



TRADE & INDUSTRIAL POLICY STRATEGIES

ILLICIT FINANCIAL FLOWS, TAX HAVENS AND INDUSTRIAL DEVELOPMENT IN SOUTH AFRICA

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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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ABBREVIATIONS

AMCU	Association of Mining and Construction Union
ABF	Associated British Foods
BEPS	Base Erosion and Profit Shifting (OECD)
BFSI	Bilateral Financial Secrecy Index
BoP	Balance of Payments
BVI	British Virgin Islands
CIPC	Companies and Intellectual Property Commission
CTHI	Corporate Tax Haven Index
DBSA	Development Bank of South Africa
DMRE	Department of Mineral Resources and Energy
DOTS	Direction of Trade Statistics (IMF)
DTIC	Department of Trade, Industry and Competition
EU	European Union
FDI	Foreign Direct Investment
FIC	Financial Intelligence Centre
FICA	Financial Intelligence Centre Act
FSI	Financial Security Index
GDP	Gross Domestic Product
GEPF	Government Employees Pension Fund
GFI	Global Financial Integrity
HMN	Hot Money Narrow Method
IAWG	Inter-Agency Working Group on Illicit Financial Flows
ICTA	International Corporate Tax Avoidance
IDC	Industrial Development Corporation
ICASA	Independent Communications Authority of South Africa
IFFs	Illicit Financial Flows
IMR	International Mineral Resources
LBC	Large Business Centre (SARS)
LPS	Local Production System
MNCs	Multinational Corporations
NPA	National Prosecuting Authority
OECD	Organisation for Economic Co-operation and Development
PGM	Platinum Group Metals
PIC	Public Investment Corporation
RoW	Rest of the World
SARB	South African Reserve Bank
SARS	South African Revenue Service
SEZs	Special Economic Zones
SDGs	Sustainable Development Goals
TJN	Tax Justice Network
UK	United Kingdom
US	United States
WBR	World Bank Residual Method
WMSL	Western Metal Sales Limited
WPL	Western Platinum Limited

1. INTRODUCTION

Illicit financial flows (IFFs) of various kinds, and the role of tax havens in facilitating these flows, have come under increased scrutiny since the global financial crisis of 2007-2009. In advanced economies, taxpayer-funded bailouts for the financial system combined with the harmful effects of fiscal austerity on ordinary people in the years after the crisis have generated sharp critique of the behaviour and social role of large corporate entities and wealthy individuals. A series of high-profile scandals and leaks of sensitive information about how corporates and individuals organise their financial affairs to escape their social obligations have contributed to this interest. Prominent among these are the [Luxembourg Leaks](#) (ICIJ, 2014), the [Paradise Papers](#) (ICIF, 2017) and, closer to home and most recently, the [Luanda Leaks](#) (ICIF, 2020).

Quantifying the scale of IFFs and undeclared “offshore” wealth is notoriously difficult, but the sizeable literature on this topic, explored in more depth in Section 2, provides a sense of how much is at stake.

The Tax Justice Network (TJN) has estimated a global tax loss of around US\$500 billion a year due to profit shifting by multinational companies (Cobham, 2017). Cobham and Jansky (2017a) have argued that misalignment between where United States (US) multinational corporations (MNCs) declare their profits and where these profits are generated has risen rapidly over the past 25 years or so to reach almost 30% of gross profit. According to this research, the majority of this shifted profit is declared in a handful of countries, with the Netherlands, Ireland, Bermuda and Luxembourg the most important among these. More recently, Torslov et al (2020) estimated that 40% of global multinational profits were shifted to tax havens in the year 2015.

Estimates of the total stock of offshore wealth range up to US\$32 trillion (James, 2012), implying an additional loss of revenue approaching US\$200 billion, as returns to this stock of wealth escape income tax. Zucman (2013, p.1325) notes that around 40% of global foreign direct investment is channelled through tax havens, significantly distorting international statistics and generating some absurd results in the International Monetary Fund’s Coordinated Direct Investment Survey data (IMF, 2020):

“In 2011 for instance, 30% of India’s inward direct investments came from Mauritius; 25% of Brazil’s came from The Netherlands; 60% of China’s came from Hong Kong and the British Virgin Islands.”

Research by TJN and others suggests that developing countries have been disproportionately affected by tax havens, with estimated offshore wealth and associated revenue losses out of proportion relative to gross domestic product (GDP) (Crivelli et al, 2016).

