides?

Promoting investments in Africa's fisheries and aquaculture sector continues to be a primary interest of international donors and African governments, albeit with the recognition that such investments must be sustainable and take cognisance of the environmental and social hazards. The fisheries sector has seen a surge in promoting ethical consumerism and fighting illegal fishing at sea, but only slowly are these efforts expanding to address the secretive nature of financial flows and ownership in fisheries. In the fight against illegal fishing, the Norwegian government is taking a leading role, with other key actors including Interpol, the UNODC and the OECD. However, these efforts need to be joined by addressing underlying corruption, otherwise they may not be as successful as they could be.

In 2017, the EU will finalise a new regulation that will lead to the publication of details on all fishing authorisations for EU-owned vessels in foreign countries, including, hopefully, the names of the beneficial owners of the vessels. This year could also see members of East Africa states, through the South West Indian Ocean Commission, agree to new rules on providing fisheries authorisations for foreign vessels. This would include increasing public knowledge on which vessels are provided licenses and, hopefully, on what they pay for these licenses.

Mauritania and the Seychelles have also supported the launch of the Fisheries Transparency Initiative, which is supported by several of the largest multilateral donors in fisheries, and leading international NGOs working on marine conservation and the rights of coastal communities. It is unmistakably modelled on the EITI, but is broader in scope to cover access agreements, company ownership, catch data and the payment of subsidies. These and other efforts illustrate how improving accountability of financial flows and ownership must become central to global efforts at achieving sustainable fisheries.

### Case study:

## The EMATUM scandal

by Andre Standing

Mozambique has been experiencing one of the most damaging corruption cases in its history. It began with the sudden announcement in 2013 that Credit Suisse and the Russian bank VTB Capital had issued USD 850 million bonds to fund a new tuna fishing company called EMATUM. These bonds were guaranteed by the previous Mozambique government headed by Armando Guebuza, with the promise of impressive returns for investors of 8.5% over five years. The money was intended to purchase 24 fishing vessels and six patrol boats, to be supplied by a boat-building company in France whose beneficial owner, Iskandar Safa, has a sprawling business interest in supplying military patrol boats, naval security and ship building. Potential investors were sent a three-page prospectus for the venture, which to this day remains confidential. In this prospectus, it was envisaged that EMATUM, which is equally owned by three government agencies, would generate at least USD 200 million a year of revenues from tuna fishing. This was roughly the same amount the government claimed was being stolen from its waters by illegal foreign fishing boats. The Mozambique parliament and foreign donors reacted with horror: the entire deal exposed the country to enormous debt, the financial arrangement had not been discussed in parliament or among donors, and it was plain to see that USD 850 million was far in excess of what was needed to invest in a sustainable tuna fishing company.

EMATUM was one of three companies established under Guebuza's government that received secretive financing by Credit Suisse and VTB Capital. The other two, also ostensibly established to develop maritime security and involving lucrative contracts for companies owned by Safa, raised the level of debt to two billion dollars.

Within a year or so, EMATUM received its first fishing and patrol vessels, but the vessels were catching far less than anticipated and they were not set up to the standards needed to export fish to the EU, meaning they had to sell fish at cheaper prices to Asia. The company posted substantial losses for successive years, until the new government had to absorb a large part of the debt into the central budget, along with the debts of the other two companies. In total, annual repayments for the loans surpassed USD 300 million. Mozambique's currency depreciated as news of the debt default spread, and allegations of embezzlement of the funds became widespread.

# Capital flight from Africa: Trade misinvoicing as the remaining hiding place

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In 2001, the public was 'shocked' to learn that Africa was a 'net creditor' to the rest of the world (Boyce and Ndikumana 2001). Africa still is. Indeed, the stock of capital accumulated through capital flight from Africa over the past decades, vastly exceeds the debt owed by the continent to the rest of the world. As of 2010, the continent was a net creditor to the rest of the world by up to USD 1.4 trillion (Ndikumana et al. 2015). A key mechanism of the illicit export of capital from Africa is trade misinvoicing.

Illicit financial flows originate either from illicit and illegal activities, illicit and illegal transactions or hidden capital concealed from tax and regulatory authorities, or any combination of the above. Every year, developing countries lose more through illicit financial flows, than they receive in external development assistance (Global Financial Integrity 2015; Reuter 2017). The full developmental impact of illicit financial flows is yet to be quantified, but it is large, and there is an urgency to act. Fortunately, there is an increased global attention on the broader problem of illicit financial flows.

While capital flight and illicit financial flows originally were deemed to be a developing country problem only, it has become clear that it is a global problem. Attention from major developed countries has especially been ignited by geopolitical interests like the financing of the fight against terrorism, money laundering and other financial crimes. Recently, governments of advanced economies have scaled up efforts to combat corporate tax evasion in an era of high stress on national budgets. As a consequence, there is increased global interest to design and enforce strategies to combat illicit financial flows. However, the attention is still primarily focused on financial flows. Relatively less attention is paid on trade misinvoicing, which is an important channel of capital flight and illicit financial flows. Trade misinvoicing is indeed the 'remaining hiding place' for capital seeking to evade regulations and public scrutiny.

## What is trade misinvoicing?

Trade misinvoicing consists of discrepancies between the trade records of a country and those of its trading partners, which cannot be accounted for by the cost of insurance and freight associated with moving goods from the origin to destination. Trade misinvoicing takes various forms, but the main mechanisms are overinvoicing and underinvoicing of imports and exports. Export underinvoicing is the situation where the partner's imports exceed the exporter's recorded value by significantly more than the cost of insurance and freight. Export overinvoicing is the opposite situation. In the case of import overinvoicing, the reporter's imports exceed the value of exports reported by its partner plus the cost of insurance and freight. Import underinvoicing is the reverse situation.

Export underinvoicing and import overinvoicing result in unrecorded outflows of foreign exchange and consequently contribute to capital flight and illicit financial outflows. In contrast, export overinvoicing and import underinvoicing result in unrecorded inflows of foreign exchange, which reduces net unrecorded capital outflows. Trade misinvoicing arises from actions by individuals and firms at the origin and/or destination of the transaction. There are many motives of trade misinvoicing. One is access to foreign exchange that is not controlled by the regulatory authority. Another is evasion of taxes and other levies on international trade. Trade misinvoicing is also motivated by the desire to take advantage of specific export promotion incentives, which induce exporters to inflate the quantity or value of exports.

## Why care about trade misinvoicing?

The overriding reason for paying attention to trade misinvoicing is that it is an important mechanism for illegal export of capital from Africa. It constitutes a major fraction of capital flight and illicit financial flows from the continent. While it is not possible to obtain a precise point estimate of trade misinvoicing, the existing empirical evidence overwhelmingly suggests that the associated flows are large, persistent and even increasing in many countries. Trade misinvoicing is particularly prevalent in natural resources, a sector dominated by large multinational corporations that control the global value chains. In the case of Zambia, for example, while national data shows that Switzerland is the top buyer of its copper (51 percent of total), Swiss trade data shows no copper imports from Zambia (UNCTAD 2016). In contrast, trade between Zambia and China shows export underinvoicing worth USD 5.6 billion over 1995-2014 period. Excluding Switzerland, copper export underinvoicing in Zambia over this period stood at USD14.4 billion.

The loss of foreign exchange revenue through export underinvoicing and import overinvoicing, as well as the loss of tax revenue through import underinvoicing have severe developmental implications. In particular, these losses undermine African governments' ability to finance the much needed public investment to boost growth and social services to accelerate human

development. In a continent where the majority of countries missed most of the MDGs, illicit export of capital and loss of tax revenue have debilitating human costs. If unattended, trade misinvoicing and the associated capital flight pose a threat to the continent's ability to reach the Sustainable Development Goals.

Trade misinvoicing also merits attention because it is a prime channel for money laundering in Africa, and also globally. It also helps to fuel the parallel foreign exchange markets in African countries, which pose serious challenges to monetary policy and undermines the stability of national currencies. Trade misinvoicing also has important geopolitical and security implications when the mechanisms facilitate the financing of terrorist activities. For example, trade-based money laundering is a key mechanism of moving pirate money in the Horn of Africa (World Bank 2013).

From a knowledge perspective, increasing attention to trade misinvoicing and sustaining public debate on the issue provide insights on the quality of trade statistics, which helps identify areas of focus of strategies aimed at improving the quality of trade statistics.

### What to do about it

The current global momentum of the efforts to fight tax evasion and financial crimes, offer a unique opportunity that should be leveraged to raise the attention on the specific problem of trade misinvoicing. Unlike the case of stolen public assets, the foreign exchange and tax revenues lost through trade misinvoicing will never be recovered. It is therefore imperative to prevent trade misinvoicing from taking place in the first place.

The biggest facilitator of trade misinvoicing is lack of transparency in trade statistics. Therefore, the first step is to improve the quality, timeliness, consistency and comparability of trade statistics across partners. Such data must be fully accessible to the public. African governments must endeavor to coordinate and harmonise data across government departments and ensure that all international trade transactions are adequately and systematically recorded and shared with global institutions (the IMF and the United Nations Statistics agencies responsible for compilation of trade statistics). To this effect, they must adopt and systematically use the unique consignment reference (UCR) so that each shipment is uniquely identified and recorded in trade statistics. Africa's trading partners on their part must enforce rules of transparency and systematic recording of all trade transactions.

Given that one of the motives of trade misinvoicing is tax evasion, global initiatives to combat tax evasion will also contribute to combatting trade misinvoicing. In particular, enforcement of systematic disclosure of beneficial ownership will help discourage tax evasion by corporations operating in African countries. African partners can help by committing to and delivering on reciprocity of exchange of information under the Standard for Automatic Exchange of Financial Account Information, a process

monitored by the [Global Forum on Transparency and Exchange of Information for Tax Purposes](#). Success in combatting trade misinvoicing requires concerted efforts by all governments and other stakeholders in Africa, its trading partners and in the global community.

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# The rise and fall of the mining royalty regime in Zambia

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## Abolishing corporate income tax

Since the 2006 elections, mining taxation has become a central part of a polarised political debate in Zambia. There is a strong perception among many Zambians, media and civil society organisations that international mining companies deprive them of their wealth and that the Government's distribution of wealth is unjust. In November 2012, the Deputy Minister of Finance stated that 'Zambia loses between USD 1.5-2 billion every year due to tax evasion and avoidance, mainly in the mining sector'. The mining industry disputed this claiming that Zambia received a reasonable level of tax revenue from the sector. The positions reflect a deep-rooted distrust between the Government and the mining companies. The lack of trust creates an unsustainable situation as the country's mineral resources are being depleted, and must be seen in relation to the poorly implemented privatisation of the Zambian mines in the 1990s.

Until recently, a shared assumption between the Government and the mining sector has been that profit-related taxes, such as the corporate income tax (CIT), should be a main component of the mining tax regime. Profit-related taxes such as the CIT are supposed to deliver a significant share of the total government revenue from the resource production and export. However, in 2013 corporate income tax contributed only 16% of the total revenues from the mining sector, compared to 21% for royalties and 17% for personal income taxes paid by the employees of the mining companies in the form of PAYE.

