TIPS
TRADE & INDUSTRIAL POLICY STRATEGIES

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Illicit financial flows and industrial development in South Africa: A discussion of policy options

OVERVIEW

This policy brief provides a broad introduction to illicit financial flows (IFFs), some key IFF mechanisms, and how these flows serve to undermine industrial development, particularly in developing countries. IFFs are usually connected to tax havens, and serve to maximise income for a handful of people while eroding the tax base, undermining government capacity and harming industrial development. There is strong evidence to suggest that IFFs are happening at significant scale in South Africa. This is likely to have a negative effect on the country's existing industrial base and industrialisation efforts via a number of channels that require policy attention. Government departments and agencies with the authority to act on these illicit channels, including via industrial, competition and procurement policy, need to develop the capacity to do so. The brief concludes with recommendations of industrial policy measures that can be implemented to limit the extent and impact of illicit financial flows on industrial development in South Africa.

Trade & Industrial Policy Strategies (TIPS) is a research organisation that facilitates policy development and dialogue across three focus areas: trade and industrial policy, inequality and economic inclusion, and sustainable growth

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DEFINING ILLICIT FINANCIAL FLOWS

The common definition of illicit financial flows, as noted by the Tax Justice Network (TJN, n.d.) and Global Financial Integrity (GFI, n.d.), is very broad: international movements of money during which funds are generated, transferred or used illegally.

However, a strictly legal definition excludes a range of activities that ought to be considered as IFFs. For this reason, a broader definition based on harm rather than illegality is preferred for this brief, defining IFFs as "cross-border flows that are illegitimate because they are based on an abuse of power and cause harm to a society" (Khan et al. 2019).

For policy purposes it is important to understand different types of IFFs and the mechanisms through which they take place.

IFFs can be organised into four categories (Cobham, 2014):

1. Market/regulatory abuse;
2. Tax abuse;
3. Abuse of power (typically relating to state funds); and
4. Proceeds of crime.

IFFs can also be organised according to whether the illicit element of a given cross-border financial flow has its roots in the **capital source** (e.g. criminal enterprises or theft of state funds) or in the **nature of the transaction** (e.g. tax evasion or avoidance). Table 1 provides some additional parameters by which IFFs can be organised: the **channels** through which they tend to take place, the specific types of **manipulations** through which an ordinary capital flow is rendered an IFF mechanism[1], and their **motivations**.

Table 1: Examples of illicit financial flows

IFF TYPE	CHANNEL	MANIPULATION	MOTIVATION
Market/ regulatory abuse	Export	Overpricing	Repatriate undeclared capital
Tax abuse	Intra-company loan	High interest rate	Shift profits offshore, reduce tax
Abuse of power	Inward investment	Secrecy of origin	Hide political influence
Proceeds of crime	Import	Overpricing	Shift criminal funds offshore

Source: Derived from Cobhan (2014) typology. [1]*An IFF mechanism can be understood as the combination of an ordinary capital flow and a specific manipulation applied to such a channel.*

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The common thread between the various flows described, with their various sources, motivations and mechanisms, is that they represent activities that are harmful to society, and thus require secrecy to protect those involved from the social (including legal) consequences that would likely follow their publicisation (Cobham and Jansky, 2020).

Terms such as “tax haven” and “offshore wealth” tend to evoke images of specific, physical locations: the Caribbean island and the Swiss bank have a particularly rich legacy in films and other popular media. James Henry (2012, p.9) encourages people to shed these preconceptions, pointing out that in the modern global financial system, these terms refer fundamentally to a set of capabilities, spread across multiple jurisdictions, and embodied in “networks of legal and quasi-legal entities and arrangements that manage and control private wealth”.

From Henry’s (2012) perspective, tax havens’ core capabilities are to provide:

1. Secrecy;
2. Financial security;
3. Tax minimisation; and
4. Remote access to and management of offshore wealth.

These capabilities cater to the needs of a wide range of entities and individuals, from multinational corporations (MNCs) and wealthy individuals, to corrupt politicians and criminal networks.