Ajayi and Ndikumana’s (2015) study of 39 African countries estimates that around US\$1.3 trillion of capital made its way unrecorded beyond their borders between 1970 and 2010. One of their key findings is that this stock of hidden wealth significantly exceeds the stock of external debt owed by these 39 countries collectively. Prior work by Boyce and Ndikumana (2012) found that resources lost to 33 Sub-Saharan African countries via capital flight alone (one of a few key channels comprising IFFs as a whole) exceeds the foreign direct investment (FDI) they received by more than US\$150 billion over the same 1970-2010 period.

These findings suggest that the study of IFFs and tax havens, and the development of policies aimed at curbing illicit outflows and repatriating domestically-generated resources, are potentially extremely beneficial for developing countries with relatively narrow tax bases and constrained finances. The argument made by scholars such as Boyce and Ndikumana should also prompt a reassessment of the nature of the relationship between the global financial system and developing countries in general,

and African countries in particular, and the interrogation of whether the benefits of global financial integration have materialised in the ways predicted by mainstream economic theory.

Juxtaposed with the scale of the problem, this report has modest aims. Drawing on the academic literature and investigative journalism, it explores the relevance of these issues for South Africa, presenting case studies that illustrate some of the key mechanisms through which IFFs have taken place and the role that tax havens have played in these. Its sole novel contribution is to explore the channels through which IFFs and tax havens may negatively impact South Africa's industrial base specifically, and to propose a set of policy options and research initiatives aimed at limiting such negative effects.

South Africa entered the COVID-19 pandemic and the resulting global economic crisis in an exceedingly fragile state. As societies worldwide confront the consequences of the retreat of the state from key areas of economic policy and social provision, and take steps to redress this, so too should South African policymakers aim to develop bold and creative measures to address the country's needs. This report aims to draw attention to a need requiring such measures.

One of several arguments advanced is that a strong recovery from the present crisis (and the achievement of a "new economy") will be predicated on solving a range of serious underlying conditions (co-morbidities, to stretch the medical analogy), including the country's chronically weak rate of investment and its slippage into a trend of "premature deindustrialisation" (Andreoni and Tregenna, 2018).

Stemming the loss of resources to IFFs and recovering offshore wealth can play an important role in mitigating these structural weaknesses, and important steps have been taken in recent years to co-ordinate action taken by a range of government agencies and departments. However, government's current approach has a number of shortcomings, and further measures are required. This report proposes that approaching the problem of IFFs and offshore wealth from an industrial development lens, and with a view to applying industrial policy measures, can strengthen government's response in ways that not only help to reduce IFFs and tax haven exposure, but also incentivise productive investment, protect existing capabilities and promote industrial development in general.

Section 2 addresses definitions and basic mechanisms, and provides an overview of methodologies used to estimate IFFs. Section 3 focuses on the South African context, presenting a set of case studies that illustrate how the mechanisms discussed in Section 2 operate in practice, and providing an indication of the scale of IFFs and which tax havens play a significant role in facilitating these. Section 4 explores the channels through which IFFs and tax havens affect industrial development, and makes the case for an active role for industrial policy in protecting South Africa's industrial base from IFF and tax haven exposure. Section 5 provides an overview of existing measures to curb IFFs and tax haven activities, noting significant progress and a number of shortcomings. Section 6 sets out a number of industrial policy interventions that the Department of Trade, Industry and Competition (DTIC) and other government agencies may develop to reduce the impact of IFFs and tax havens on industry in South Africa, accompanied by research proposals aimed at enhancing such efforts.

2. THE ABCS OF IFFS AND TAX HAVENS

In 2015, the UN's Sustainable Development Goals (SDGs) included reducing illicit financial flows as part of its [seventeen goals](#) to be achieved by 2030. In 2013, the Organisation for Economic Co-operation and Development (OECD) [declared](#) Luxembourg “non-compliant with international standards on tax transparency, and placed it on a blacklist of non-co-operative jurisdictions” (Brunsden, 2017). In the midst of the COVID-19 crisis in 2020, a number of governments around the world have [refused](#) to provide state aid to companies registered in tax havens (Shah, 2020).