According to the Mineral Value Chain Monitoring Project Baseline Report (January 2015), only two mines, Kansanshi and Chibuluma, out of nine major cobber mines have consistently paid CIT in recent years. The others have reported losses or marginal profits. This illustrates, in the words of the Africa Progress Panel (2013: 65), that: *"Resource-rich countries in Africa are highly vulnerable to aggressive tax planning and tax evasion facilitated by the extensive use of offshore companies, the high levels of intra-company trade and the commercial secrecy surrounding foreign investment activity. African governments lack the human, financial and technical*

*resources needed to secure tax compliance, and the commercial market intelligence needed to assess company tax liabilities. As a result, they are losing significant revenue streams."*

The administrative challenges of taxing profits in extractive industries and the relatively low revenue yield from CIT, led the Government to make the unprecedented step in 2014 to abolish CIT and increase the royalty rates substantially.

## The extractive sector in Zambia

Extractive industries are a key part of Zambia's economy and government revenue (2012/13):

- Zambia is the 8th largest producer of copper in the world
- 9th largest producer of cobalt
- The mining sector contributes 9% of GDP
- Indirectly, the mining sector may contribute as much as 50% of GDP
- 67% of export earnings
- 33% of total government revenue (direct and indirect taxes, royalties etc)

Source: <https://eiti.org/Zambia>

## From a profit based tax system to a revenue based tax system

Royalties are, in principle, payments made to the government to compensate for the right to extract a non-renewable natural resource. Royalty, which was a well-established component of the mining tax regime in Zambia, was considered to have key administrative advantages relative to other taxes. In principle, the tax base is easier to observe, often based on a percentage of the value of the output (ad valorem), easier to administrate and, thus, less subject to tax avoidance pressures. Based on these rather simplistic assumptions, royalty was expected to imply more revenue stability and less volatility compared to profits taxes.

In the October 2014 Budget Speech, the Minister of Finance announced that mineral royalties on the norm value of base metals produced, would increase from 6% to 20% on open cast mining, with 8% on underground mining. Ad valorem royalty rates for copper vary between countries, generally ranging between 0% and 8%. The new rate in Zambia for open mines was way above this range. The corporate income tax rate applicable on the mining operations with an exception of mineral processing, was revised from 30% to 0%. Variable profits tax of up to 15% when the taxable income exceeded 8% of gross sales, was abolished. These changes, effective from 1 January 2015, changed the mining tax regime from a profit based tax system to a revenue based tax system. The royalty regime aimed to close the loopholes companies had used to evade corporate income tax.



### The fall of the royalty regime

Major tax reforms benefit from transparent and thorough consultations between the Government and taxpayers. Experiences show that such consultations may help identify undesirable implications of drafted proposals and contribute to the legitimacy of the new tax regime. Consensus among key stakeholders is a prerequisite for a sustainable tax framework.

Interviews conducted by the research team with a large number of stakeholders in the private and public sectors in Lusaka in 2015, found that ‘consultations’ of any substance between the Government and the industry on the new mining tax legislation were largely missing or dysfunctional. Most were taken by surprise by the new royalty rates and were only made aware of them when the Budget was announced by the Minister of Finance in October 2014. When the budget was announced and the specific changes made public, the mining sector mobilised against the new tax legislation. The new royalty regime coincided with a significant drop in the copper prices. When the new mining act was passed in Parliament in December 2014, the Canadian owned Barrick Gold Corporation, owner of the Lumwana open pit mine in Northwestern Province, issued a statement that the company would suspend its operations.

## Zambia has a long history of disputed changes of the mining tax regime with damaging effects on the working relations between the Government and the mining sector. A more constructive public-private dialogue is essential to ensure a sustainable tax framework and taxpayers’ trust in the tax system.

Media reports following President Michael Sata’s death in late October 2014 indicated that the mining companies had already started to renegotiate the new tax regime. As expected, shortly after the elections of April 2015, the Government announced it would revert to the previous corporate income tax structure and reduce the mineral royalty rate from 20% to 9% for open cast mines, and from 8% to 6% for underground mines. This change was enacted on 1 July 2015. Unsurprisingly, it was generally well received by both the industry and tax practitioners. Barrick-Gold’s Lumwana mine resumed its operations. The 2016-17 Budget maintains the current enacted tax regime, which might reflect that no immediate further changes of the mining tax regime are being prepared.

The rise and fall of the royalty regime, follows a pattern in Zambia that once a new government is in place, one can almost be certain that mining interests come to the fore.

Underlining the individualised negotiations and international business influence over State House, it was the President himself who announced the revocation of the mining act in 2015.

### Implications for policy

The choice of tax bases in extractive sectors varies between countries. For Zambia, it is important to secure stability, predictability and transparency in the mining tax regime. Experiences with the rise and fall of the mining tax regime provide some lessons for policymakers.

- *The tax regime should be predictable for investors.* The erratic and frequent changes in the mining tax regime, especially since 2009, have damaged the credibility of the mining tax regime in Zambia and have had negative impacts on trust relations between the Government and the industry. Stability does not imply that changes cannot be made, but these should be well prepared and based on consultations with key stakeholders.
- *Consensus among key stakeholders is a prerequisite for a sustainable tax regime.* The absence of real and substantive consultations on major tax reforms have contributed to undermine trust between the industry and the Government.
- *There is a need to establish clear, unambiguous rules with few exemptions and equal treatment of companies.* The original Mining Developing Agreements (MDAs) in Zambia were damaging in this respect, establishing different tax regimes for individual mining companies.
- *The tax system should be simple to understand and implement for both tax administrators and taxpayers.* The royalty regime proved to be difficult to administrate since it implied different royalty rates between open and underground mines. For some mines, it was also difficult to assess what share of the extracted minerals came from open and deep shafts, respectively.
- *Zambia should revamp its mineral revenue model and move towards a national modelling team* integrating transfer pricing, costs and pricing monitoring, and audits into this. This may help develop better mechanisms for information and data sharing between key public finance management agencies, and, thus, contribute to develop more reliable data for revenue projections and tax policy design.

### Questions for further research

- How is tax policy shaped in the extractive sectors in Africa? Who are the key stakeholders involved, and in what fora do they operate to influence policies and public opinion?
- How does the taxpaying behaviour of multinational companies in extractive sectors affect the tax behaviour of domestic companies, for instance through lobbying for exemptions and other measures to reduce their tax burden?

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# 5 International initiatives and their relevance for Africa

## 5. International initiatives and their relevance for Africa

For the last ten years, international organisations have paid increased attention to the problems of financial secrecy and tax havens. Civil society organisations, such as Tax Justice Network, Action Aid, Christian Aid and Natural Resource Governance Institute among others, have played a key role in moving the tax haven issue high on the political agenda, both domestically and internationally. Public pressure has led to a number of policy initiatives (Owens et al. 2017). This section looks at initiatives by the the United Nations, OECD, the African Union, the European Union, The International Monetary Fund and the World Bank.

### The United Nations

As early as the 1920s, the League of Nations, the predecessor to the United Nations (UN), started a process for better cooperation and coordination in international taxation. Although the UN has been working with international tax matters for a long time, for instance by developing an alternative model tax treaty, the OECD remains the dominant international institution in this area.

The UN's most important institution working on tax issues is the UN Tax Committee, established in 1967. In 2004, the UN Secretary General Kofi Annan upgraded the status of the Tax Committee from an ad-hoc group to a permanent expert committee.

At the UN Financing for Development (FFD) summit in Addis Ababa in 2015, the formal status of the Tax Committee became one of the most contested issues. Developing countries, represented by the G77, demanded that the Committee should be upgraded to an intergovernmental tax body, which would give the United Nations larger influence on international tax rules. This proposal met strong opposition from a number of OECD countries. Civil society organisations worked hard to upgrade the tax committee, which they considered a more democratic arena to establish international tax rules (Eurodad 2016b). The outcome of FFD, however, was that the tax committee was granted some additional resources, but not an upgrade in status.

The Addis Tax Initiative (ATI) was set up with the support of 40 countries and organisations, and launched at the FFD conference. The declared ambition of ATI is to enhance resource mobilisation and to improve the fairness, transparency, efficiency and effectiveness of tax systems. The participants pledged to collectively double their technical cooperation in the area of domestic revenue mobilisation and taxation by 2020.

### The Addis Ababa Action Agenda

At the Third Conference on Financing for Development, on 17 July 2015, the international community endorsed the Addis Ababa Action Agenda, as the core document on means for implementing Agenda 2030 (UN 2015). This agreement includes the following powerful statement, which constitutes and summarises the global efforts:

'We will redouble efforts to substantially reduce illicit financial flows by 2030, with a view to eventually eliminate them, including by combatting tax evasion and corruption through strengthened national regulation and increased international cooperation. We will also reduce opportunities for tax avoidance, and consider inserting anti-abuse clauses in all tax treaties. We will enhance disclosure practices and transparency in both source and destination countries, including by seeking to ensure transparency in all financial transactions between governments and companies to relevant tax authorities. We will make sure that all companies, including multinationals, pay taxes to the governments of countries where economic activity occurs and value is created, in accordance with national and international laws and policies.' From a development policy perspective and against the international background, the following three issues are of particular interest:

- 1) Enabling developing countries to take advantage of the progress made on the international tax agenda, such as the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project and International Cooperation in Tax Matters (including information exchange).
- 2) Integrating developing countries into the current global tax dialogue, which enables a better understanding for their idiosyncratic hurdles for customised solutions.
- 3) Improving taxation and revenue management of resource-rich developing countries.

### Building tax capacity in developing countries

The Addis Ababa Action Agenda (UN 2015) emphasises that there must be less focus on aid, and more focus on how developing countries can generate their own financial resources for development. A wide variety of international organisations and development agencies currently support tax capacity building. There are growing signs of uncoordinated, overlapping or competitive donor activity, which can be counter-productive. Experience suggests that coordination is most successful if the recipient government takes the lead. The capacity of tax administrations varies widely among developing countries. Different strategies are called for, depending on their given institutional context. However, there are four key recommendations for donors seeking to build tax capacity that apply across all contexts:

1. Tax capacity does not depend solely on tax administrations. Efforts should also be targeted towards tax policy units within ministries of finance and building capacity in the judiciary, as any disputed tax cases will end up in the courts. Donors should consider measures to inform and empower parliamentarians and citizens in order to promote the passing of better legislation and greater accountability.
2. Mentoring is better than training. Building longer-term mentoring relationships has proven to be immensely fruitful. Staff from the national revenue agencies of donor countries can be very effective providers as they 'speak the same language' as their counterparts. However, this type of work depends upon the willingness of donor country tax administrations to commit skilled staff to what might be seen as a low priority activity.
3. Facilitate South-South Cooperation. This is advantageous because it is less supply-driven, and advisors are more likely to have relevant experience in similar contexts. While South-South cooperation has been increasing through organisations like the African Tax Administration Forum (ATAF), donors can support 'triangular cooperation' where more advanced developing countries offer capacity building to countries that are further behind.
4. Capacity building is essentially about building trust. A focus on building trust will encourage donors to be sensitive to local contexts and needs, and willingness to commit to long-term support.

