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ILLICIT FINANCIAL FLOWS: CHALLENGES AND POSSIBLE COURSES OF ACTION FOR SWISS DEVELOPMENT POLICY

Since the 2008/9 financial crisis, the issue of "illicit financial flows" has been discussed intensively – not just by academia and civil society, but also in the government circles of OECD countries. Even greater weight is attached to the issue in Switzerland as one of the financial centres with the highest levels of bank deposits from customers domiciled abroad, and as an international commodity trading hub. What does "illicit financial flows" mean? What is the significance of this phenomenon to Swiss development policy? What is the Swiss government's current position? This DP Brief provides an overview of the debate and considers possible courses of action for Swiss development policy.

Clearly exasperated, Nigeria's finance minister, Ngozi Okonjo-Iweala, voiced her opinion unequivocally on 25 March 2013 in the British newspaper *The Guardian*: "I'm really frustrated at these illicit flows. What would it take for G8 and G20 countries to take some specific steps to put pressure on those countries acting as tax havens?"

Meanwhile in Accra, over a thousand kilometres away from the Nigerian capital, local traders are selling beer purchased from one of the world's largest beer producers which also has a subsidiary in Ghana. One such trader was Marta Luttgrodt who rose to international fame in 2010 as the manager of a beer stand with three employees turning a monthly profit of GBP 220. From that amount she paid a fixed fee to the city administration and a quarterly charge to the *Ghana Revenue Authority*. In contrast, her supplier, the multinational group *SABMiller*, generally posted losses between 2007 and 2010 and consequently only paid business tax on one occasion during this period. However, *SABMiller* at the same time transferred millions abroad – presumably legally to a large extent – to Mauritius, the Netherlands and Switzerland.

At least this was the account given by the British NGO ActionAid concerning the (non-)taxation of *SABMiller* in Ghana. The example illustrates a fundamental challenge facing developing and emerging countries – mobilising their own resources by means of appropriate and fair taxation, and deploying them to ensure the sustainable development of their nations.

The example highlights a further issue. Various countries with high and the highest percapita income are actively competing to attract investment and bank deposits, notably through tax competition. This is a situation that developing and emerging countries can generally do little to counteract – owing to a lack of their own capacities – and to prevent the outflow of capital.

Finally, *illicit financial flows* also present a challenge for development policy. As developing countries lack their own financial resources, foreign public development aid flows into the country while at the same time there is an outflow of profits (including to Switzerland) generated in the country itself. Ghana is a priority country for Swiss development cooperation.

ILLICIT FINANCIAL FLOWS: CONCEPT AND SCALE

Even according to conservative estimates, vast sums of money are transferred each year from developing and emerging countries to various low-tax locations in OECD countries illegally and in a way that is detrimental to development.

How *illicit financial flows* should be defined and measured has been and still is the subject of intense debate and controversy. Notwithstanding, after 10 years of discussions and research, *illicit financial flows* have now become a mainstream issue recognised as a problem by governments and international organisations.

The narrow definition of *illicit financial flows* only refers to illegal transactions that are prohibited under the legal systems of the country of origin and the destination country, or that are improperly accounted for in the case of internal transactions within a company. However, a broader definition of the term also covers practices which are not officially unlawful but are nevertheless detrimental to development. See graph on the concept below.

The OECD's definition of the term *illicit financial flows* includes (a) abusive transfer pricing between subsidiaries of the same group for the purposes of tax avoidance (b) tax evasion and (c) manipulative trade mispricing. Further classifications are (d) money laundering and (e) bribery. The term covers financial transactions by companies as well as by private individuals.[1]

The OECD estimates that tax evasion and strictly illegal forms of tax avoidance make up 60 to 65% of all illegal financial flows; 30 to 35% are accounted for by criminal activities and 3% by bribery, corruption and theft by public officials.