These developments indicate that issues related to IFFs and tax havens are now firmly on the global policy agenda. However, as Cobham and Jansky (2020) point out in their extremely helpful review of the leading methodologies for addressing IFFs, issues of definition and measurement remain both complex and critical to the success of multilateral initiatives. Simply put, without reasonably effective measures and indicators, neither the true extent of IFFs nor the degree of success in reducing them can be determined. The enormous variety of mechanisms through which IFFs take place makes this type of work extremely difficult.

There is similarly no universally agreed-on definition for tax havens, and thus no corresponding list of countries that can be referred to. Lists of tax havens published by organisations such as the European Union or the OECD have tended to become highly politicised and thus unreliable, while the academic literature has used a range of definitions.

The ambition is not to make a novel contribution to the academic literature, but to provide the reader with a general orientation on these phenomena and to foreground the analysis in subsequent sections. This section therefore proceeds from an overview of the most important mechanisms through which IFF and tax haven activities take place to the definitions and methodological approaches that have emerged to describe and quantify these phenomena. A key point to note at the outset is that measures of IFFs describe **flows** of resources, when estimates of offshore wealth in tax havens describe **stocks** of assets, which themselves generate further flows of income.

2.1 What are illicit financial flows?

A common definition of illicit financial flows, as noted by [Tax Justice Network](#) and [Global Financial Integrity](#) (GFI), two of the leading research organisations on the topics addressed in this paper, is extremely broad: international movements of money where funds are generated, transferred or used illegally.

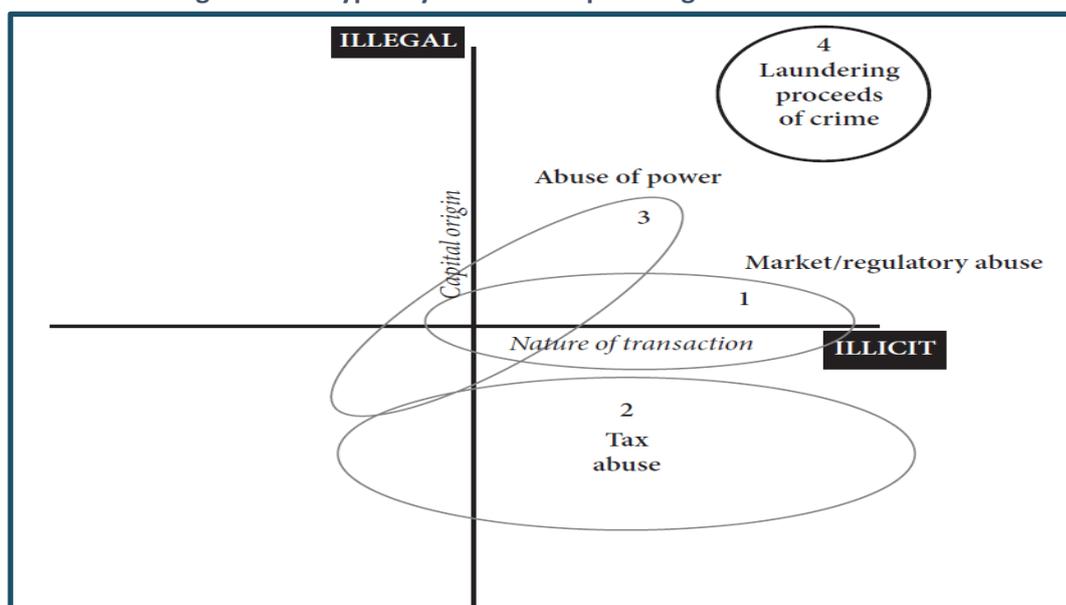
However, a strictly legal definition excludes a range of activities that ought properly to be considered as IFFs. Therefore, the broad definition of IFFs drawn on in this report turns on harm, rather than illegality: “We define IFFs as cross-border flows that are illegitimate because they are based on an abuse of power and cause harm to a society” (Khan et al, 2019). The 2015 Report of the AU/ECA High Level Panel on Illicit Financial Flows from Africa (“The AU/ECA Report”) suggests that aggressive tax avoidance is emblematic of the type of IFF that is not necessarily illegal, but is nevertheless harmful (p.27). The important OECD Base Erosion and Profit Shifting (BEPS) initiative proceeded from a similar standpoint – that misalignment, illegal or not, between where profits are declared and where underlying real economic activity (production, employment and sales) takes place is a fundamentally harmful phenomenon. This report returns later to the implications of this approach, particularly in regard to developing a policy-relevant approach to IFFs.