This text is a shortened version of an IDS Policy Briefing written by Mick Moore and colleagues in 2015. <https://opendocs.ids.ac.uk/opendocs/bitstream/handle/123456789/6522/PB96.pdf?sequence=3>.

### The High Level Panel on Illicit Financial Flows

The UN launched the eight Millennium Development Goals (MDGs) in 2008. These were ambitious goals, ranging from halving extreme poverty rates to halting the spread of HIV/AIDS and providing universal primary education by 2015.

A few years after the launch, it was clear that Africa might not reach its goals.

Despite the inflow of aid, the African continent continued to suffer from insufficient resources. This led to the decision to focus on illicit financial outflows from Africa, specifically on the steps that were required to radically reduce these outflows to ensure that these resources remained within the continent. The High Level Panel on Illicit Financial Flows from Africa was established to ensure that Africa's development should rely as much as possible on its own resources. In 2011, the African Union and the United Nations Economic Commission for Africa (AUC/ECA) jointly commissioned The High Level Panel.

In 2015, the report "Illicit Financial Flows - Report of the High Level Panel on Illicit Financial Flows from Africa" (also called "The Mbeki report") was delivered by the panel (UNECA 2015). The report gained huge attention. It stated that the African continent annually lost more than USD 50 billion through illicit financial outflows. Highlights from the report's recommendations are:

- African countries should require the provision of beneficial ownership information when companies are incorporated or trusts registered and the information should be public. Beneficial ownership declarations should also be required of all parties entering into government contracts.
- Regional integration arrangements should be used to introduce accepted standards for tax incentives to prevent harmful competition in the effort to attract foreign direct investment.
- Double taxation agreements can contain provisions that are harmful to domestic resource mobilisation and can be used to facilitate illicit financial outflows. The report recommends African countries to review their current and prospective double taxation conventions to ensure that they do not provide opportunities for abuse. This is particularly important in jurisdictions that are significant destinations of IFFs. The Model Double Taxation Agreement developed by the African Tax Administration Forum (ATAF) is suggested as an alternative.
- A system for automatic exchange of tax information among African countries should be established. African countries should also call for automatic exchange of tax information globally.
- African countries should require that multinational corporations operating in their countries provide comprehensive reports showing their disaggregated financial reporting on a country-by-country or subsidiary-by-subsidiary basis.
- Public finance institutions in Africa should be strengthened, particularly financial intelligence units, revenue agencies and financial crime agencies.
- Robust regimes for supervising banks, including mandatory reporting of transactions that could be tainted with illicit activity, should be put in place.
- African countries were encouraged to join the African Tax Administration Forum and to provide the Forum with the necessary support.

- African countries and companies operating in extractive industries in Africa should join voluntary initiatives like the Extractive Industries Transparency Initiative.

Several of the recommendations in the report build on existing initiatives championed by institutions, like the OECD and the EU. However, a number of OECD and EU initiatives are designed for developed countries, and not to meet the specific needs of the developing countries. Therefore, there is a need for initiatives tailored for African countries.

### The Organisation for Economic Co-operation and Development (OECD)

The OECD works mainly to promote economic growth and cooperation in its member countries. Currently, the OECD consists of 35 of the world's richest countries. The organisation is considered the international institution with most technical expertise in taxation, and it is a central arena for intergovernmental tax cooperation.

In 2013, the OECD presented its largest project to date aimed at combatting the consequences of harmful tax competition: the Action Plan on Base Erosion and Profit Shifting (OECD 2013). According to the OECD, the action plan represents a turning point in international tax cooperation. BEPS aims to ensure payment of taxes where value creation takes place and to prevent the depletion of national tax bases.

The BEPS action plan contains 15 action points intended to increase intergovernmental cooperation in international corporate taxation, increase transparency and predictability, and ensure increased effectiveness of international standards and existing tax treaties (<http://www.oecd.org/ctp/beps-actions.htm>). Two central action points from the plan are described in more detail below.

### Exchange of information between countries

The development of model law texts and model treaties are at the core of the OECD's work on tax. The OECD model tax treaty has been used as the basis for most bilateral tax treaties between countries. However, as tax havens have zero or very low tax, there is no point in other states negotiating agreements on tax distribution with them.

The OECD strategy from around 2000 focused on trying to increase the countries' ability to access information from these jurisdictions. The OECD developed model agreements for information exchange on request (TIEAs). These agreements are supposed to make it easier for a country to get information on, for instance, how much money one of its citizens has hidden in a bank account in a tax haven.

Few developing countries have managed to negotiate such 'on request' agreements with tax havens. They often lack the administrative capacity to efficiently use such agreements



(Durst 2015; Oguttu 2016, 2017; Readhead 2016). Civil society organisations have argued for a system of Automatic Information Exchange (AIE) where information is shared automatically between national tax authorities, not on request.

In 2013, G20 finance ministers decided to launch a system of automatic exchange of tax information. The OECD received the mandate to implement this, which led to the “Common Reporting Standard” (CRS) – a framework for automatic exchange of tax information between the 80 countries, due to start during 2017 and 2018 (<http://www.oecd.org/tax/automatic-exchange/common-reporting-standard/>).

A major problem with the CRS standard is that the rules require ‘reciprocity’, meaning that a country must be able to collect and send information in order to receive information. There is a concern that many developing countries will be left in the dark. They do not have the resources to set up the structures for collecting the relevant information, making it impossible for them to comply with the ‘reciprocity’ principle.

To understand why reciprocity is a problem, consider first how many wealthy Nigerians are likely to stash assets secretly in Switzerland – then consider how many wealthy Swiss citizens are likely to locate their secret wealth in Nigeria. Nearly all the active tax havens are located in rich countries, and the flow of illicit money is generally in one direction: from poor countries to rich.

Another major problem is the fact that many tax havens have very little information, or information of low quality. The real owners of bank accounts can be hidden behind nominees, for instance a lawyer. Often, there is no requirement to report annual accounts or perform audits. A framework for sharing information is therefore of limited value when the information does not exist in the first place.

If these problems are fixed, the CRS could mean a significantly increased ability for tax residents who have moved money and assets abroad. It may have a powerful deterrent effect, even if developing countries do not have the capacity to make full use of the data they are provided with.

### Investors make the case for increased transparency

A coalition of business leaders known as “The B Team” has demanded transparency on the beneficial ownership of companies (The B Team 2015). They say transparency is good for business because it will make it easier for companies to know who they are doing business with, for financial institutions to know who their customers are, and for citizens to gain insight on who is benefiting from public funds, as well as being an important tool to combat crime and corruption. The B Team’s view is supported by reports that show that shareholder risk is higher in companies with little transparency; that country-by-country reporting is not harmful to corporate profits; and that lack of transparency increases both financial, legal and reputational risk for a company.

### Country-by-country reporting by multinational companies

Multinational companies traditionally produce annual financial reports on a consolidated level, but do not provide detailed information on income and taxes incurred in each country. This makes it very hard to detect whether companies are shifting profits from one country to another to avoid tax.

Country-by-country reporting (CBCR) requires that multinational companies break down the numbers in their financial reports on a country-by-country-basis and aims to increase the transparency of multinational companies through a new instrument of financial reporting.

There are many benefits to CBCR. It can be an important tool for tax authorities. Further, it will enable the press, civil society and ordinary citizens to hold companies accountable. The reports will also provide investors and creditors with better information, thereby potentially contributing to better functioning markets.

Developed countries have a special responsibility to enforce CBCR rules. Most multinational companies have their home in developed countries and will have stronger enforcement powers over these companies. These countries will, because of this, naturally have more access to information about these companies. Hence an information asymmetry already exists between developed and developing countries. It is challenging and time consuming for tax authorities in developing countries to gain access to CBCR information if they first need to file a request to access the reports from another country.

Public CBCR may also pressure governments to take action to raise tax revenues from multinational corporations. It is therefore vital, both for tax authorities and the general public, that all country-by-country reporting is made public.

### The European Union (EU)

In recent years, the EU has introduced a number of measures to combat harmful tax practices and harmful tax competition.

#### Country-by-country reporting by EU

Following the OECD, the EU has made a big push towards more transparent reporting from multinational companies and has implemented two variants of CBCR:

- In many resource-rich developing countries, multinational companies in the petroleum and mining sectors extract huge wealth. They have also made use of advanced tax avoidance schemes with the result that the companies pay very little tax. Acknowledging the particular challenges in these sectors, the EU adopted CBCR requirements for companies in the extractive and forestry sectors in 2013, as part of the EU accounting and transparency directive. Similar regulations in the United States (the “Dodd-Frank”-rules) provided the model for the legislation.

- In 2013, the EU implemented CBCR for banks and financial institutions, under the Capital Requirements Directive IV (or “Banking Directive”). However, this CBCR required only a reporting format with a relatively low level of detail, and there are no sanctions in place if the companies abstain from reporting. Therefore, it is unclear if all banks and financial institutions actually report. In several EU countries, especially in Eastern Europe, none report at all.

## EU stops Apples Irish tax tricks — demands Euro 13 billion in additional tax

In 2014, Apple paid a meagre 0.005% tax on its international revenues by routing all income earned outside the United States through Ireland where they had a special agreement, a so-called ‘sweetheart deal’, with the tax authorities. In 2016, the EU commissioner for competition, Margrethe Vestager, found this arrangement to be illegal under the EU competition rules and ruled that Apple should pay up to Euro 13 billion in taxes to Ireland. Both Ireland and Apple have appealed this decision (European Commission 2016). The final outcome of this case might be an important turning point and have consequences for taxation of multinational companies in the EU. Starbucks has already been ruled to pay more taxes related to its subsidiary in the Netherlands. Luxembourg’s agreements with both Amazon and McDonalds are under investigation by the European Union, and several other companies are under scrutiny.

The two CBCRs mentioned above are sector specific requirements, but profit shifting by multinational companies is not limited to companies in the extractive industries or the finance sector. The European Parliament is therefore pushing for CBCR to be mandatory for all larger companies across all sectors.

The CBCR reports promoted by the EU are publicly available, as opposed to the OECD reports, which are only accessible to public authorities.

### Beneficial ownership registries

A beneficial owner is the physical person who is ultimately in control and responsible for a company. These persons are sometimes hidden behind several layers of secrecy. The complex corporate structures in several tax havens enable this secrecy. A real owner can pay so-called “nominee” owners to act on their behalf. A nominee will not be involved in making any real decisions about the company, but they provide an effective way to conceal the identity of the real owner.

Most tax havens, and a number of other countries, allow the establishment of companies without requesting the minimum information, such as the names of beneficial owners, the articles of association, and the identity of people with significant control over the company.

When the real owners of companies and assets are concealed or anonymous, it is impossible for tax authorities to calculate the amount of taxes both

individuals and businesses should pay. Furthermore, it seriously undermines the possibility for citizens to hold companies to account for environmental and other serious crimes.

