Illicit financial flows, tax havens and industrial development in South Africa

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TIPS
TRADE & INDUSTRIAL POLICY STRATEGIES

Outline

1. Introductory issues
2. Case studies
3. Impacts on industrial development
4. Policy discussion

Introductory issues

IFFs - Definitions

- Common definitions turn on illegality: “international movements of money where funds are generated, transferred or used illegally.”
- Misalignment, illegal or not, between where profits are declared and where underlying real economic activity takes place is fundamentally harmful.
- Broader definition preferred here: “<u>“We define IFFs as cross-border flows that are illegitimate because they are based on an abuse of power and cause harm to a society”</u> (Khan et al, 2019).

Introductory issues

IFFs - Examples

MECHANISM	MOTIVATION	HARM
Repatriate undeclared profits via over-pricing exports	Evade tax on foreign earnings	Reduces tax revenues
Shift profits offshore via intra-company loans with inflated overseas interest payments	Avoid tax on domestic earnings Conceal dominance	Reduces tax revenues Distorts markets
Manipulation of inward investments via secrecy of origin	Acquire and conceal political influence	Facilitates corruption Private influence on policy formation
Shift profits overseas via over-paying for imports	Evade tax on domestic earnings Shift criminal funds offshore	Reduces tax revenues Proceeds of crime leave jurisdiction

Introductory issues

Tax havens and offshore wealth – jurisdictions or capabilities?

- Stereotypical image of a tax haven – Caribbean island, Swiss bank
- Unhelpful for policy
- Fundamentally about access to a **set of capabilities**, spread across jurisdictions (Henry, 2012)
- Main functions: 1. Secrecy; 2. Financial security; 3. Tax minimisation; 4. Remote access and management

Introductory issues

Tax havens and offshore wealth – jurisdictions or capabilities?

- Capabilities approach useful for a number of reasons:

1. Focus on “enablers” and their clients, rather than countries – avoids undue politicisation
2. Spectrum rather then binary – avoids arbitrary thresholds, more policy relevance
3. Higher degree of specification – enables deeper understanding, e.g., distinguishing intermediary vs. destination tax havens, or “secrecy jurisdictions” vs. “corporate tax havens”