Cobham (2014) provides a helpful introductory typology in which IFFs are comprised of four components: **1. Market/regulatory abuse; 2. Tax abuse; 3. Abuse of power** (typically relating to state

funds); and **4. Proceeds of crime**. The AU/ECA Report adopts a similar framework, dividing IFFs among commercial, criminal, and corrupt components, but also subdividing the commercial component between tax abuse and market/regulatory abuse.

These are reflected in Figure 1, which place them on a set of axes indicating the legal or illegal nature of the **capital source** (Y-axis) and the licit or illicit nature of the **transaction** involved in the cross-border flow.

Figure 1: IFF types by nature of capital origin and transaction



Source: Cobham and Jansky (2020)

Cobham and Jansky (2020, Tables 1.1 and 1.2) further organise these various types of IFFs by their **motivation** (tax evasion/avoidance, laundering criminal proceeds, hiding market dominance), the **type of harm** they cause (draining fiscus, corrupting state institutions, distorting markets), the **channels** through which they tend to take place (direct investment, portfolio, import/export, intra-company transfer), and by the specific types of **manipulations** (distorted prices, transfers, interest rates, fees, royalties) through which an ordinary capital flow is rendered an IFF **mechanism**.¹

Importantly, while IFFs are often conceived of purely as harmful outflows of resources, organising them as Cobham and Jansky have done enables identification of a range of illicit inflows that are also highly undesirable. Indeed, some have suggested that the detrimental effect of inflows on governance may well be more developmentally harmful than net resource outflows (p.66).

Table 1: Examples of illicit financial flows

IFF TYPE	CHANNEL	MANIPULATION	MOTIVATION
Market/regulatory	Export	Over-pricing	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	Over-pricing	Shift criminal funds offshore

Source: Derived from Cobham (2014) typology

¹ For this report, an IFF mechanism can be understood as the combination between an ordinary capital flow channel and a specific manipulation applied to such a channel.

Cobham suggests that, of these categories, tax abuse is the largest. Importantly, this category itself exists on a spectrum between, at the one end, forms of clearly illegal tax evasion and, at the other, forms of tax avoidance which may yet be found to be unlawful on challenge by tax authorities (Picciotto, 2018). This highlights at the outset the need for a range of different estimation methods and finely-tuned policy responses. A number of the case studies in Section 3 illustrate how these mechanisms work in practice.

Two further points made by Cobham and Jansky (2020) are worth reflecting on. First, no typology is likely to be exhaustive, as any type of transaction has the potential to be rendered illicit, depending on the source, transfer or application of the capital involved. Second, in practice, there is a great deal of overlap between mechanisms used for IFFs, different sources of capital, and different motivations for cross-border transfer. In their words:

“The opportunity to hide, where it exists, is likely to be exploited for multiple purposes. For example then, the legal use by a multinational of highly secretive jurisdictions may both provide cover for illegal use of the same secrecy, and also inadvertently legitimize such behaviour.” (2020 p.13).

This creates a number of challenges for attempts to measure IFFs.

It is also worthwhile to briefly discuss the difference between what is described by illicit financial flows, and what is described by **capital flight**, as the two are often used interchangeably. Capital flight is defined by Ndikumana and Boyce (2019), two of the leading scholars of capital flight from Africa, as “unrecorded capital outflows”; that is, outflows that are not reported to the relevant authorities and are therefore illicit by definition. For Ndikumana and Boyce therefore, “while all capital flight is illicit, not all illicit financial flows are capital flight”. Applying the framework presented previously in this section, it is possible to observe that the overseas transfer via licit channels of criminally-acquired funds would meet the definition of an IFF, but not of capital flight. Thus, as noted by Cobham and Jansky (2020), there is inevitable overlap between approaches to measuring IFFs and capital flight, although important differences remain, as will be seen in subsequent sections.²

2.2 What is a tax haven? Where is “offshore”?

The truly common thread between the various flows described above, 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 publication (Cobham and Jansky, 2020).

If a cross-border flow has an illicit source, is transferred in an illicit manner, or is ultimately used to fund illicit activities, the parties involved are likely to require a means through which to obscure this fact, thereby protecting both themselves and the resources transferred. In this subsection, the ways tax havens provide this function is explored.