The EU has come a long way in combatting secret ownership, and now requires all EU countries to establish registries naming the real, or “beneficial” owners of companies. This is part of the EU’s Anti-Money Laundering Directive (AML) of the EU. To date, several countries have implemented such registries and have made them publicly available.

The AMLD require banks and financial institutions to ‘know their customer’, meaning they must be certain of the identity of their clients who wish to open a bank account or use financial services provided by the bank. However, due to secrecy in tax havens and complex corporate structures, this requirement can be difficult to meet. This has consequences for the effectiveness of automatic exchange of banking information between countries (AIE), because AIE systems are dependent on verifying the identity of account holders.

Beneficial ownership was a key issue in the High Level Panel report from the African Union and they recommended that information should be publicly available. This is important as it means developing countries can efficiently gain access to the registries established in developed countries.

### New rules for taxing multinational companies

The basic principles of the international tax system were established a century ago, when companies operated in a very different way. Despite this, the basic principles are still used today. Back then, businesses were often located in just one country. Some large companies traded in several countries, but were officially located in one.

Today, many businesses are multinational in nature. They often operate in and through several countries and jurisdictions, but are closely interlinked and controlled as one big entity. Therefore, it becomes challenging for tax authorities when the company they try to tax correctly is part of a corporate structure consisting of hundreds of subsidiaries all over the world.

As described in previous sections, multinational enterprises (MNEs) have had a number of opportunities to transfer profits from a high-tax country to subsidiaries in tax havens. It is very difficult for tax authorities to establish the actual profits generated in their country.

Civil society organisations, researchers and politicians have voiced proposals for simpler and more effective approaches to tax MNEs, in order to ensure a fairer distribution of corporations’ tax base between countries. One such approach is referred to as ‘unitary taxation’ (Picciotto 2017).

Unitary taxation is an approach that treats the whole MNE as one single unit. This is done by calculating the total profits of the MNEs and totalling the profits from all subsidiaries in all countries. The next step is to divide the profits, or tax base, fairly between countries. Only countries where real business activities are taking place are entitled to part of the profit. Real business activities, or value creation, are the activities where the company has means of production (such as factories), employees, or access to a market.

Under a unitary taxation system, only countries where employees live, where the factories are physically located, and where the consumers live, will have a right to tax of the MNE's total profits. Such an approach would mean, for instance, that for an extractive company, a large share of the total profit would be allocated to the country where there are large-scale mining operations with many employees. However, subsidiaries in tax havens are often only a mailbox or an empty "shell company" without employees, which implies that little or none of the profits would be located there. The unitary system does not undermine the sovereign right of states to determine their own tax policy as each country would continue to decide its corporate tax rate.

Unitary taxation would make tax evasion more difficult. A similar system has been in place in the USA for a long time, where the system is used to distribute the tax base between different states. However, the proposal for a global unitary tax system has met fierce resistance, especially from the OECD. The introduction of a unitary taxation system would make the current system, based on the OECD arm's length principle, redundant.

The EU is now proposing a variant of a unified tax system, named the Common Consolidated Corporate Tax Base (CCCTB). A previous attempt to introduce the CCCTB halted in 2011, but relaunched in 2015. The idea has received considerable attention and political support, and is supported by the business community. New approaches to corporate taxation are clearly gaining headway.

### **The International Monetary Fund**

The International Monetary Fund (IMF) is an organisation of 189 member countries. The IMF's primary purpose is to ensure the stability of the international monetary system - the system of exchange rates and international payments that enables countries to transact with each other. The IMF also gives loans and advises countries to design policy programmes to solve balance of payments problems. The Fund's mandate was updated in 2012 to include all macroeconomic and financial sector issues that bear on global stability. IMF staff are primarily economists with wide experience in macroeconomic and financial policies.

Since 2000, the IMF expanded its work on anti-money laundering (AML) and extended the work to include combatting the financing of terrorism (CFT). In 2009,

the IMF launched a donor-supported trust fund to finance AML/CFT capacity development in its member countries. The IMF is especially concerned about the possible consequences of money laundering, terrorist financing, and related crimes for the integrity and stability of the financial sector and the broader economy. These activities can discourage foreign investment and distort international capital flows. In an increasingly interconnected world, global harm is done by these activities. Money launderers and terrorist financiers exploit the inherently complex global financial system, as well as the differences between national laws; jurisdictions with weak or ineffective controls are especially attractive to them.

Between 2004 and 2015, the IMF and the World Bank jointly published the annual Global Monitoring Report ([www.worldbank.org/en/publication/global-monitoring-report](http://www.worldbank.org/en/publication/global-monitoring-report)), which assessed progress towards meeting the Millennium Development Goals (MDGs) ([www.imf.org/external/np/exr/facts/mdg.htm](http://www.imf.org/external/np/exr/facts/mdg.htm)). In 2015, with the replacement of the MDGs with the Sustainable Development Goals (SDGs) ([www.imf.org/external/np/exr/facts/sdg.htm](http://www.imf.org/external/np/exr/facts/sdg.htm)) under the 2030 Global Development Agenda, the IMF and the World Bank have engaged in the global effort to support the Development Agenda. Each institution has committed to new initiatives to support member countries in reaching their SDGs. They are also working together to support the development of stronger tax systems in developing countries.

### **The World Bank**

The World Bank is the broad term for the five international organisations tasked with providing financial assistance and counselling to developing countries ([www.worldbank.org/](http://www.worldbank.org/)). It aims to promote economic development and contribute to poverty alleviation. The World Bank is part of the UN system, but is an independent organisation, owned by the countries that finance it.

The World Bank has initiated projects related to secrecy in tax havens, including the Stolen Asset Recovery Initiative (StAR). This is a joint project with the United Nations (UNODC) that targets the laundering of proceeds from grand corruption and aims to repatriate these funds to developing countries. In 2011, StAR published the report "The Puppet Masters – How the corrupt use legal structures to hide stolen assets and what to do about it" (de Willebois et al. 2011). The study shows how money from crime and corruption is hidden through shell companies, foundations and secret owners in tax havens. The World Bank provides assistance to developing countries to enable them to participate in international exchange of tax information, primarily through the OECD-led *Global Forum on Transparency and Exchange of Information for Tax Purposes* ([www.oecd.org/tax/transparency/](http://www.oecd.org/tax/transparency/)).

The World Bank has been criticised for not taking the problem of hidden money flows and tax havens sufficiently seriously. Partly as a response to this criticism, the World Bank published an overview of their total portfolio of activities related to illicit financial flows and their action plan to strengthen efforts in this field for the future (World Bank 2016).

The World Bank's investment fund for private sector development in developing countries, the International Finance Corporation (IFC), has been particularly criticised for using banks and finance institutions in tax havens for their investments.

### **The Financial Action Task Force on Money Laundering (FATF)**

The Financial Action Task Force on Money Laundering (FATF), a 37-member inter-governmental body was established by the 1989 G7 Summit in Paris ([www.fatf-gafi.org/](http://www.fatf-gafi.org/)). FATF has primary responsibility for developing a worldwide standard for anti-money laundering (AML) and combatting the financing of terrorism (CFT). It works in close cooperation with other international organisations, including the IMF, the World Bank, the United Nations, and FATF-style regional bodies.

To help national governments set up effective AML/CFT regimes, the FATF has issued a list of recommendations that set out a basic, universally applicable framework of measures covering the criminal justice system, the financial sector, certain non-financial businesses and professions, transparency of legal persons and arrangements, and mechanisms of international cooperation. In 2012, these recommendations were revised and updated. In 2013, the FATF adopted a revised a common Methodology for Assessing Technical Compliance with the FATF Recommendations and the Effectiveness of AML/CFT Systems ([www.fatf-gafi.org/topics/fatfrecommendations/documents/fatfissuesnewmechanismstostrengthen-moneylaunderingandterroristfinancing-compliance.html](http://www.fatf-gafi.org/topics/fatfrecommendations/documents/fatfissuesnewmechanismstostrengthen-moneylaunderingandterroristfinancing-compliance.html)). The G7 and G20 have supported these efforts, most recently in the context of initiatives to address corruption and cross-border tax evasion.

### **Civil society organisations**

In June 2000, Oxfam published *Tax Havens: releasing the hidden billions for poverty eradication*. "This report marks the starting point for a broad, popular opposition to tax havens," said Jeffrey Owens, the then head of OECD's Centre for Tax Policy and Administration:

"The emergence of non-governmental organizations intent on exposing large-scale tax avoiders could eventually achieve a change in attitude comparable to that achieved on environmental and social issues: Tax is where the environment was 10 years ago." (Cited in *Financial Times* November 2004)

In recent years, tax havens and international taxation have become key issues on the international political agenda. Leaks about how tax havens hide the wealth of elites and facilitate tax evasion, for instance the LuxLeaks and the Panama Papers, have recently dominated newspaper headlines and public debates. As these issues have become widely covered by the media, politicians have taken a more active stance, both acknowledging the problem and proposing solutions and measures that civil society organisations had discussed in solitude for a long time.

## **The International Tax Justice Academy**

Despite efforts to bring the tax justice agenda to the centre of the public agenda, there is still a large knowledge gap, particularly in Africa and other parts of the developing world. With this in mind, the Tax Justice Network-Africa (TJN-A) developed the International Tax Justice Academy (ITJA), an annual week-long training programme discussing key areas of tax justice such as inequality, investments, illicit financial flows and the financial architecture. The programme aims to bridge the knowledge gap on tax justice in Africa and empower partners across the five regional blocs in Africa. The first academy training took place in Nairobi, Kenya, in 2014. Over 97 participants from 27 countries from Africa, Latin America and Europe attended.

Organisations such as the Tax Justice Network (TJN) and alliances like the Global Alliance for Tax Justice have been influential voices in the global debate on taxation. For instance, an advisor to TJN, Richard Murphy, first developed country-by-country-reporting, a measure now adopted by the OECD.

International development organisations, such as Oxfam and Action Aid, see tax justice as an integrated part of their effort to combat global poverty and injustice. Increased tax revenues to developing countries will make it possible for these countries to mobilise their own financial resources for development. This is also a key element of the new sustainable development goals.

An overview of civil society organisations engaged in tax justice issues in Africa is presented at the end of this book.



# 5 ARTICLES: International initiatives and their relevance for Africa

# Corporate tax avoidance, evasion and the offshore system

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## The offshore secrecy system and transnational corporations

The tax haven system was developed over the last century to facilitate tax avoidance and evasion by wealthy families and transnational corporations (TNCs). TNCs led in refining it from the late 1950s, especially by adding the important element of offshore finance. Financial liberalisation from the 1970s made this offshore tax haven and financial secrecy system easy to use also for money-laundering of the proceeds of corruption and crime.

Corporate tax avoidance is clearly only a relatively small part of the total illicit flows through this system, and the bulk of those flows do not involve direct losses of government revenue. Nevertheless, they all use the same facilities and techniques. Further, the growth of a culture of increasingly aggressive tax planning and its toleration as a valid business strategy have affected the boundaries of acceptable behaviour. The removal of incentives for TNCs to use the system could clearly be a significant step towards ending its wider damaging effects.