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1 For an analysis of the issue and contributions from various countries to resolving the problem, see *Measuring OECD Responses to Illicit Financial Flows from Developing Countries. OECD – Better Policies for Better Lives, Paris, December 2013*. www.oecd.org/dac/governance-development/IFFweb.pdf

With regard to the scale of the problem, the OECD relies on figures produced by *Global Financial Integrity (GFI)*, a leading international research institute in this field. For 2001–2010, GFI estimates the volume of *illicit financial flows* at USD 5.9 trillion; in the same period official development aid amounted to a total of USD 677 billion.[2] A commission appointed by the Norwegian government *(Commission on Capital Flight from Developing Countries)* and the UN Development Programme (UNDP) arrive at similar conclusions.

GFI believes that almost half of the estimated total amounts between 2001 and 2010 come from China – a figure that is five times higher than that of Mexico which is ranked second highest. Other heavily affected countries include Malaysia, Russia and Saudi Arabia followed by the Philippines, Nigeria, India, Indonesia and the United Arab Emirates.

In a further study also including inflows, GFI concludes that for the continent of Africa, net transfers abroad have taken place almost exclusively over the entire 30-year evaluation period.

In terms of the scale of the issue, a consensus exists today that *illicit financial flows* from developing and emerging countries far exceed public development aid funding. A negative balance is still shown even if direct international investment is taken into account.

If these estimated figures are compared with the amounts of illegally acquired assets of politically exposed persons which have been confiscated and returned by OECD countries, the total restitution figure stands at well below 5% of the estimated total amounts of *illicit financial flows*.

2 http://www.gfintegrity.org/content/blogsection/11/148

SIGNIFICANCE FOR DEVELOPING COUNTRIES – A CHALLENGE FOR EVERYONE

Illicit financial flows are nevertheless also a challenge for OECD countries as these states are also losing out on tax revenues on a large scale.

One main reason for the development of *illicit financial flows* and the related consequences is the advanced level of globalisation of the international economy and financial industry. Whereas the political, legal and judicial instruments of control are generally found at national state level, the players involved in the international financial industry – banks, financial service providers, companies and private individuals – operate internationally. Loop-holes in national legal systems, contradictions between them, and the insufficient capabilities of developing countries to enforce them or international agreements, enable economic players and individuals to transfer financial resources internationally in a targeted way on a large scale. Furthermore, there is often a lack of political will in fragile contexts: the government, administration and judicial system frequently benefit from inadequate structures and exacerbate the problem through direct complicity with corrupt groups.

A leading expert summed up the challenge as follows in a World Bank publication: "(It...) would take the form of greater international cooperation to identify and sanction transfer mispricing, further limiting the scope for the abuse of tax havens, easing and introducing more automaticity into the exchange of information among national tax authorities, requiring banks to be more vigilant against illicit funds and money laundering, expanding the scope of the Extractive Industries Transparency Initiative, more vigorously extending and implementing legislation that criminalizes acts of corruption overseas by citizens of and companies registered in the more economically influential countries, reforming international accounting standards, strengthening mechanisms and laws to facilitate the recovery of stolen assets located overseas, increasing watchfulness in relation to the financial affairs of politically exposed persons, reinforcing the regulation or self-regulation of corporate service providers, and requiring larger transnational corporations to give more information in their accounts about the location of their sales or profits."[3]

3 Mick Moore, in: Reuter, P. (2012) *Draining development?: Controlling flows of illicit funds from developing countries* (World Bank: Washington DC), page 475 https://openknowledge.worldbank.org/bitstream/handle/10986/2242/668150PUB0EPI0067848B09780821388693.pdf?sequence=1