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 readers to shed these preconceptions, pointing out that in the modern global financial system, these terms refer fundamentally to a **set of capabilities**, spread

² Frank Barry (2015) provides a helpful account of the relationship between tax havens and capital flight, for readers with a specific interest in the capital flight component of IFFs.

across multiple jurisdictions and embodied in “networks of legal and quasi-legal entities and arrangements that manage and control private wealth”.

From Henry’s perspective, the core capabilities of tax havens 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 MNCs and wealthy individuals, to corrupt politicians and criminal networks.

Approaching tax havens from a capabilities perspective is useful for a number of reasons. First, it focuses attention on the functions and services provided to specific entities and individuals, rather than on the place itself. As Henry (2012), Shaxson (2019), and Cobham and Jansky (2020) have pointed out, attempts by multilateral organisations to create tax haven [blacklists](#) have become heavily politicised and subject to influence from such organisations’ most powerful members.

Second, and related to the first point, a focus on capabilities highlights both the inadequacies of a binary approach to tax havens and the benefits of thinking in terms of a spectrum. Rather than attempting to define some threshold to separate tax havens from non-tax havens (an unnecessarily arbitrary and political choice), Cobham, Jansky and Meinzer (2015) argue that all countries can be situated on a “secrecy spectrum”, reflecting both the degree to which it facilitates financial secrecy and the scale of the flows attracted. The Tax Justice Network’s [Financial Secrecy Index](#) (FSI) and [Corporate Tax Haven Index](#) (CTHI) are applications of this approach, illustrating the benefits of eliminating both undue politicisation and the confusion that arises from attempting to define tax havens purely in terms of low tax rates (Cobham and Jansky 2020). Thus, from the perspective of a country like South Africa, focus shifts from navigating the politics of international lists of tax havens toward the more policy-relevant exercise of determining the extent of the country’s exposure (via trade and other flows) to jurisdictions that allow a high degree of financial secrecy – and then designing appropriate counter-measures. The AU/ECA Report’s vulnerability indices and Jansky, Meinzer and Palansky’s (2018) Bilateral Financial Secrecy Index both reflect the value of such an approach.

The third advantage of a capabilities perspective is the degree of specification that it enables. Organising relevant jurisdictions by the specific capabilities they offer, and the role they play in an international ecosystem of cross-border flows, helps to distinguish between a number of different types of tax haven. “Intermediary havens”, typically small countries, including a number of Caribbean and Channel Islands, specialise in facilitating flows via complex networks of shell companies and subsidiaries. “Destination havens”, often larger countries such as the US, United Kingdom (UK) and Germany that usually aren’t considered tax havens at all, specialise in receiving flows from intermediary havens, insulating them from taxation and scrutiny, and providing the ultimate beneficiaries with access to a wide range of advanced economy benefits. Within these two categories, are many further degrees of specification, with some havens tailoring their services for [multinational corporations](#), others for wealthy individuals, and still others developing a strategy aimed at specific [countries](#) and [regions](#). Although they are often used interchangeably, Cobham and Gibson (2016, p.11) propose a distinction between “**secrecy jurisdictions**”, which “enable people or entities to escape the laws, rules and regulations of other jurisdictions, using secrecy as a prime tool” and “**corporate tax havens**”, which specialise in helping MNCs avoid paying tax in the countries in which they actually operate and generate their profits.

Last, a focus on capabilities rather than jurisdictions concentrates attention on the critical role played by the providers of the technical expertise underpinning tax haven capabilities. Henry (2012) notes that a specialised industry of “enablers”, embodied in law, accounting, insurance and banking firms, has emerged to provide the specialised skills required by MNCs, wealthy individuals, criminal networks and other clients with money to move. These networks operate across havens, and are driven by the most dominant firms in their sectors.

2.3 Approaches to measuring IFFs and offshore wealth in tax havens

Cobham and Jansky’s (2020) recent review of the methodologies used to estimate IFFs divides these among scale and non-scale indicators, where the latter refers to methods that do not aim to provide a quantitative estimate of IFFs. Scale indicators are divided among those focusing on trade-based IFFs (at country, commodity and transaction level), on estimates of capital account anomalies and offshore wealth, and on estimates of profit shifting by multinationals.