ILLICIT FINANCIAL FLOWS, TAX HAVENS AND SOUTH AFRICA

The three case studies in this policy brief serve to illustrate how a number of the IFF mechanisms operate in practice, and how complex the mechanisms, networks and dynamics underlying IFFs can be. More systematic studies of the scale of IFFs in South Africa, their underlying methodologies, and a range of approaches for determining which tax havens are especially relevant for South Africa are discussed in the full Working Paper.

Table 2 summarises some of the key studies of the scale of IFFs in South Africa.

These provides a broad sense of the range of results that different methods generate when applied to South Africa. Given the complex and overlapping nature of IFFs and the challenges involved in estimating them, it is unsurprising that these results vary so widely and present a somewhat confusing picture of the scale of IFFs. Some of the other

Table 2: Examples of illicit financial flows

	AUTHORS	METHOD	RESULT	POLICY RELEVANCE
TRADE MISINVOICING	AU/ECA Report (2015)	Trade-based estimate of misinvoicing using country- and product-level mirror statistics based on UN Comtrade data.	US$81.8 billion in trade-based IFFs from South Africa between 1970-2008, 11% of Africa total; annual outflow from continent estimated at US$60 billion per annum in 2010, led by oil and minerals industries.	Country- and product-level estimates: useful for scale estimates but excludes important IFF channels and prone to imprecision (but more robust than standard mispricing models).
TAX ABUSE (PROFIT SHIFTING)	Wier and Reynolds (2018)	Estimate of average total profit shifting through comparison of profit-to-wage ratios between foreign firms vs. foreign firms with a parent firm in a tax haven.	R11.4 billion of profits shifted to 19 tax havens in 2014; implied revenue loss of R3.2 billion; largest 10% of foreign-owned firms account for 98% of tax loss; driven by extractive and financial sectors.	Firm-level study: yields specific findings about exactly which firms appear to be driving profit shifting in South Africa; although not the aim of the study, the approach could be highly relevant for policy and enforcement purposes.
CAPITAL FLIGHT (TRADE AND CAPITAL FLOW CHANNELS)	Ndikumana and Boyce (2019); Ndikumana, Naidoo and Aboobaker (2020)	Trade- and capital-based estimate of total capital flight from South Africa indicated by anomalies in trade ad capital flow mirror statistics.	U$327 billion of capital flight from South Africa from 1970-2017, including US$146 billion misinvoicing from 1998-2017; misinvoicing in gold, silver, platinum, iron is significant.	Country- and commodity-level estimates: useful for scale estimates and highlighting problem sectors, but method is prone to imprecision.

IFF and tax haven activities appear to be happening at a large scale in South Africa. This is likely to be having a negative effect on the country's industrialisation efforts via a number of channels.

challenges overlap between different IFF types, availability and reliability of statistical data, and the difficulty inherent in reliably quantifying financial flows that are hidden by design and via a range of sophisticated mechanisms.

A number of the studies in Table 2, along with other non-scale approaches to IFF measurement, also provide some indication of which tax havens and non-havens appear to be closely involved in networks that facilitate IFFs in the South African context. The results of one approach, the Tax Justice Network's Bilateral Financial Secrecy Index (TJN, 2018), are shown in Table 3.

Case studies and more systematic studies of IFF scale illustrate how much MNCs can benefit (and how much tax authorities can lose) as a result of serious deficiencies in the prevailing international corporate taxation system, characterised by technical and legal grey areas that MNCs use to escape their social responsibilities. The summary of scale estimates of South African IFFs shows how much these can vary according to the method employed and the type of IFF targeted.

Efforts to reduce IFFs face critical challenges, including shifts toward more sophisticated IFFs not identifiable via simple anomalies in trade data. IFFs in service sectors (for which there is a distinct lack of systematic data), manipulation of intangible assets such as intellectual property and "know-how", the challenges for existing tax policy posed by digitalisation, and the relative decline in the importance of goods mispricing and misinvoicing, all make the policymaker's task an unenviably difficult one (Torslov, Wier and Zucman, 2020; Cobham and Jansky, 2020).