The creation and continuation of the tax haven and offshore secrecy system results from a fundamental flaw in the international tax rules. Designed almost a century ago, these rules were primarily aimed at portfolio investment. Hence, the primary rights to tax business profits ('active' income) were given to the country where the business was located, while returns on investment (interest, dividends, etc., or 'passive' income) should be taxed in the country of residence of the investor. TNCs posed problems, since it is hard to determine the appropriate level of profits of the parts of a corporate group, so tax authorities were given powers to adjust the accounts of related entities. However, they were contradictory: while based on the understanding that the parts of a TNC are under unified control, the basis for adjustment was that the income should reflect what might be expected if the entities were independent.

Especially in the period of rapid growth from the 1960s, many TNCs began to exploit this independent entity principle to reduce their overall tax liabilities, by creating intermediary entities in convenient jurisdictions. Entities, which might exist

only on paper, can own assets or perform functions for which operating affiliates pay royalties, interest or fees, which are deductible from profits, thus reducing tax on business profits. Yet these payments can remain untaxed, if channelled through conduits to take advantage of treaty benefits, to affiliates in zero-tax countries. Such techniques enable deferral of tax on retained earnings, which has been a major factor in financing the expansion of TNCs, and their competitive advantage.

TNCs now typically consist of hundreds of affiliates in complex corporate groups. The shift to the knowledge economy and digitalisation has facilitated the restructuring of operations around global value chains, which can be tax-driven. This enables the fragmentation of different business functions (research, design, assembly, marketing, distribution, and back-office activities). The independent entity principle enables TNCs to attribute only routine levels of profit to entities in high-tax countries, while using payments for intangibles, finance and fees to channel substantial revenue to low-taxed affiliates. Countries now compete to offer tax advantages to attract the location of entities which perform such high value-adding functions.

## Addressing corporate tax avoidance: unitary taxation

Since the 1980s, many commentators have advocated a reform of international tax rules based on treating TNCs as unitary firms. Such a shift was implicit in the mandate from the G20 world leaders in the St Petersburg Declaration of 2013 for the project on base erosion and profit shifting (BEPS), to ensure that TNCs could be taxed 'where economic activities occur and value is created'. Unfortunately, the outcomes have mostly aimed to strengthen existing rules, and failed to provide clear criteria for the allocation of profit, although work on this continues. The main achievement was the establishment of a system for country-by-country reporting by the largest TNCs, which for the first time will give tax authorities an overview of the group, details of its parts, and data on its profits, tax paid and employees in each country.

Several approaches involve treating TNCs as unitary firms, and they could build on elements in existing rules. One is residence-based worldwide taxation, under which the ultimate home country of a TNC taxes its worldwide profits, but with a credit for foreign taxes paid. This would extend existing rules by treating all affiliates of a TNC as 'controlled foreign corporations'. However, it would create an incentive for TNCs to locate their parent in low-tax countries, since corporate residence is hard to define, which would exacerbate tax competition.

A second is destination-based cash-flow taxation, which bases corporate tax on sales to third parties, with deductions for investment and production costs. This reduces the competition to lower tax rates, but could be damaging to revenues of countries with relatively small consumer markets. It poses serious problems of collection from firms that have no business presence in countries where they make large sales. This could be solved by an international system of collection, but this would need close

international cooperation. More seriously, to prevent avoidance the cost of imports would be non-deductible (it would be 'border adjusted'). For some this is an attraction, especially in the USA, where such a proposal was proposed by Republicans in the Congress in June 2016, and is now being hotly debated. Although it could be introduced unilaterally, it would be enormously disruptive. Since it would be a violation of world trade rules, it could trigger trade wars. It is also likely to result in a major appreciation of the dollar, with unpredictable consequences for the many dollar-denominated activities worldwide.

Finally, there is unitary taxation with formulary apportionment. This would apportion the consolidated world-wide profits of a TNC according to factors reflecting its real presence in each country, such as employees and sales. This could be adopted gradually, by developing the profit-split method under existing transfer pricing rules, and agreeing factors for allocating profits appropriate for different business models.

### References

For further details see S. Picciotto (ed.). 2017. *Taxing Multinational Enterprises as Unitary Firms*. International Centre for Tax and Development. <http://ictd.ac/publication/6-books-journal-articles/164-taxing-multinational-enterprises-as-unitary-firms>

# Development finance institutions and tax havens — still too cosy a couple

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Development finance institutions (DFIs) will continue to play a big role as actors mobilising finance for the private sector in developing countries. However, as it stands the DFIs do not have effective responsible tax policies in place to ensure that profits from these activities do not end up in tax havens escaping taxation. They are missing an opportunity to play a transformative role in the global economy and continue to legitimise a network of tax havens.

Under their human rights obligations, states are required to mobilise the maximum available resources to finance the progressive realisation of economic, social and cultural rights, as well as to advance civil and political rights and the right to development. The financing gap to achieve the sustainable development goals (SDG) agreed in 2015, and to be achieved by 2030, is estimated at USD 2.5 trillion (Unctad 2014). Undoubtedly, the private sector will need to play a role to complement public financing. The private sector will also need to contribute to domestic resource mobilisation through corporate tax payments.

However, corporate income taxation is challenged. The international tax system is particularly challenged by tax havens that seek to attract companies and wealthy individuals by promising low or no taxation on profits. The mobility of functions in large companies operating in several countries, allows for a great degree of flexibility in whether profits actually follow where the economic activity takes place. The impacts of this are clear around the world: financing to ensure that all children receive education or that healthcare is available to all remains inadequate.

European governments are increasingly making private finance central to their international development efforts, and DFIs are playing an increasing key role in channelling investments from the North to the South through the private sector.

The role of DFIs in development finance has increased dramatically. Globally, the International Finance Corporate (IFC), which is the private sector arm of the World Bank Group, is the biggest player in this field and its investment

## National and international development

**finance institutions (DFIs)** are specialised development banks or subsidiaries set up to support private sector development in developing countries. They are usually majority-owned by national governments and source their capital from national or international development funds or benefit from government guarantees.

commitments have increased six-fold since 2002. In Europe, the consolidated portfolio of EDFI members increased nearly four-fold between 2003 and 2015, from Euro (€) 10bn to €36bn (Joint NGO briefing 2016). Such large amounts of finance also necessitate larger projects and larger companies as partners – often transnational companies (TNC). These are the type of companies that can engage in creative tax planning that can undermine developing countries' ability to raise tax revenue. UNCTAD estimates that developing countries lose more than USD 100 billion a year through the use of tax havens (Tax Justice Network 2015).

This is a particular challenge for the DFIs that increasingly invest in or partner with TNCs. Research shows that DFIs are largely failing to use their influence as investors in companies operating in developing countries in tax matters (Joint NGO brief 2016). Two roles are relevant in this regard. First, they are not transparent about their own use of offshore financial centres (or tax havens). For instance, they do not demonstrate that their use of tax havens does not contribute to reduced tax payments in developing countries. Generally, they do not clearly distance themselves from the tax competition that these secrecy jurisdictions are the root cause of. Second, due diligence procedures related to the choice of clients and monitoring client operations are far from sufficient to ensure that taxation is not escaping developing countries through tax havens by tax avoidance measures. Finally, this group of investors should also assume their role as the impact investors they inspire to be and play a much greater role in ensuring the promotion of market standards for responsible tax practices by only partnering with or investing in companies that can demonstrate a responsible tax policy and practice. There is a particular need for DFIs to play this role, given the scale of global tax dodging and its negative impact on developing countries' ability to raise domestic resources. DFIs largely use public money and DFI investments in developing countries are significantly increasing.

The results of the lack of engagement were clearly shown when Oxfam analysed the investments by IFC made in Sub-Saharan Africa and their links to tax havens. In 2015, Oxfam research found that 51 of the 68 companies that IFC supported in this region use tax havens. In total, these companies – whose use of tax havens has no apparent link to their core business – received 84 per cent of the IFC's investments in the region in 2015. Oxfam also found that more than 80 per cent of the dollars invested by IFC in Sub-Saharan Africa in 2015 were channelled to companies that are present in at least one tax haven, without any apparent link

to their core business and with a very low level of transparency (Oxfam 2016). This shows that there is significant risk that the IFC support companies with public finance that might be engaged in aggressive tax planning through these tax havens.

Furthermore, recent research found that at least seven of the nine DFIs in a recent survey invest in companies or financial intermediaries incorporated in tax havens. In addition to investments in companies incorporated in tax havens, DFIs might well invest in companies that use tax havens in their corporate structures as shown for the IFC (Joint NGO brief 2016).

### Trends that appear particularly relevant to highlight

As portfolio sizes increase, the DFIs will continue to struggle to reach the domestic small and middle income companies (SMEs) of developing countries, but instead see advantages of large partnerships with global transnational corporations. Here, due diligence on tax matters are absolutely crucial as they have been the core of the scandals of tax avoidance and use of tax havens. Due diligence to ensure that clients are responsible taxpayers is crucial, but also signalling clearly to the marketplace of clients that tax avoidance is unacceptable. It should be noted that while often considered to be immoral, international tax avoidance is, technically speaking, legal. This is why the emphasis is on the responsibility of clients in their tax matters. Tax evasion, on the other hand, is illegal and DFIs should also be vigilant to ensure that their investment flows are in no way associated with tax evasion. Public transparency is crucial especially as DFIs are using taxpayers' money. Today it seems that investors' interests overrule transparency.

Financial markets have gained increasing prominence in DFIs' commitments. On average, over 50 per cent of the public finances flowing from DFIs to the private sector goes to the financial sector, including banks, in the form of loans and equity. The IFC invested more than USD 50 billion in the financial sector during 2010–15. Research by Oxfam shows that, in addition to problems associated with direct investments in companies, the use of financial intermediaries comes with significant challenges regarding management and effective implementation of due diligence. This can have quite severe negative impacts on the affected communities (Oxfam 2015). Development impacts from the funds channelled through financial intermediaries can be hard to monitor and the use of third parties is problematic because there is a lack of knowledge about who the beneficiaries of the funds are and, sometimes, who the beneficial owners are. This creates a significant risk as it does not allow DFIs to identify tax avoidance schemes or even financial crimes such as money laundering and tax evasion.

All of these concerns call into question the appropriateness of the private sector as a major channel of development finance as long as tax havens continue to feature prominently in corporate structures of clients. It raises particular questions about whether the use of third-party financing undermines people-centred, inclusive models of development.



### Implications for policy

The first steps for DFIs to ensure corporate responsibility in tax matters and their effective contribution to domestic resource mobilisation would be:

- To establish, in consultation with civil society, a tax-responsible investment policy that clarifies roles and responsibilities of DFIs own operations as well as requirements for clients.
- To not use tax havens to channel investments to developing countries, but work actively to improve the financial infrastructure in the countries to receive the investment.
- To ensure that all clients (or partners that benefit from a business relation with DFIs), in particular transnational corporations, are subject to due diligence to ensure that they are responsible taxpayers that pay their fair share.