For the reasons explored in section 2.1, there are areas of significant overlap between these approaches. A brief, non-exhaustive account of each broad methodological approach, including non-scale measures of IFFs, provides further insight into a range of key IFF mechanisms and the challenges involved in quantifying them. This will also help to foreground a discussion of how to approach IFFs and tax havens in a policy-relevant manner in the South African context.

The limitations of the various methods discussed will be addressed only very briefly; readers interested in the full complexity of the debates around these are strongly encouraged to consult Cobham and Jansky (2020) in the original.³

Trade-based estimates

Methodologies aimed at estimating trade-based IFFs have tended to focus on anomalies in trade flows, taken to reflect misreported or mispriced transactions. IFFs measured by this approach typically take place either through **misinvoicing**, the deliberate misreporting of transactions and form of illegal tax evasion, or **mispricing**, the abuse of price-setting between entities and a more legally complicated matter associated with tax avoidance. When this type of activity takes places between unrelated entities, it is referred to as **trade misinvoicing** or **trade mispricing**. When it happens between related entities, such as an MNC parent and a domestic subsidiary, it is referred to as **transfer mispricing**.

This type of transaction takes place through four main mechanisms, reflected in Table 2 alongside typical motivations driving them.

³ Freely available [online](#).

Table 2: Key trade-based IFF manipulations

FLOW	MANIPULATION	ILLICIT MOTIVATION	IFF TYPE
Exports	Over-pricing	<ul style="list-style-type: none"> - Exploit subsidy regime - Repatriate undeclared capital 	<ul style="list-style-type: none"> - Tax abuse - Market/regulatory abuse
	Under-pricing	<ul style="list-style-type: none"> - Shift undeclared (licit) income/profit - Shift criminal proceeds out - Evade capital controls (including on profit repatriation) 	<ul style="list-style-type: none"> - Tax abuse - Laundering proceeds of crime - Market/regulatory abuse
Imports	Over-pricing	<ul style="list-style-type: none"> - Shift undeclared (licit) income/profit - Shift criminal proceeds out - Evade capital controls (including on profit repatriation) 	<ul style="list-style-type: none"> - Tax abuse - Laundering proceeds of crime - Market/regulatory abuse
	Under-pricing	<ul style="list-style-type: none"> - Evade tariffs - Repatriate undeclared capital 	<ul style="list-style-type: none"> - Tax abuse - Market/regulatory abuse

Source: Adapted from AU/ECA Report (2015 p.88)

Country-level estimates of trade-based IFFs are largely based on a method known as “mirror trade statistics”. This method, generally drawing on IMF Direction of Trade Statistics (DOTS) or UN Comtrade data, compares what Country A reports that it exports to/imports from the rest of the world (RoW) with what RoW reports that it imports from/exports to Country A. When differences or residuals arise, these are taken to be indicative of IFFs in the form of misinvoicing.⁴ For example, if South Africa reports exporting R10 million worth of goods to Botswana, but Botswana reports receiving R12 million worth of goods, then this is indicative of export under-pricing from the South African perspective. R2 million has been shifted outside of South Africa’s borders.

It is important to note the serious limitations of the country-level data and methodologies described above. UN Comtrade data, the most detailed available for these purposes, does not have full coverage of products or countries, is subject to inconsistency in how different countries classify the same transaction, and only covers goods, excluding the sizeable global trade in services. Further, a number of concerns have been raised about a range of important assumptions that country-level estimates rest on (Cobham and Jansky, 2020 pp.33-43), and are thus recommended for use mainly in preliminary studies.

Commodity-level IFF estimates turn on the detection of “abnormal” pricing of particular commodities. These methods aim to quantify IFFs taking place through trade mispricing (between unrelated entities) or transfer mispricing (between related entities) when prices are raised or lowered with the aim of shifting revenues from one jurisdiction to another. For example, if Firm A, resident in a relatively high-tax location, is owned by its parent company, Firm B, resident in a jurisdiction with lower taxes, the two could agree for Firm A to procure a good or service from Firm B at an inflated price. This

⁴ Ndikumana and Boyce (2019) and the AU/ECA Panel (2015) provide net figures, whereas GFI presents gross outflows on the basis that “there is no such thing as net crime” (Cobham and Jansky, 2020; Spanjers and Salomon, 2017).

effectively shifts Firm A’s revenues to a lower-tax jurisdiction; thus, at the level of the group (subsidiary Firm A + parent Firm B), less money is lost to taxation and profits are maximised.