Table 3: Bilateral Financial Secrecy Index

RANK IN 2018 BILATERAL FINANCIAL SECRECY INDEX FOR SOUTH AFRICA	JURISDICTION
1	Bermuda
2	United States
3	Guernsey
4	Luxembourg
5	Germany
6	Switzerland
7	Mauritius
8	Ireland
9	Kenya
10	Malta

For Khan et al, the complexity inherent in the processes driving IFFs and in their measurement strongly suggests that a "battery of different indicators for different levels of aggregation" will need to be developed, and that these must be complemented by qualitative analysis, including of rents, sectoral value chains and country-specific political economy dynamics (2019, p.32).

ILLICIT FINANCIAL FLOWS, TAX HAVENS AND INDUSTRIAL DEVELOPMENT

Gauging the impact of IFFs and tax havens on industrial development is not an exercise for which clear data or methodologies appear readily available. The overlapping and hidden nature of IFFs makes accurate estimation of scale extremely difficult. This also applies to attempts to isolate and quantify their effects on specific sectors. IFFs through mispricing may have different sources, drivers and effects from IFFs through outright smuggling, or through capital flight. Similarly, illicit inflows of various kinds are likely to have effects dissimilar to those caused by illicit outflows. The literature on IFFs and tax havens has tended to focus on tax revenue losses, which drain resources available for governments to spend on stimulating industrial development among other things, and the literature on capital flight includes some important contributions on its developmental and macroeconomic impacts. However, the impact of IFFs and tax havens on industrial development is under-explored and requires additional research.

The core argument is, however, straightforward, and proceeds as follows: IFF and tax haven activities appear to be happening at a large scale in South Africa; this is likely to be having a negative effect on the country's industrialisation efforts via a number of channels; and, therefore, government departments and agencies with the authority to act on these channels, including via industrial, competition and procurement policy among others, ought to develop the capacity to do so. The five channels through which this negative effect is likely to take place are:

1. Impact on investment and demand at a macro-economic level: The literature on capital flight (a key component of IFFs) suggests a link between IFFs and reduced levels of savings, wages and dividends (and therefore of levels of investment and demand in the economy). The South African paradox of high profitability and low investment has been a driver of poor outcomes for the industrial base, and IFFs are likely to contribute to deepening this challenge.

CASE STUDY ONE

Profit shifting via tax havens in the telecoms sector: MTN

Reporting by investigative journalists on billions of rands worth of intra-group transfers from MTN's African subsidiaries to other MTN entities based in Mauritius and Dubai provide a useful insight into the ways in which MNCs may be using fees associated with intangible assets and various intra-group services to lower their tax obligations.

According to McKune (2015) these payments are for management services ("know-how, technical expertise and back-office support") and for licensing of intellectual property associated with the MTN brand. Fifty-five percent of the fees flowed to MTN in Mauritius, and 45% to Dubai (where subsidiaries benefit from a 0% tax rate). However, the Mauritian entity that receives the bulk of the fees "employs no staff and cannot, therefore, physically provide a service" (McKune and Turner, 2015).

The company acknowledges that it employs no staff in Mauritius, and that the bulk of the MTN group's management and technical capabilities are located in South Africa. However, it will not confirm how much of the management fees received in Mauritius are paid on to South African subsidiaries and "were unable to explain why the payments were made to Mauritius first" (Turner, 2015). Turner, in amaBhungane, reports that, in 2010, MTN's Mauritian entities received hundreds of millions of rands in management fees from various subsidiaries, but it could only confirm that R58 million ended up in South Africa, where the management and technical capacity is based.

While secrecy around company finances means that hard evidence of illegal behaviour is unlikely to come to light, it is plausible that MTN is effectively shifting profits out of its African subsidiaries and into Mauritius (acting as an "intermediary" tax haven), with a portion of these flowing on to other low-tax jurisdictions around the world (acting as "destination" havens).