Case studies: Lonmin

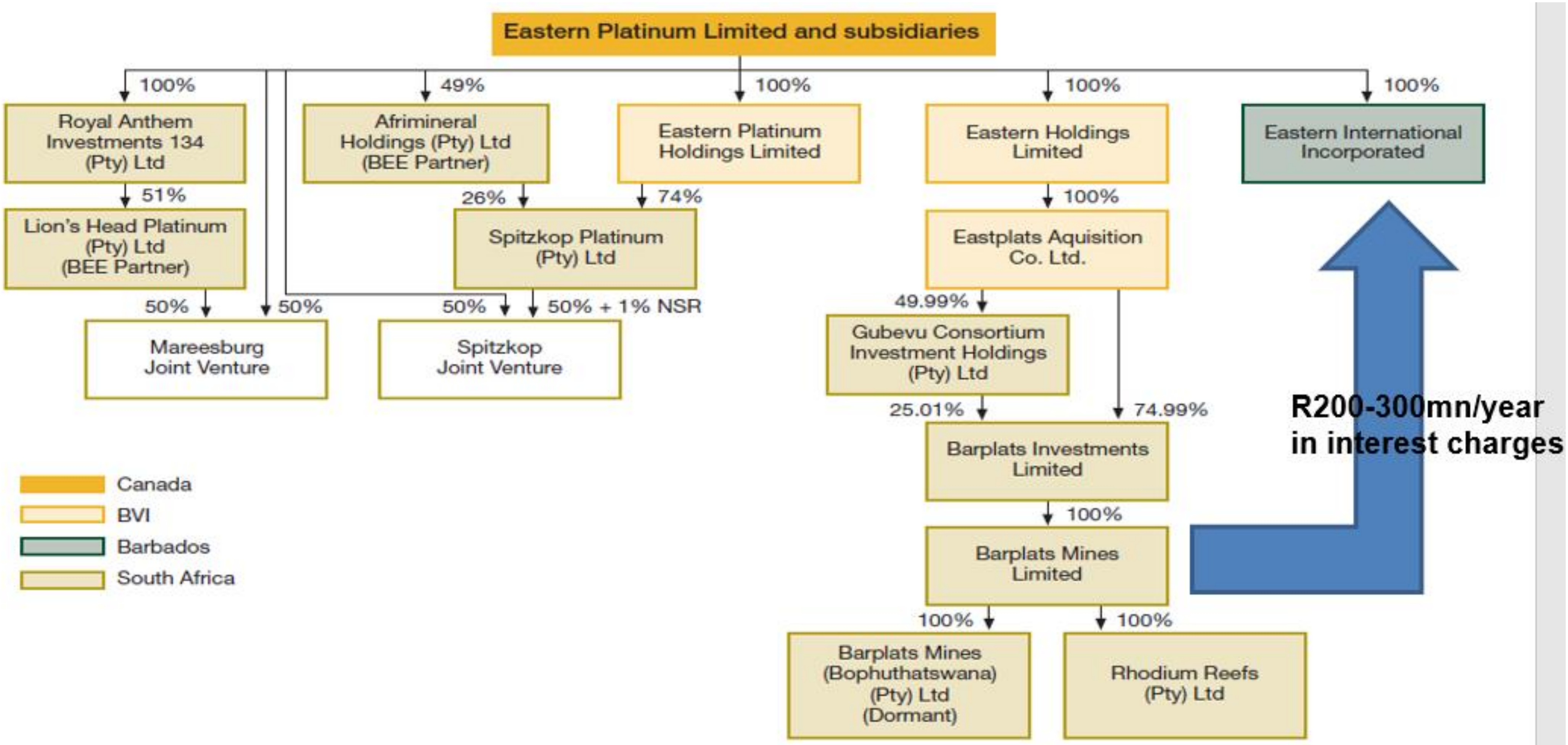
Forslund (2015): "Thin capitalisation", impact of transfer pricing and internal mgmt. fees on wages, taxes, dividends

- Trading of PGM mined coordinated through trading company established in Bermuda – "no income tax on individuals or firms, no capital gains, no branch profit tax and no transfer pricing legislation"
- Hundreds of R millions per annum in "sales commissions" paid to "sales agent" in Bermuda over years – no staff, no commercial rationale
- Argument that impact of profit shifting on wage negotiations and dividend payments ought to be considered, not just tax implications

Policy implication:

- Review of frameworks regulating overseas trading arms, intra-group loans and "management" fees

Case studies: Lonmin



Barplats Investments Limited (Barplats), is the Eastplats operating subsidiary in South Africa and Eastplats has a 74.99% interest in it. The BEE company, Gubevu Consortium Holdings (Pty) Ltd (Gubevu) has a 25.01% interest in Barplats. Eastplats has a 49.9% stake in Gubevu, giving it a beneficial interest of 87.5% in Barplats.

Case studies: MTN

amaBhungane and Finance Uncovered (2015): R billions moved by MTN to tax havens from subsidiaries on the continent

- R85.6-million shifted from from MTN Uganda to MTN Mauritius in 2009 (3% of revenues); R3.7-billion shifted from MTN Ghana to MTN Dubai between 2008 and 2013, with an unknown portion flowing on to Mauritius (9.6% of revenues); R512.9-million shifted from MTN Côte d'Ivoire to MTN Mauritius from 2012 to 2013 (estimated 5% of revenues)
- Internal transfers made for "intellectual property rights, know-how, technical expertise and back-office support" – additional challenge in regard to intangible assets
- MTN Mauritius has no staff, is "effectively managed from SA" – yet for e.g. in 2010 MTN Mauritius received hundreds of R millions in mgmt. fees while the MTN Group received only R58m.