The key then to a commodity-level methodology is to construct a set of “normal” prices for a range of commodities, so as to detect “abnormal” deviations from this benchmark and use the difference to estimate the scale of IFFs taking place through the underlying transactions. The construction of “normal” prices is tricky, relying on a range of assumptions about what the price would be if the transaction was conducted at “arm’s length”, i.e. if the transacting parties were unrelated and set the price at the prevailing market rate. Since product- and transaction-level data are often unavailable, product categories are used to estimate the “normal” price at a given moment. However, this approach rests in turn on assumptions about heterogeneity within product categories; there are often legitimate reasons for the prices of products in the same category but of different qualities or made by different brands to differ significantly. For these reasons, abnormal pricing methodologies are not recommended for accurate estimation of the scale of IFFs, but rather as “non-scale” risk indicators.

Transaction-level estimates are described by Cobham and Jansky (2020) as the “research frontier” – the most promising among trade-based approaches to IFF estimation. Based on extremely detailed data on the specific products and parties involved in individual transactions, it is effectively the ideal form of the commodity-level estimation methodologies discussed above. However, this method is also the most limited for geographical coverage, with relatively fewer countries collecting data at that level of granularity, and even fewer making it available to researchers.

Fortunately for the purposes of this report, the first ever study of transfer mispricing in a developing country using transaction-level customs data was conducted in South Africa by Ludvig Wier (2018). Access to data identifying transactions at the level of the specific product, the relation between the firms involved, the country of origin, the year, the number of units and the unit price, is the critical requirement of the methodology he employs. This level of specificity enables Wier to provide “the first direct evidence of transfer mispricing in a developing country” – showing that deviations from “arm’s length” prices are related to tax-motivated shifting of profits from South Africa to lower-tax jurisdictions.

We conclude this section with Cobham and Jansky’s summary of their review on trade-based estimated of IFF.

Figure 2: Summary of review of trade-based estimates of IFFs

Prevailing level of data	Prevailing sources of data	Prevailing method	Recent examples	Reliability of the methodology	Availability and country coverage
Country (and commodity)	IMF (and UN Comtrade)	Mirror trade statistics	GFI’s Spanjers & Salomon (2017)	Not recommended as estimates of scale, perhaps suitable for preliminary identification for audit purposes	Excellent and most of the world
Commodity (and transaction)	Country-specific (and UN Comtrade)	Abnormal prices	Chalendard, Raballand, & Rakotoarisoa (2019)	Not recommended as estimates of scale, perhaps suitable for preliminary identification for audit purposes	Excellent and most of the world
Transaction	Country-specific	Systematic differences between intra-firm and arm’s length prices	Davies, Martin, Parenti, & Toubal (2017)	Good (estimates of scale and for audit purposes)	Limited and only a few countries

Source: Cobham and Jansky (2020 p.29)

Capital account and offshore wealth estimates

While trade-based estimates of IFFs rely on identifying anomalies of various kinds in the current account, the methodologies covered in this section rely on anomalies in the capital account. These are used to estimate IFFs as well as stocks of offshore wealth and the further flows of income that accrue to these stocks. The World Bank Residual Method (WBR) and the Hot Money Narrow (HMN) method are the two most common approaches to estimating IFFs through capital account anomalies (Cobham and Jansky, 2020 p.64). Both approaches rely on balance of payments (BoP) data and the BoP identity, with the WBR method considering the disparity between total funds entering a country and total funds used by a country to reflect IFFs, and the HMN method designating all external account errors (“net errors and omissions”) as IFFs.

The limitations of these methods, as with methods based on anomalies in trade flows, is that they are simply too imprecise and open to challenge to be used either as sufficiently accurate quantitative estimates of total IFFs, or to guide tax enforcement and other policy aimed at holding the actors driving IFFs accountable. For Cobham and Jansky (2020 p.68), the two most noteworthy concerns are: 1. There are strong possibilities that these methods mistakenly capture licit transactions and simple data errors as IFFs; and 2. That these methods generate estimates at a high level of aggregation and therefore lack the specificity required for policy relevancy. Their most appropriate and successful use has therefore been to draw public and scholarly attention to the issue, rather than to drive solutions.