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# Tax treaties and illicit capital outflows from Africa

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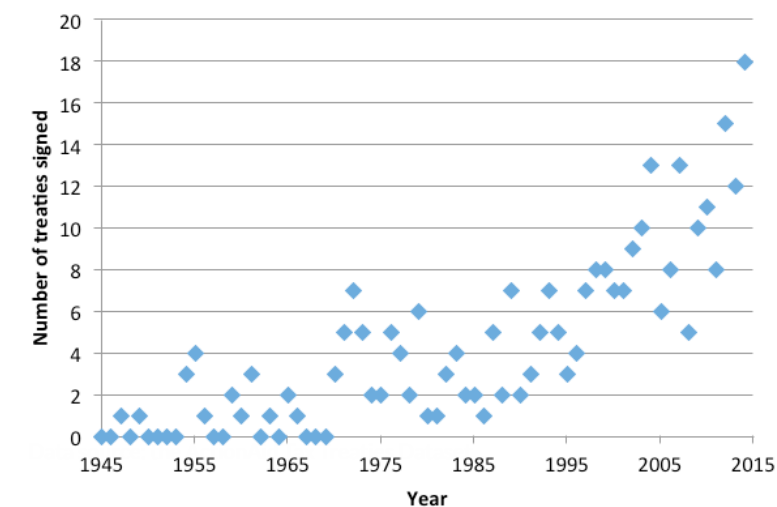
*The Report of the High Level Panel on Illicit Financial Flows from Africa* warns that tax treaties can facilitate illicit financial outflows. This chapter takes a closer look at Sub-Saharan Africa's treaty network. How do treaties provide opportunities for abuse and what can be done about it?

### Tax treaties on the rise

There are now more than 300 tax treaties that low and lower middle income countries in Sub-Saharan Africa are party to. The number is rapidly increasing (see Figure 1). Once signed and ratified, each tax treaty limits the contracting states' taxing rights until the treaty is terminated or renegotiated. Even though some treaties are very old, they are still as powerful as they were when they were first agreed.

The formal motivation for tax treaties is to avoid double taxation - paying tax in two jurisdictions on the same income or transaction. Tax treaties distribute the rights to tax between two jurisdictions that could claim the right to collect tax on cross-border economic activity.

Figure 1. The number of tax treaties signed by low and lower middle income countries in Sub-Saharan Africa



### So what's the problem?

*“Double taxation agreements can contain provisions that are harmful to domestic resource mobilization and can be used to facilitate illicit financial outflows. We recommend that African countries review their current and prospective double taxation conventions, particularly those in place with jurisdictions that are significant destinations of IFFs, to ensure that they do not provide opportunities for abuse.”*

Report of the High Level Panel on Illicit Financial Flows from Africa. United Nations. Economic Commission for Africa, 2015.

*“ ‘Treaty shopping’ – the use of tax treaty networks to reduce tax payments – is a major issue for many developing countries, which would be well-advised to sign treaties only with considerable caution.”*

IMF Policy Paper – Spillovers in International Corporate Taxation. Keen, M. et al 2014.

Tax treaties can have unintended consequences. Global corporations use and misuse tax treaties to limit their tax contributions where they generate profits. About one third of the world's foreign-owned firms are owned via tax havens or special purpose entities – a low transparency corporate structure (UNCTAD 2015). One reason for this is to obtain tax treaty benefits (ActionAid 2013a).

Tax treaties that ban taxes on pre-tax payments carry a real risk. Taxing money that leaves the country as interest, royalty and service payments is a proven means to discourage corporations from using these payments to shift profits to a low tax jurisdiction to avoid paying tax. Tax treaties that remove these taxing rights can provide opportunities for abuse.

In February 2013, ActionAid showed that Zambia's tax treaty with Ireland was used by the food giant Associated British Foods to avoid tax in Zambia (ActionAid 2013b). Large loans from South African and US commercial banks were routed through Ireland on paper, thereby taking advantage of a particularly unfair tax treaty between Zambia and Ireland. This prevented the Zambian government from charging any of the tax that would normally be levied on the interest payments made on these loans. Two years later, ActionAid uncovered how Malawi lost out on USD 27 million in taxes, as the Australian mining company Paladin shifted significant sums of money out of Malawi and back to Australia via the Netherlands (ActionAid 2015). The tax savings were made possible due to the old Malawi – Netherlands tax treaty that exempts interest payments and management fees from tax in Malawi.

Tax revenues fund schools and hospitals everywhere. When global corporations aren't paying as much as they should in developing countries, it takes billions of dollars away from vital public services every year. Women and children, especially those marginalised or living in poverty, suffer the most when public services are starved of adequate funding. It is within all governments' power to assess whether their treaties are contributing to revenue losses in developing countries and, if so, take action.

### Rewriting the rules

Tax treaties are voluntary; they can be renegotiated and cancelled.

In March 2015, a renegotiated treaty between Zambia and Ireland was signed. The clause that enabled tax avoidance on interest payments was successfully renegotiated as a result (ActionAid 2016). When Malawi and the Netherlands renegotiated their treaty in April 2015, Malawi's right to tax outgoing interest payments was reinstated, though the ban on taxing management fees is still in place.

Whilst some loopholes and revenue drains are plugged up, others are written into law. ActionAid has commissioned original research that makes the content of more than 500 tax treaties signed by lower-income countries in Asia and Sub-Saharan Africa available to the public and open to scrutiny for the first time. The ActionAid Tax Treaties dataset (Hearson 2016) exposes eleven other treaties where a Sub-Saharan African country has given up the right to tax interest payments to overseas lenders in the other contracting state. It also shows how Sub-Saharan African countries are rapidly increasing their number of treaties with tax havens. These treaties can come at a particularly high cost, as money routed through tax havens as part of tax avoidance strategies often rely on tax cuts contained in treaties signed by those havens (Keen et al. 2014)

### Conclusion

The fine-print in tax treaties urgently requires the attention of policy-makers. For Sub-Saharan African governments that wish to ensure their right to tax is upheld, both examples of (a) unusually restrictive individual treaty provisions, and (b) restrictions on a large number of taxing rights, constitute causes for urgent tax treaty review. Hopefully the freely available ActionAid Tax Treaties Dataset can be of use in this process.

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# The financial secrecy of tax havens

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In 1998, the OECD issued a Report on “Harmful Tax Competition”. It argues that tax-haven jurisdictions are characterized by a lack of transparency and effective exchange of information, few statutory formalities for conducting business transactions in or through them, and high levels of secrecy in the banking and commercial sectors (OECD 1998). Companies or persons who use tax-havens get confidentiality which makes it difficult for foreign tax authorities to ascertain their identity for purposes tax collection. Such secrecy provisions are often abused in tax havens to facilitate tax evasion and avoidance. In one Cayman Islands case (*in the matter of Bank of America Trust and Banking Corp (Cayman) Ltd, and In the matter of Bank of America National Trust and Savings Association 1992 93 CILR 574*), a bank from the USA with a subsidiary in the Cayman Islands was issued with a summons by the USA Internal Revenue Service for the purpose of identifying (for tax liability) persons who had transferred or received large sums of money during a specific period. The Cayman Islands court held that the safeguarding of confidentiality was a cornerstone of the banking business and the preservation of this principle was the basis on which the economy of the Cayman Islands so substantially relied. It thus outweighed the interests of the USA’s Internal Revenue Service in enforcing its summons.

The challenge is that secret investments in tax-haven jurisdictions encourage harmful tax practices that may lead to the depletion of other countries’ tax bases. They also distort financial and investment flows between countries. Nevertheless, the use of a suitable tax-haven jurisdiction is considered a necessary component of international tax planning and many of the world’s business transactions take place in tax-haven jurisdictions. Today’s leading mutual funds, stock broking firms and banks are based in tax havens, where they dominate international activities such as shipping, aircraft financing and captive insurance. Major international banks make use of tax havens because of their permissive regulatory regimes, zero or minimal tax rates and their secrecy arrangements. The significance of tax havens lies in the fact that large amounts of money are sheltered there.

## Illicit capital flows via tax havens

Tax havens have become major players in the global financial markets as conduits for cross-border capital flows, to such an extent that it has been noted that tax

havens “oil the wheels of financial capitalism” (Christensen 2009). The OECD estimates that over half of all international bank lending and approximately one-third of foreign direct investment is routed via tax havens, and that 50% of global trade is routed on paper via these jurisdictions, even though they only account for about 3% of world GDP (OECD 2009). It is also estimated that over two million international business corporations and millions of secretive trusts have been created in tax havens. It is assumed that worldwide personal wealth totaling USD 11.5 trillion has been shifted offshore by the super-rich, thus evading global tax revenues of over USD 255 billion annually. The British NGO Oxfam released a report in 2000 that exposes the impact of tax havens on international development, estimating that tax havens cost poorer countries USD 50 billion a year due to aggressive tax avoidance (Oxfam 2000). Tax havens create wealth inequality and deplete countries’ tax bases. They create a weak link in the global financial chain.

## International measures to curtail investments in tax havens

The international community has taken some measures to stifle the development of tax havens. In 1992, the European Union (EU) issued a “Code of Conduct” on business taxation in order to assess national tax measures that fell foul of the Code and to blacklist harmful national tax measures. In addition, the EU came up with Directives such as the Savings Income Directive, to prevent harmful tax practices. In 1998, the G7 countries also issued a comprehensive Code of Conduct on Business Taxation. In 1998, the United Kingdom’s (UK) Home Secretary issued the Edwards Report to Parliament, which reviewed the Financial Regulations in the UK Crown Dependencies of Jersey, Sark, Guernsey and the Isle of Man. Then in 2000, the UK engaged the KPMG accounting firm to investigate the financial regulations of the British Overseas Territories of Anguilla, Bermuda, the British Virgin Islands, the Cayman Islands, Montserrat and the Turks and Caicos Islands.

The greatest onslaught on tax havens has been conducted by the OECD. In 1998, the OECD issued a Report on “Harmful Tax Competition” which recommended that countries should have rules that pertain to reporting of international transactions and foreign operations of resident taxpayers and that they should exchange information obtained under such rules. A further recommendation was that countries should adopt effective legislation to curb tax avoidance. OECD member countries were called upon to list tax-haven jurisdictions, and countries with political, economic or other links with tax havens should ensure that such links were not used to promote harmful tax practices. In a successive report, issued in 2000, the OECD compiled a list of tax-haven countries consisting of: Andorra, Anguilla, Antigua and Barbuda, Aruba, Barbados, the Bahamas, Bahrain, Belize, the British Virgin Islands, the Cook Islands, the Commonwealth of Dominica, Gibraltar, Grenada, Guernsey, the Isle of Man, Jersey, Liberia, the Principality of Liechtenstein, the Republic of the Maldives, the Republic of the Marshall Islands, the Principality of Monaco, Montserrat, the Republic of Nauru, the Netherlands Antilles, Niue, Panama, St Kitts and Nevis, St Lucia, St Vincent and the Grenadines, Tonga, the Turks and Caicos Islands, the United States Virgin Islands, and the Republic of Vanuatu

(Makhlouf 2002). The OECD report called on the listed jurisdictions to commit themselves to ensuring transparency and the effective exchange of information. If not, they would be regarded as uncooperative tax havens that presented a threat not only to the tax systems of developed and developing countries, but also to the integrity of international financial systems (OECD 2000a). Over the years, many of these jurisdictions committed to effective exchange of information and transparency, in terms of the OECD “Framework for a Collective Memorandum of Understanding on Eliminating Harmful Tax Practices” (OECD 2000b). Some tax haven jurisdictions worked together with the OECD to form a Global Forum which developed a “Model Agreement on Exchange of Information on Tax Matters”. This agreement promotes international cooperation in tax matters and uses international standards on transparency and effective exchange of information. Today, many tax havens have signed exchange of information agreements with various OECD member countries, and currently there is apparently no country on the OECD list of uncooperative tax havens.