Policy implication:

- Imperative to close loopholes and legal grey areas regarding transfer of intangible assets to lower-tax jurisdictions – trademarks, branding, IP, "know-how, technical expertise and back-office support".

Case studies: De Beers

Bracking and Sharife (2014): Analysis of extreme discrepancy between value per carat of imported vs exported rough diamonds

- Role of De Beers power in value chain, network of subsidiaries/related entities
- Overpricing of diamond imports -> shifts money out of De Beers SA to De Beers Botswana and Namibia;
- Underpricing exports -> shifts profits out of SA, avoids tax on diamond exports meant to support local beneficiation.
- In period of study (2004-2012), import price appears to be 5x export price.
- Conservative estimate according to authors: $3.9bn inflation of import value, implying significant tax loss
- Government Diamond Valuator appears ill-equipped to regulate/investigate appropriately, lacks access to critical sales information and valuation criteria

Policy implication:

- Value chain-, industry-, product-specific regulatory capabilities required

Case studies: ABF and Illovo Sugar

Lewis (2013) on Associated British Foods (ABF): Treaty shopping allowing for manipulation of mgmt. fees and intra-group loans

- In 2006, ABF acquired a majority stake in Illovo Sugar – SA-based, Africa's largest sugar producer with operations in Zambia, Mozambique, Malawi and Tanzania, etc.
- Illovo South Africa houses management and technical capabilities, but large "management" fees have been paid to another Illovo subsidiary based in Ireland
- Ordinarily, these types of fees paid to entities in other jurisdictions would be subject to a 15% withholding tax in Zambia, but this tax is reduced to 0% due to a tax treaty maintained between Zambia and Ireland.
- In 2007, Zambia Sugar borrowed around US$70 at 17% interest from two London-based banks – generated almost US$30 million in interest payments between 2007-2013.
- The two banks made the loan to Illovo Sugar Ireland, which then made an identical loan to Zambia Sugar – routing via Ireland avoided a withholding tax that would have applied had the loan been made directly

Policy implication:

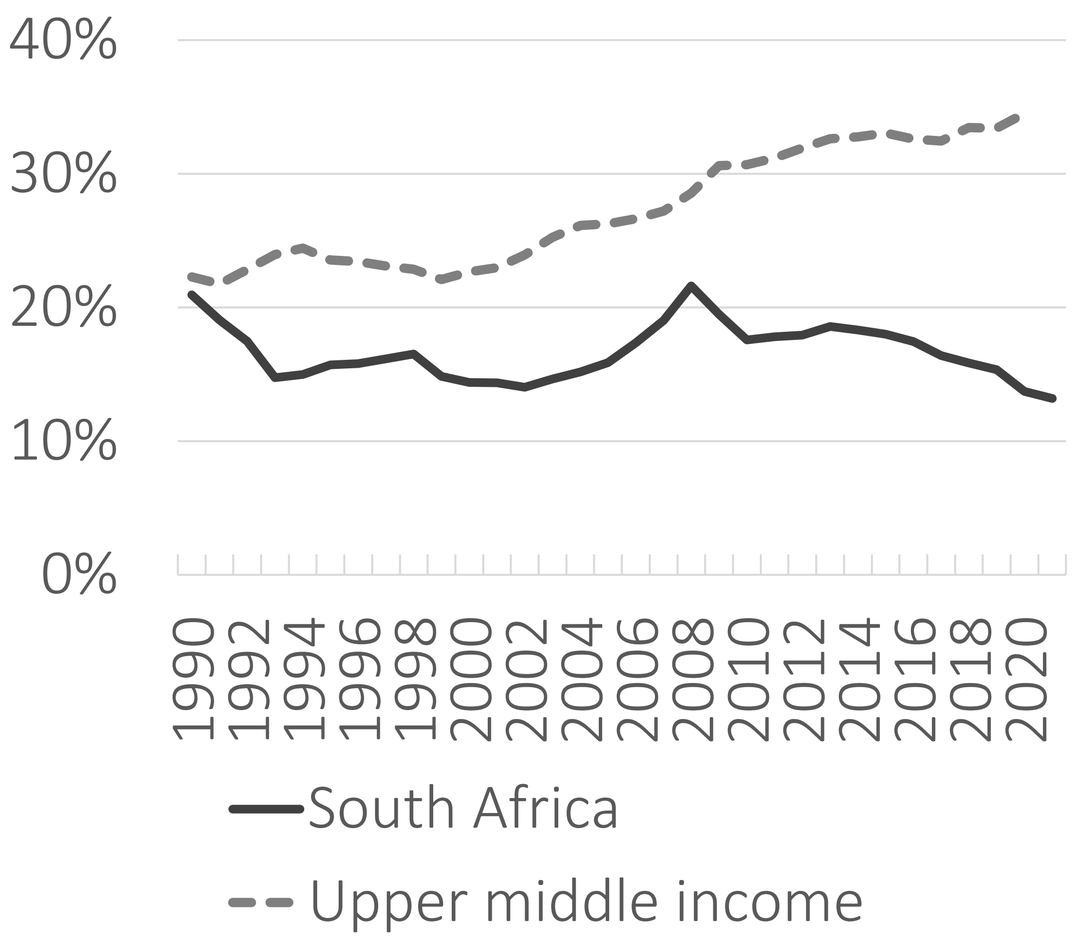
- Need to act on ways in which SA facilitates extraction from neighbouring countries – in general need to revisit and renegotiate bilateral treaties that allow for profit shifting