Sources: Mbanga (2015); McKune and Turner (2015); Turner (2015)

2. Undermining of linkages in the local production system: The strengthening of production, consumption, fiscal and technological linkages in the economy is a key driver of industrial development and diversification. Available evidence suggests that historically dominant and strategically important heavy industries have been key sites for IFFs and tax haven exposure, entrenching the weakness of the linkages between these industries and the rest of the economy, and providing the largest and most dominant firms with an outlet for resources that might otherwise have been ploughed back into forward and backward linkages with domestic firms.
3. Anti-competitive distortions placing small, compliant, downstream and domestic firms at a systematic disadvantage vis-à-vis large, upstream firms: Illicit financial flows – both inbound and outbound – are increasingly considered to provide an unfair competitive advantage to the firms involved in such flows, especially as the available evidence suggests that these activities are mainly undertaken by the largest firms. Firms fully compliant with the law and firms not exploiting legal grey areas to reduce their tax liabilities can be placed at a systematic competitive disadvantage in relation to their rivals. A growing body of evidence also suggests that smaller firms and domestic firms are far more likely to be negatively affected by these arrangements than to benefit from them. The largest corporations and multinational groups appear to benefit most, including in the South African context.
4. Leakages from critical developmental sources of finance: Available evidence suggests that IFFs and tax haven arrangements globally and in the South Africa context have been driven to a significant extent both by firms in mining and other resource-extractive and commodities industries, and by larger firms. The lending and investment profiles of some key development finance institutions (DFIs) expose them to IFF- and tax haven-related leakages to an unnecessary degree, and this exposure ought to be investigated and mitigated against.
5. Undermining of the state's capacity to regulate and discipline capital in accordance with national developmental strategies: IFFs and access to tax haven capabilities are likely to undermine the state's capacity to play the co-ordinating and managing role in relation to capital that has been so critical in successful cases of late industrialisation. Due to the size of the rents involved, beneficiaries of IFFs and tax haven flows are likely to expend significant effort and resources to prevent relevant South African institutions from changing in ways that may reduce these rents. In short, rent-seeking by beneficiaries of IFF and tax haven activities – i.e. their strategies for maintaining access to IFF-related rents – are highly likely to be well-resourced, vigorous, and aimed at subverting key institutions and agencies responsible for driving structural transformation and economic governance more generally.

CASE STUDY TWO

'Sales commissions' and profit shifting in the platinum industry: Lonmin Plc

Dick Forslund's (2014) study of alleged profit shifting by UK-based Lonmin Plc in the years leading up to the tragic events at its Marikana mine near Rustenburg highlights IFF mechanisms, including questionable management fees, the apparent manipulation of inter-company loans, and "sales commissions" paid to a subsidiary in Bermuda. This last mechanism is explained briefly below.

Forslund's analysis of one of Lonmin's South African subsidiaries, Western Platinum Limited (WPL), indicates that all of WPL's sales of platinum group metals (PGM) were conducted by another Lonmin subsidiary, Western Metal Sales Limited (WMSL).

WMSL was registered in Bermuda, a British dependency which "has no income taxation on individuals or firms, no tax on capital gains, no branch profit tax and no transfer pricing legislation" (2014, p.23). For the service of marketing the minerals extracted by WPL in South Africa, WMSL received "sales commissions" of R248 million rand in 2006 and R276 million in 2007. Forslund estimates that sales commissions paid to WMSL in Bermuda amounted to US$162 million (R1,2 billion by his measure) between 2008 and 2012.

Forslund's evidence also suggests that the Bermuda operation that brought in hundreds of millions of rands per annum had no staff. In response to a press enquiry, the company also conceded that "the fact is that all of Lonmin's metal is sold directly by Lonmin's operating subsidiary (WPL) direct to third parties" (2014, p.30).

Forslund also shows that Impala Platinum, a rival PGM producer, marketed its own platinum from South Africa using a team of four to five in-house staff. This is a stark contrast to the hundreds of millions per annum paid by Lonmin subsidiaries in South Africa to have their product marketed through Bermuda.

Source: Forslund (2014)

South Africa has made significant progress in developing the legal framework and institutional capacity required to curb illicit financial flows and exposure to tax havens in the past 10 years or so. While this period has also seen a number of serious setbacks, the erosion of highly valuable capabilities within the South African Revenue Service prominent among these, there is a great deal to be positive about, particularly with cross-departmental co-ordination in law enforcement initiatives.