ILLICIT FINANCIAL FLOWS: SOURCES, METHODS, COUNTERMEASURES

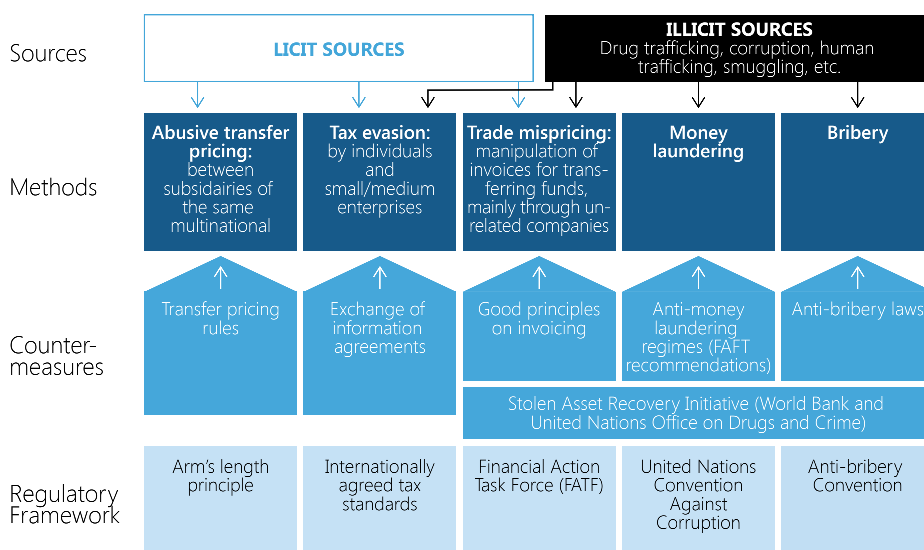

Figure 1: Measuring OECD Responses to Illicit Financial Flows from Developing Countries (Preliminary Edition). Paris, 2013

THE INTERNATIONAL COMMUNITY – POLITICAL AREAS OF ACTION

The debate about the extent, importance and consequences of *illicit financial flows* has also had a lasting impact on the international development agenda. Matters concerning taxation and tax transparency are today high on the agendas of major international organisations and forums such as the G8/G20, the OECD and the UN. Great importance is also being attached to the reduction of *illicit financial flows* in the post-2015 development agenda process and within the framework of the Global Partnership on Effective Development Cooperation.

Despite the complexity of the issue and the differences of opinion, a general consensus nonetheless exists. On the one hand, better use of the tax base of developing countries is required through increased efforts on the part of these states. On the other, various obstacles and mechanisms, which are related to the international framework and contribute to the vast outflow of funds from countries where financial resources are already scarce, have to be eliminated. From a development policy perspective, the emphasis is placed on challenges in the following main areas:

A. International tax affairs: exchange of information through legal and administrative assistance; mutual support with tax collection
B. Combatting tax avoidance: reporting, accounting practices and taxation of multinational companies
C. Countering abusive activities: measures to combat corruption, bribery and money laundering in international financial transactions and greater restitution of stolen assets
D. Strengthening the capacities of developing countries to mobilise their own resources and to increase good governance

SWITZERLAND'S DEVELOPMENT POLICY – STRATEGIC POSITIONS OF THE FEDERAL COUNCIL ...

As a leading financial centre, Switzerland has a responsibility and a particular interest to be part of the efforts of the international community and has embraced its lines of action.

In particular, the Federal Council has recognised the problem of *illicit financial flows* and has developed a broad perspective and understanding of the problem that is in line with the position of international organisations over key issues. The key points are that Switzerland has a strong interest in systematically preventing the inflow of funds from illicit sources; particular attention should be paid to the correct taxation of natural and legal persons, including companies operating internationally.

With regard to developing countries, the Federal Council's position is that *illicit financial flows* constitute a fundamental obstacle to economic growth and good governance in these countries. Switzerland has a particular development policy interest in preventing the outflow of funds abroad from developing countries by means of tax evasion, money laundering and corruption. The Federal Council aims to achieve this goal with a wide range of instruments including measures to counter (a) money laundering, (b) tax evasion and tax avoidance and (c) corruption. It also intends to take action to ensure (d) the restitution of stolen assets of politically exposed persons to the countries of origin and (e) to reinforce the capacities of developing countries to promote improved governance and the internal mobilisation of resources. With decisions of 4 September 2013 and 20 November 2013, the Federal Council declared its willingness to present to Parliament an overall appraisal of the issue, comprising an analysis of the importance of the financial flows to Switzerland, the country's role in the issue, the (reputational) risks involved and possible countermeasures.