Impacts on industrial development?

- The nature of IFFs, profit shifting makes estimation of scale extremely difficult – same applies to isolating effects on particular sectors or economic processes.
- Literature has tended to focus on revenue loss – effects on industrial development specifically appear under-explored
- What are the channels through which tax-motivated IFFs and profit-shifting may affect industrial development in SA?

Impacts on industrial development?

Impact on investment and demand



	Average GFCF (2011-2020)
South Africa	16,9%
Brazil	17,7%
Malaysia	24,5%
Thailand	24,3%
Upper middle income	32,8%

Impacts on industrial development?

Impact on investment and demand

YEAR	TOTAL UNDER-UTILISATION OF PRODUCTION CAPACITY (%)	REASONS FOR UNDER-UTILISATION				
		SHORTAGE OF:			INSUFFICIENT DEMAND	OTHER
		RAW MATERIALS	SKILLED LABOUR	SEMI/UNSKILLED LABOUR		
2015	19.4	2.0	1.1	0.2	11.6	4.6
2016	18.2	2.0	1.0	0.2	10.9	4.1
2017	19.6	2.0	1.0	0.2	11.8	4.2
2018	18.7	1.9	1.0	0.2	11.4	4.2
2019	19.2	2.3	1.0	0.2	12.0	3.7
2020	20.7	3.1	1.1	0.2	12.7	3.6

Impacts on industrial development?

Impact on investment and demand

- Fofack and Ndikumana (2015) provide evidence that capital flight has a negative effect on monetary policy targets, depleting savings, constraining investment and reducing output.
- Ndikumana et al. (2020): "By draining domestic savings, capital flight erodes investable capital and slows capital accumulation in the source country"
- Forslund (2014) - Profit shifting strategies result not only in tax revenue losses, but also in "wage avoidance" and "dividend avoidance", implying a negative impact on savings, investment and demand
- Clearly requires empirical work, but a plausible channel

Impacts on industrial development?