However, a number of issues remain. Perhaps unsurprisingly, given the scale of the challenges involved, capacity building within and co-ordination between government agencies needs to continue to develop. A lack of public engagement and disclosure is also a significant shortcoming.

A number of important gaps and loopholes remain in the existing framework for dealing with IFFs and tax havens, which tends to define IFFs on illegality alone, rather than the broader definition more appropriate for dealing with their impact on economic development. A reliance on voluntary disclosure programmes rather than more extensive investigation, enforcement and accountability measures is a strong reflection of current weaknesses. The most critical shortcoming, however, is the absence of an industrial development perspective on the challenges posed by IFFs and tax havens, and of an industrial policy response to them.

RECOMMENDATIONS FOR INDUSTRIAL POLICY MEASURES

Based on the research undertaken, a number of industrial policy measures can be implemented to limit the extent to which illicit financial flows are able to negatively impact on industrial development in South Africa. These include:

Extensive and transparent company reporting: Companies registered with the Companies and Intellectual Property Commission should be required to disclose their corporate structure (including all foreign affiliates – parent firms, subsidiaries and other related entities), and submit reports showing, for example, revenues, wages and taxes paid in all jurisdictions. Additional requirements could include full disclosure on the identities and locations of the beneficial owners of companies and other entities registered in South Africa.

No state incentives or financing for IFF- and tax haven-linked firms: Firms previously linked to IFFs or with significant connections to tax havens ought not to be able to access incentives or industrial finance from the South African government in any form, including incentive support from the Department of Trade, Industry and Competition.

Empower the competition authorities to investigate and intervene: When market inquiries are undertaken into industries that have been identified as having high potential for IFFs, these ought to include

CASE STUDY THREE

Aggressive tax planning in the sugar industry: ABF and Illovo Sugar

ActionAid's 2013 report by Mike Lewis on the British food conglomerate, Associated British Foods (ABF), provides further examples of how multinational groups can be structured in ways that help them avoid their responsibilities to the societies in which their profits are generated. In 2006, ABF acquired a majority stake in Illovo Sugar, a multinational group based in South Africa and with operations in Zambia, Mozambique, Malawi and Tanzania, among others.

Lewis's research focuses on how a range of profit shifting and tax minimising activities enabled by Illovo's structure have affected the tax paid in Zambia by one its subsidiaries, Zambia Sugar Plc. The report describes the arrangements which have resulted in this subsidiary's tax liabilities being minimised through a range of transfers made to other Illovo subsidiaries based in tax havens such as Mauritius, Jersey, the Netherlands and Ireland. In 2007, Zambia Sugar borrowed ZK280.5 billion (equivalent to around US$70 million at the time) at an interest rate of 17% from the London branches of two overseas banks, South Africa's Standard Bank and Citibank in the US. According to Lewis, this loan had generated almost US$30 million in interest payments between 2007-2013. Crucially however, the loan was sent on a "dog-leg" via Ireland; the two banks made the loan to Illovo Sugar Ireland, which then made an identical loan to Zambia Sugar. The routing of this loan via Ireland meant that the interest payments were considered exempt from a withholding tax of around 10% that would have applied had the loan been made directly from the UK to Zambia Sugar. This type of arrangement is known as "treaty shopping", allowing a single bilateral treaty (in this case between Zambia and Ireland) to be abused for tax avoidance purposes by MNCs.

Lewis also details arrangements that reduce the tax paid on dividends from Zambia Sugar to Illovo Sugar in South Africa, the parent company housing ABF's African sugar producers. The starting point is that the relationship between Illovo SA and Zambia Sugar is not a simple parent-subsidiary one. Illovo SA owns Zambia Sugar via "a complicated nest of intermediate companies", spread across Mauritius, Ireland, Jersey and the Netherlands. Prior to 2007, Zambia Sugar's majority shareholder was Illovo Ireland. However, Ireland levies a 20% withholding tax on dividends paid to foreign companies, creating an undesirable barrier to sending profits on to Illovo Sugar in South Africa.