Nevertheless, the effectiveness of the OECD efforts was criticized. Its member nations continued to have dealings with and lend credibility to many tax havens. Critics also argued that OECD member nations failed to acknowledge that they had benefited from their involvement with tax havens and showed little political will to curtail the problems caused by the use of tax havens.

When the world was hit by the 2007/2008 global financial crisis, the G20 national leaders pointed out that “major failures in the financial sector and in financial regulation and supervision were fundamental causes of the crisis,” and that unregulated shadow banking and offshore tax havens were at the heart of the financial crisis (G20 2009). Although tax havens did not cause the crisis, many of the roots of the global economic crisis can undoubtedly be traced back to tax havens. Lax tax haven regulations and the evolution of the off-balance sheet shadow banking system lay at the heart of the financial crisis. The active collusion between banks and tax havens created the shadow side of the world’s banks and mega-corporations. This is vividly demonstrated by the United States investigations into the operations of the Swiss bank UBS and the Liechtenstein bank LGT. The financial crisis largely happened due to the lack of regulation that encouraged shadow bankers to deplete minimum capital bank reserves, conceal illiquidity, and muddle debt accountability while depending on constant refinancing to survive. These shadow activities were largely conducted in tax havens.

In the aftermath of the 2007/2008 global financial crisis, concerns about multinational enterprises (MNEs) not paying their fair share of corporate taxes were again brought to the forefront by non-governmental organizations like Christian Aid and the Tax Justice Network. When MNEs manipulate gaps in tax systems to artificially reduce taxable income or shift profits to low-tax jurisdictions where they have little or no economic activity, the result is tax base erosion. At the G20 summit in Mexico in 2012, national leaders explicitly referred to the need to prevent tax “base erosion and profit shifting” (BEPS). Faced with budgetary deficits as a result

of the 2007/2008 global financial crisis, OECD and G20 countries found the political will to curtail BEPS. They called upon the OECD to address the matter, and in February 2013 the OECD released its Action Plan to curtail BEPS. In 2015, the OECD issued its 15 Point Package of BEPS measures which are intended to ensure that profits are taxed in the countries where economic activity takes place and value is created (OECD 2015). The hope is that the BEPS measures (for example, Country-by-Country Reporting of the global income and taxes paid by MNE’s as set out in Action 13) will be instrumental in exposing investments in and illicit capital flows via tax havens.

### **Have the measures to curtail tax havens been effective?**

The 2015 BEPS measures provided ‘wind in the sails’ for OECD, but its efforts were dampened when the International Consortium of Investigative Journalists (ICIJ) released the “Panama Papers” in April 2016. The Panama papers detailed financial information on shell companies and tax havens by a single law firm in Panama. Yet, this is just the tip of the iceberg. A worldwide network of secrecy jurisdictions is exploited by powerful individuals to create dubious entities and shell companies that serve no economic or entrepreneurial purpose but to hide great fortune. Collusion between the world’s biggest banks, specialized law firms, and consulting and accounting firms has led to a global system designed to hide money and avoid taxes by virtue of secretive offshore structures.

### **Conclusion**

The Panama papers are evidence that secret investment in tax havens and illicit capital flows still continue with impunity, despite the international onslaught on tax havens. Although there seems to be no immediate end to tax havens, governments gradually realize that it is in their own interest to phase out secrecy jurisdictions. The Panama papers have paved the way for a complete rethink of whether offshore tax havens are justifiable in the modern age. Public reporting on tax haven activities will go a long way to put an end to tax havens.



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# Glossary

This glossary was first published in the U4 Issue Paper "Tax-motivated illicit financial flows: A guide for development practitioners" (Hearson 2014).

## Arm's length principle

Tax treaties and transfer pricing regulations generally state that transfer pricing transactions within a group of companies will only be recognised for tax purposes to the extent that they observe this principle. It requires that the terms of these transactions are consistent with those that would have been arrived at by independent companies. This is intended to prevent companies from manipulating their transfer pricing transactions to reduce their tax bills.

## Base erosion and profit shifting (BEPS)

According to the OECD (<http://www.oecd.org/ctp/beeps/>), this refers to "tax planning strategies that exploit gaps and mismatches in tax rules to make profits 'disappear' for tax purposes or to shift profits to locations where there is little or no real activity, but the taxes are low resulting in little or no overall corporate tax being paid." The OECD coordinates the BEPS project, and it involves G20 countries. The project seeks to reform international tax standards that have become open to exploitation by multinational firms.

## Double taxation, single taxation, and double non-taxation

Where a company or individual incurs a tax liability in more than one country, international tax instruments strive to ensure that any given transaction is taxed only once by the different countries with a claim on it (single taxation). If two countries' claims on the taxing rights overlap, this creates double taxation; if neither country claims the taxing rights, this creates double non-taxation. Some tax avoidance strategies exploit international tax instruments in ways that were not intended, for example by ensuring that the right to tax a transaction is allocated to a country that levies no or low taxation on it. Others take advantage of inconsistencies in tax systems to engineer double non-taxation.

## False invoicing

The practice of falsely declaring the value of imported or exported goods to evade customs duties and taxes, circumvent quotas, or launder money. The value of goods exported is overstated, or the value of goods imported is understated, and the proceeds are illicitly transferred overseas. Most estimates of trade-based illicit financial flows focus on this mechanism.

## Inward investment

Inward investment are actions designed to encourage investment in developing economies by companies based overseas. Developing countries pursue inward investment predominantly in more developed economies. In large part, the investment under consideration is foreign direct investment, where the overseas company owns a large enough stake in the local company (10% in the OECD definition) to exercise a significant degree of influence over it. This stake may be acquired by purchasing an interest in an existing local company or by establishing a new business.

## Mutual assistance

This refers to cooperation between the tax authorities of two or more countries and usually requires the legal mandate of a treaty. It is an essential component of the toolbox for tax authorities to counter tax-motivated IFFs. OECD conventions provide the framework for three types of cooperation: exchange of information and cooperation between authorities of different countries in investigations, collection of taxes owed to one country by the administration of the other, and service of official documents issued by one country in the other.

## Permanent establishment (PE)

This concept in international tax standards is when a country is entitled to tax a foreign resident company that is earning income within its borders. The PE definition is a key area of

disagreement in tax treaty negotiations because it limits a developing country's capacity to tax overseas investors. The OECD's analysis of BEPS highlights certain areas in which the PE rules within its model treaty are vulnerable to tax planning by multinational firms.

### Progressive tax

A progressive tax is a tax that takes a larger percentage from high-income earners than it does from low-income individuals.

### Regressive tax

A regressive tax takes a larger percentage of a lower-income and a smaller percentage of a higher income.

### Round-tripping

Domestic investors sometimes obtain benefits intended for overseas investors by channelling their investment through an offshore jurisdiction. A widely cited example is Indian investors' use of Mauritius to avoid capital gains tax: the terms of the India-Mauritius treaty prevent India from taxing capital gains by a resident of Mauritius, even if this is a shell company set up by an Indian national.

### Secrecy jurisdiction

A jurisdiction may create a legal environment specifically for the use of nonresidents, one aspect of which is financial secrecy. The originators of illicit financial flows may need to prevent the authorities in the country of origin from identifying them (for example, if the money is the proceeds of tax evasion), in which case the flow will be directed to a secrecy jurisdiction. IFFs seek out low taxes and secrecy so many tax havens are also secrecy jurisdictions, but the concepts are not identical.

### Tax avoidance

According to a common formal definition, tax avoidance practices are those designed to gain a tax advantage by contravening the intention of legislation, but not its letter. Such practices can be prevented through statutory anti-avoidance rules. However, where such rules do not exist or are not effective, tax avoidance can be a major component of IFFs.

### Tax evasion

This refers to actions by a taxpayer to escape a tax liability that has arisen under the law of a country. Doing so generally involves concealing the income on which the tax liability has arisen from the revenue authority. Tax evasion can be a major component of IFFs.

### Tax exemption

An exception to the statutory tax rate may be provided for certain activities or to groups of taxpayers. Governments use these to incentivise certain behaviours and to shield poorer parts of the population from an otherwise regressive tax. Tax exemptions for investors ("tax incentives") cover various corporate taxes and are intended to stimulate domestic and foreign investment in certain sectors or geographic areas, although competition between developing countries through tax incentives appears to have had a limited impact on actual levels of investment. Where tax exemptions are granted to companies on a discretionary basis, especially where there is a lack of transparency and scrutiny, there is a significant risk of corruption and IFFs.

### Tax haven

A jurisdiction whose legal regime is exploited by non-residents to avoid or evade taxes. The OECD formulated the most authoritative definition in 1998. It states that a tax haven has no, or very low nominal tax rates, in combination with one or more other factors including lack of effective exchange of tax information with other countries, lack of transparency in the tax system, and no requirement to have substantial activities in the jurisdiction to qualify for tax residence. Tax havens are the main channel for laundering the proceeds of tax evasion and routing tax avoidance.

### Tax information exchange

In this form of mutual assistance, one jurisdiction shares information on its taxpayers with other jurisdictions that are signatories to a treaty. The exchange can be spontaneous, on demand, or automatic. Information exchange allows tax authorities to detect and combat tax-motivated IFFs.

### Tax planning

This refers to tax strategies designed to prevent a tax liability from arising. Unlike tax evasion and tax avoidance, tax planning does not contravene either the letter or the spirit of the

law. The term refers to a range of activities, from those explicitly intended or condoned by the government (for example, taking advantage of a tax incentive) to more "aggressive" activities that do not meet the technical definition of tax avoidance (for example, tailoring a business's presence in a country to push the limits of the definition of permanent establishment).

### Tax treaty

Formally known as tax conventions on income and capital, bilateral tax treaties between countries were originally known as double taxation treaties. By concluding them, countries reach a negotiated settlement that restricts their source and residence taxation rights in a compatible manner, alleviating double taxation and allocating taxing rights between them. Treaties also harmonise the definitions in countries' tax codes, provide mutual agreement procedures that can be invoked if there are outstanding instances of double taxation, and establish a framework for mutual assistance in enforcement. A treaty between a developing country and a country from which it receives investment will shift the balance of taxing rights away from the developing country. This creates opportunities for treaty shopping by foreign investors.