Impact on linkages in the local production system

- Outflows driven to a significant extent by large multinational firms in relatively profitable and highly concentrated industries.
- Strong linkages between profitable lead firms in key sectors and the rest of the economy critical for sustained, dynamic growth
- Fotoyi (2016) illustrates that backward and forward linkages between mining and manufacturing subsectors in SA have weakened significantly post-1994
- The opportunity to build IFFs into cross-border flows provides a clear incentive for firms seeking to shift profits to source inputs globally rather than locally – case for stricter local content policies
- Plausible that profit shifting disrupts process of “linking back” required to build a robust local production system

Impacts on industrial development?

Competitive distortions

- IFFs increasingly considered to provide an unfair competitive advantage to the largest firms
- Compliant domestic firms at a systematic competitive disadvantage in relation to MNC rivals – growing body of evidence suggests that smaller firms and domestic firms are far more likely to be negatively affected by these arrangements than to benefit from them
- Wier and Reynolds (2018) find that SA-based subsidiaries of tax haven-based parent firms appear to underreport their profits by as much as 80%
- New entrants may be discouraged from investing and competing in industries that are made to appear less profitable than they actually are
- EU competition authorities have investigated IKEA , Amazon, McDonald's, Fiat and others on this basis

Impacts on industrial development?

Leakage of strategic development resources

- Exposure of PIC, IDC to firms that use of tax havens and other tax-reducing and secretive arrangements is likely to drain scarce development finance resources
- By diversifying its portfolio towards downstream and especially manufacturing industries, the IDC's funding would be both better able to support structural transformation and less exposed to leakages
- AU/ECA Panel (2015): "[T]he greater the transparency of the partner jurisdiction in a given bilateral transaction, the lower will be the risk of something being hidden."
- Its corollary – that the lesser the transparency, the greater will be the risk of something being hidden – would seem a good principle to guide investment of public resources in private enterprises.

Impacts on industrial development?

Undermining economic governance

- Dominant upstream industries in SA have been able to extract tax breaks, industrial finance, discounted electricity without conditionalities – historically, state is weak vis-à-vis dominant fractions of capital
- IFFs and tax havens create new incomes that would not exist and enlarges existing income streams that would be smaller without them.
- Beneficiaries will expend significant effort and resources to prevent relevant institutions from destroying the rents associated with IFFs.
- **Rent-seeking/protection** by beneficiaries are likely to be well-resourced, vigorous, and aimed at subverting the institutions and agencies mandated with reducing IFFs.

Discussion on policy recommendations

- **DTIC**
  - First step: establish relevance to industrial development
  - Competition policy - can draw from EU experience
  - Public Procurement regulations
  - Recent progress on beneficial ownership registers
- **Industrial and development finance institutions**
  - Review of PIC, IDC portfolios?
- **SARS**
  - Wier recommendations – enforcement, data, flagging systems
  - LBC and transfer pricing unit recovery
  - Treasury review of debt-financing
- **Licensing requirements**
  - Minerals, Energy, Communications
- **Role of law, accounting, banking firms – "the enablers"**
  - Open Secrets report
  - Role of FIC/FSCA in implementing policy on beneficial ownership? Progress in FIC Amendment Bill
- **Support for more general advocacy and public awareness**
  - Maintenance of lists of companies
  - Potential for diverse coalitions on "wage and dividend avoidance"?

Discussion on policy recommendations

Wier (2018): Transaction-level customs data – organised by firm-relation-origin-product-time – allows for systematic approach to transfer mispricing and deviation from arm's length principle

- First direct evidence of tax-motivated transfer mispricing in an EME
- Ineffectiveness of OECD reform in SA – need for greater enforcement and audit capability
- Support for argument that service transactions and intangibles like IP have become major drivers of profit shifting, rather than goods mispricing (Torslov et al, 2018)

Discussion on policy recommendations

Wier and Reynolds (2018): Testing for relation between firm size and profit shifting among MNEs using corporate tax returns

- 98% of tax loss caused by largest 10% of firms
- Limited to SA firms with foreign parents
- Progress possible with additional data on relations between SA subsidiary → foreign affiliate and SA parent → foreign subsidiary