A solution was found when, in 2007, Illovo Ireland sold its stake in Zambia Sugar to Illovo Sugar Cooperatief in the Netherlands (Illovo Netherlands henceforth). Illovo Ireland made an interest-free loan of €203 million to Illovo Netherlands to fund the purchase, which was tax-free due to a 0% capital gains tax on Irish firms' share sales. Illovo Netherlands was registered there as a form of cooperative, allowing the dividends flowing there from Zambia to be reclassified in a way that allowed them to flow on, free of withholding tax, to other subsidiaries in Mauritius and Jersey, and then to Illovo in South Africa. The net effect of this confusing web of ownership was to reduce the tax liability on the flow of dividends from Zambia to South Africa from 20% to 5%.

Source: Lewis (2013)

assessments of the nature and scale of the competitive distortions generated by transfer pricing, misinvoicing, and other forms of profit shifting. This is an as yet untested, but potentially powerful set of tools that may be brought to bear to promote competition and industrial development in markets affected by IFF and tax haven exposure.

Exclude IFF- and tax haven-linked from public procurement: Provisions allowing procuring authorities to exclude tender applications from firms with high exposure risk to IFFs and tax havens could act as a powerful disincentive against IFFs and tax act as a powerful disincentive against IFFs and tax haven links, and could channel demand toward compliant firms.

Protect trade support measures from IFF-related leakages: Policy instruments and resources designed to support exporting firms, including tax breaks, direct financing and loan guarantees, ought to be protected against leakages via IFFs and tax havens, and channelled toward firms with lower, or zero, risk exposure. The International Trade Administration Commission should investigate exclusive marketing deals and other trade arrangements that have been abused for the purposes of shifting profits offshore. Firms engaged in such behaviour should be excluded from trade support measures.

Insulate public investment and lending from IFF and tax haven exposure: Institutions involved in public investment and lending ought to undertake audits of their investments and loans with the aim of gauging exposure to IFFs and tax havens. Adjustments to the investment policies of industrial financing agencies, development banks and other institutions should include stricter eligibility criteria for beneficiaries, disclosure of foreign affiliates and beneficial owners, conditionalities and protections for exclusive marketing and other risky arrangements, and proof of alignment between the jurisdictions where profits are declared versus where they are generated.

The need to co-ordinate new initiatives across many different government actors adds a layer of complexity to an already difficult task. The risk of having multiple players and departments involved in combating IFFs is the increase in the number of points of influence, which may have the effect of helping firms and industries with powerful lobbying capacities to frustrate or subvert government policy. The size of the rents associated with profit shifting and access to tax haven capabilities is likely to incentivise extremely vigorous lobbying and rent-seeking activities aimed against government intervention. For these reasons, the scale of the challenges facing efforts to reduce the impact of IFFs and tax havens on industrial development ought not to be underestimated. A co-ordinated, "whole of government" approach to these issues is needed. Key to the development of such an approach to IFFs and tax havens will be to remedy the distinct lack of input from an industrial policy and structural transformation-driven perspective.

CONCLUSION

The negative impact of IFFs and tax havens on economic development is well-established, and a number of internationally co-ordinated initiatives aimed at curbing this impact have emerged in the past decade. This research has begun to explore the channels through which these activities may negatively affect industrial development specifically, and to explore the role that industrial policy can and should be playing in mitigating these negative impacts.

In developing countries such as South Africa, where industrialisation efforts already face a range of formidable difficulties, the challenges posed IFFs and tax havens ought to be approached from an industrial development perspective. This has the potential to generate a mutually reinforcing dynamic between industrial policy and existing domestic efforts to reduce IFF and tax haven exposure.

It is clear that IFFs and tax haven exposure negatively impact the majority of individuals, firms and institutions in any given society, while benefiting only the wealthiest and most powerful. This suggests that there is potential for a broad coalition of interests to be mobilised in support of greater regulation of and more transformative intervention against these harmful activities.

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