... AND SPECIFIC COURSES OF ACTION

With this strategic vision, the Federal Council aims to go beyond combatting abusive practices in destination countries and is prepared to tackle the outflows at source – by taking into account economic and non-economic factors in the countries of origin, and the impact of the international framework and the destination countries. However, the principal efforts here would have to be made by the developing countries themselves.

To implement this vision, the competent federal agencies within the Federal Department of Foreign Affairs, the Federal Department of Economic Affairs and the Federal Department of Finance should work together to extend, examine and launch substantial measures, with a coherent action plan if need be. Academia and civil society are also called upon to make use of Switzerland's genuine practical and political experience in the field of international tax affairs and thus contribute to the international debate. Overall, such an effort would notably include the following issues and measures:

Basic measures from an integral perspective

- Indepth analysis of the importance of double taxation agreements (DTAs) for developing countries (for the mobilisation of domestic tax resources and the containment of *illicit financial flows* via exchange-of-information clauses)
- Analysis of the systemic limitations of the current international tax system and involvement in the development of alternative models, such as *unitary taxation* or alternatives to the arm's length principle
- Fundamental work on the effectiveness and mode of operation in developing countries of any increased transparency standards and due diligence requirements for the business activities of multinational companies *(impact assessments)*

Exchange of information and support with tax collection

- Creation of a channel for the exchange of tax information with Switzerland for developing countries which have not signed a double taxation agreement with Switzerland (pro-active provision and flexible usage of tax information agreements, where necessary in combination with DTAs)
- Systematic inclusion of the issue of developing countries in Switzerland's internal strategy work in the field of automatic exchange of information and effective implementation of the multilateral OECD Convention on Mutual Administrative Assistance in Tax Matters

Reporting, accounting practices and taxation of multinational companies

- Measures to ensure greater involvement of developing countries in the BEPS process of the OECD[4] and consideration of the perspectives of developing countries in Swiss positions
- Inclusion of the interests of developing countries as part of any future legislative activities on increasing transparency standards and due diligence requirements for the business activities of multinational companies

Corruption, bribery, money laundering; restitution of stolen assets

- Measures to (a) increase transparency with regard to the beneficial ownership of natural and legal persons and (b) strengthen due diligence requirements of financial institutions and financial service providers vis-à-vis customers in accordance with the recommendations of the OECD's *Financial Action Task Force* and the newly established international standards for the automatic exchange of information
- Support of ongoing international efforts on the development of rigorous and effectively verifiable standards on corporate social responsibility (CSR) in the field of international taxation and financial market policy (supplementing regulatory measures)

Strengthening of capacities in developing countries (domestic resource mobilisation, governance)

- Extension of Switzerland's commitment to re-inforcing the technical capacities of developing countries to mobilise their own tax resources, to enforce their own legal systems and to maintain international relations over tax affairs and legal cooperation (including case-specific support or systematic strengthening of inadequate capacities in relation to the restitution of stolen assets from Switzerland)
- Measures to strengthen good governance in developing countries by promoting greater transparency, more independent research and analysis capacities, and general strengthening of democratic control mechanisms

4 BEPS – Base Erosion and Profit Shifting

With these and further measures concretizing and implementing the Federal Council's strategic decisions, Switzerland would make an effective and credible contribution to the efforts of the international community to mitigate the issue. In line with its constitution and law, it furthermore would contribute to a world with less economic inequality, as *illicit financial flows* are directly related to the further prolongation and exacerbation of global inequality.[5]

5 World Bank studies come to the sobering conclusion that the national trend towards increasing economic inequality continued in the period 1988–2008. Despite significant economic growth over the past 20 years in emerging countries, the global differences in income have not decreased. See *Branko Milanovic* http://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-6259 and http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2013/12/11/000158349_20131211100152/Rendered/PDF/WPS6719.pdf and *Andrew Norton, Overseas Development Institute* (http://www.odi.org.uk/opinion/8099-inequality-rising-zeitgeist-fear-disorder-hope-change-de-blasio-tax)

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