### Thin capitalisation

This is a tax planning scheme under which a parent company uses debt to invest in a subsidiary and then strips out its profits through interest payments on the loan, rather than repatriating them through dividends. A group financing a subsidiary located in a low-tax jurisdiction commonly provides the loan. This practice is often used to strip developing countries of taxable profit by shifting it to other jurisdictions.

### Trade mispricing

This umbrella term covers both transfer mispricing and false invoicing, two of the main components of tax-motivated IFFs.

### Transfer mispricing

A transfer price may be manipulated to shift profits from one jurisdiction to another, usually from a higher-tax to a lower-tax jurisdiction. This is a well-known source of IFFs, although not all forms of transfer pricing abuse that result in IFFs rely on manipulating the price of the transaction.

### Transfer pricing

This refers to the price of transactions occurring between related companies, in particular companies within the same multinational group. Governments set rules to determine how transfer pricing should be undertaken for tax purposes, predominantly based on the arm's length principle. Much of the debate on tax-motivated IFFs revolves around the formulation and enforcement of transfer pricing regulations, their shortcomings, and the way in which they are abused for tax evasion and avoidance purposes.

### Treaty shopping

A taxpayer can obtain a tax advantage in a cross-border transaction by seeking out one or more jurisdictions whose tax treaties are more favourable, and routing transactions through them. A treaty shopping structure may take advantage of the allocation of taxing rights to a jurisdiction – frequently a tax haven – that chooses not to tax or to tax very lightly.

### Unitary taxation

This is an alternative approach to dividing the tax base of a multinational company between countries. While transfer pricing treats the company as a collection of separate entities that cooperate with each other, unitary taxation considers it as one global entity and apportions its profits according to a formula, taking into account, for example, fixed assets, staffing, and sales. Such formulaic apportionments are used by some federal countries such as the United States to apportion corporate profits between states. Unitary taxation advocates regard it as a system less vulnerable to tax avoidance and evasion, and hence less friendly to tax-motivated IFFs.

# Overview of organisations and institutions working on tax issues in Africa

## International organisations dealing with taxation

African Development Bank (AfDB)	<a href="http://www.afdb.org/en">www.afdb.org/en</a>
African Tax Administration Forum (ATAF)	<a href="http://www.ataftax.org/en">www.ataftax.org/en</a>
European Commission (EC)	<a href="http://ec.europa.eu">ec.europa.eu</a>
International Monetary Fund (IMF)	<a href="http://www.imf.org">www.imf.org</a>
International Trade Center (ITC)	<a href="http://www.intracen.org">www.intracen.org</a>
Organisation for Economic Co-operation and Development (OECD)	<a href="http://www.oecd.org">www.oecd.org</a>
The World Bank (WB)	<a href="http://www.worldbank.org">www.worldbank.org</a>
World Customs Organisation (WCO)	<a href="http://www.wcoomd.org">www.wcoomd.org</a>
World Trade Organisation (WTO)	<a href="http://www.wto.org">www.wto.org</a>

## International research institutions working on tax and governance in Africa

Centre d'Études et de Recherches sur le Développement International (CERDI)	<a href="http://www.cerdi.org">www.cerdi.org</a>
Center for Global Development	<a href="http://www.cgdev.org">www.cgdev.org</a>
Centre for Policy Studies (CPS)	<a href="http://www.cps.org.za">www.cps.org.za</a>
Chr. Michelsen Institute (CMI)	<a href="http://www.cmi.no">www.cmi.no</a>
International Centre for Tax and Development (ICTD)	<a href="http://www.ictd.ac">www.ictd.ac</a>
International Growth Centre	<a href="http://www.theigc.org">www.theigc.org</a>
Institute on Governance (IOG)	<a href="http://www.iog.ca">www.iog.ca</a>
International Institute of Public Finance (IIPF)	<a href="http://www.iipf.net">www.iipf.net</a>

## Other relevant links on taxation

ActionAid (AA)	<a href="http://www.actionaid.org.uk">www.actionaid.org.uk</a>
Christian Aid	<a href="http://www.christianaid.org.uk">www.christianaid.org.uk</a>
Commonwealth Association of Tax Administrators	<a href="http://www.catatax.org">www.catatax.org</a>
Extractive Industries Transparency Initiative (EITI)	<a href="http://www.eiti.org">www.eiti.org</a>
Global Financial Integrity (GFI)	<a href="http://www.gfip.org">www.gfip.org</a>
Global Alliance for Tax Justice	<a href="http://www.globaltaxjustice.org">www.globaltaxjustice.org</a>
International Budget Partnership (IBP)	<a href="http://www.internationalbudget.org">www.internationalbudget.org</a>
International Bureau for Fiscal Documentation (IBFD)	<a href="http://www.ibfd.nl">www.ibfd.nl</a>
International Consortium of Investigative Journalists (ICIJ)	<a href="http://www.icij.org/">www.icij.org/</a>
International Tax Dialogue (ITD)	<a href="http://www.itdweb.org">www.itdweb.org</a>
KPMG	<a href="http://www.kpmg.com">www.kpmg.com</a>
Natural Resource Governance Institute	<a href="http://www.resourcegovernance.org">www.resourcegovernance.org</a>
Norwegian Church Aid	<a href="http://www.kirkensnodhjelp.no">www.kirkensnodhjelp.no</a>
Publish What You Pay (PWYP)	<a href="http://www.publishwhatyoupay.org">www.publishwhatyoupay.org</a>
PWC	<a href="http://www.pwc.com">www.pwc.com</a>

Tax and Accounting Sites Directory  
 Tax Justice Network (TJN)  
 World Tax  
 World Taxpayers Association (WTA)

[www.taxsites.com](http://www.taxsites.com)  
[www.taxjustice.net](http://www.taxjustice.net)  
[www.taxworld.org](http://www.taxworld.org)  
[www.worldtaxpayers.org](http://www.worldtaxpayers.org)

## Statistical databases

Aid Data  
 African Economic Outlook  
 Basel Institute's Anti-Money Laundering Index  
 Budget Advocacy Network  
 Fair Tax Mark  
 IMF Data and Statistics  
 The Government Revenue Dataset  
 World Bank Data

[www.aiddata.org](http://www.aiddata.org)  
[www.africaneconomicoutlook.org/en/data-statistics/](http://www.africaneconomicoutlook.org/en/data-statistics/)  
<https://index.baselgovernance.org/>  
[www.internationalbudget.org/groups/budget-advocacy-network-ban/](http://www.internationalbudget.org/groups/budget-advocacy-network-ban/)  
<https://fairtaxmark.net/>  
[www.imf.org/external/data.htm](http://www.imf.org/external/data.htm)  
[www.ictd.ac/datasets/the-ictd-government-revenue-dataset](http://www.ictd.ac/datasets/the-ictd-government-revenue-dataset)  
<http://data.worldbank.org/>

## African research and civil society organisations working on taxation

African Economic Research Consortium (AERC)	<a href="http://aercafrica.org/">http://aercafrica.org/</a>
Africa Forum and Network on Debt and Development (Afrodad)	<a href="http://www.afrodad.org">www.afrodad.org</a>
Africa Regional Organization of the International Trade Union Confederation (ITUC-Africa)	<a href="http://www.ituc-africa.org">www.ituc-africa.org</a>
African Network of Centers for Investigative Reporting	<a href="http://investigativecenters.org/">investigativecenters.org/</a>
African Tax Institute (ATI)	<a href="http://www.up.ac.za/african-tax-institute">www.up.ac.za/african-tax-institute</a>
Budget Advocacy Network	<a href="http://www.bansl.org/">www.bansl.org/</a>
Centre for Civil Society	<a href="http://ccs.ukzn.ac.za/">ccs.ukzn.ac.za/</a>
Centre for Social Concern	<a href="http://www.cfscmalawi.org/">www.cfscmalawi.org/</a>
Civil Society Legislative Advocacy Centre (CISLAC)	<a href="http://www.cislacnigeria.net/">www.cislacnigeria.net/</a>
Commission Episcopale Justice et Paix (CEJP/CENCO)	<a href="http://www.cordaid.org/">www.cordaid.org/</a>
Economic Justice Network of Southern Africa	<a href="http://www.ejn.org.za/">www.ejn.org.za/</a>
Egyptian Centre for Economic and Social Rights	<a href="http://www.ecesr.org/en/">www.ecesr.org/en/</a>
Endogene et Communautaire (CRADEC)	<a href="http://www.wacsi.org">www.wacsi.org</a>
Ghana Integrity Initiative	<a href="http://www.tighana.org/">www.tighana.org/</a>
Institute of Tax Administration, Tanzania	<a href="http://ita.ac.tz/">ita.ac.tz/</a>
Kenya Debt Relief Network	<a href="http://www.kendren.org/">www.kendren.org/</a>
Kenya Human Rights Commission	<a href="http://www.khrc.or.ke/">www.khrc.or.ke/</a>
Malawi Economic Justice Network (MEJN)	<a href="http://www.mejnmw.org/">www.mejnmw.org/</a>
National Taxpayers Association, Kenya	<a href="http://www.nta.or.ke">www.nta.or.ke</a>
OECD Watch	<a href="http://www.oecdwatch.org">www.oecdwatch.org</a>
Policy Forum, Tanzania	<a href="http://www.policyforum-tz.org/">www.policyforum-tz.org/</a>
Santos Development Organisation (SADO), Cameroon	<a href="http://orgs.tigweb.org">orgs.tigweb.org</a>
Social Justice, Côte d'Ivoire	<a href="http://www.socialjustice-ci.net/">www.socialjustice-ci.net/</a>
Southern and Eastern Africa Trade Information and Negotiation Institute (SEATINI-Uganda)	<a href="http://www.seatiniuganda.org/">www.seatiniuganda.org/</a>
Strathmore Tax Research Centre	<a href="http://law.strathmore.edu">law.strathmore.edu</a>
Tax Justice Network Africa	<a href="http://www.taxjusticeafrica.net/">www.taxjusticeafrica.net/</a>
West Africa Civil Society Institute, Ghana	<a href="http://www.wacsi.org">www.wacsi.org</a>
Zimbabwe Environmental Law Association (ZELA)	<a href="http://www.zela.org/">www.zela.org/</a>

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**Several African countries are among the fastest growing economies in the world. However, capital flows to tax havens are one factor limiting the benefits of economic growth for ordinary Africans. It is estimated that African countries, relative to the size of their economies, lose more in corporate tax evasion than countries anywhere else in the world.**

**Until recently, there has been little firm evidence on how the use of tax havens affects tax compliance, how it influences lobbying activities towards the domestic tax system, and how tax havens shape state-citizen relations. In this book, leading international scholars and experts explore the problem, the actors, the effects and policy measures that can address the challenges.**

**This book is developed as a part of the research project Taxation, Institutions and Participation (TIP) led by Chr. Michelsen Institute, Norway, in collaboration with Mzumbe University Dar Es Salaam Campus College, Tanzania, Institute for Finance & Economics, Zambia, and Tax Justice Network – Norway.**

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