A number of researchers use similar methods to estimate the **stock** of wealth stored offshore, rather than **flows**. In Henry (2012), four methods are combined. The first aims to quantify unrecorded capital flows (in a similar “sources-and-uses” manner as Ndikumana and Boyce, 2019); the second aggregates these flows over time to estimate the value of the total stock plus returns calculated at a conservative rate; the third supplements the first two with analysis of cross-border private banking assets; and the fourth does the same with cross-border private non-banks’ assets (Cobham and Jansky, 2020 p.71). However, since Henry’s method for estimating the stock of offshore wealth is based on a fundamentally similar approach to the flow estimates discussed, it suffers from the same limitations.

A more robust approach is provided by Zucman (2013), and elaborated on in Alstadsaeter, Johannesen and Zucman (2018), and focuses on offshore assets held by households. They draw on statistics from the Swiss National Bank (the country’s central bank) on assets managed by all Swiss banks on behalf on foreigners, Bank of International Settlements data on non-resident deposits in tax haven banks, as well as IMF balance of payments and cross-border investment data. Alstadsaeter et al estimate that offshore wealth amounts to around 10% of global GDP – US\$5,6 trillion in 2007, for reference. This is a significantly lower estimate than those based on aggregate capital flow anomalies. The study focused on households, and the authors acknowledge that it excludes or underestimates important forms of offshore wealth including portfolio securities, real estate, gold and art (2018 p.7), but it is a much more robust one. Their findings indicate 30% of this wealth is held in Switzerland, with Luxembourg, Singapore and the Cayman Islands among the leading destinations for offshore wealth. However, the availability of detailed data remains a challenge, and progress will rely heavily on international co-operation towards global financial transparency.

International corporate tax avoidance estimates

International corporate tax avoidance (ICTA) is perhaps the most important form that IFFs take in the contemporary world, due to the size and power of the actors involved, the scale at which it appears to take place, and the complexities (legal and otherwise) involved in measuring and reducing it. Its

central function, however – the shifting of profits away from where they are generated and toward lower-tax jurisdictions – is straightforward. In Cobham and Jansky’s terms:

Tax avoidance by multinational companies is the most widely recognised tax ‘injustice’. The tax affairs of technology companies such as Google and Facebook, or commodity companies such as Glencore and Chevron, have sparked both popular anger and policy responses from Italy to Indonesia, and from Australia to Zambia. The related revenue losses for lower-income countries have been a particular target for tax justice activists, development advocates and researchers at international organisations. (2020 p.81).

The mechanisms through which tax avoidance schemes shift money across borders rely in large part on the ways in which the international corporate tax system “treat[s] multinational enterprises as loosely connected ‘separate entities’” (Shaxson 2019). Treating different branches of MNCs (e.g. a parent firm and its subsidiaries) as if they are unrelated and operate at “arm’s length” from one another creates the potential for an extensive range of tax abuse IFFs, including through transfer mispricing, intra-MNC loans, exorbitant “management” and other fees and the cynical transfer of intangible assets such as intellectual property rights to lower-tax jurisdictions.

In all four cases shown in Table 3, a portion of firm B’s resources, generated in the high-tax jurisdiction and ordinarily taxable there, are shifted to the low-tax jurisdiction for the purpose of avoiding taxation. There are two major difficulties involved with measuring and curbing this type of IFF: 1. Data on intra-group transactions is not typically available to the public; and 2. Proving that these transactions are tax-motivated is a complex task requiring resources not always available to tax authorities, especially in developing countries.

There is a vast and expanding literature on tax-motivated profit shifting and the various methodologies that have emerged in response to it, and it is not feasible to review these in this report. Rather, a single study conducted by Thomas Torslov, Ludvig Wier and Gabriel Zucman (2020) will be discussed. The focus on this study is because it constitutes an entirely novel contribution, in that it draws on macroeconomic data not previously available and was published as recently as April 2020.

Table 3: Prominent profit-shifting channels and examples

CHANNEL	EXAMPLE
Transfer mispricing	Firm A in low-tax jurisdiction overcharges firm B in high-tax jurisdiction an abnormally high price for product X. Funds equal to the difference between the market price and the abnormal transfer price represent the illicit flow built into this transaction.
Intra-group loans (a)	Firm A in low-tax jurisdiction makes an unnecessary loan to firm B in high-tax jurisdiction at an exorbitant interest rate. High interest payments on this loan represent the illicit flow here.
Exorbitant fees	Firm A in low-tax jurisdiction claims to be providing management and other services to firm B in high-tax jurisdiction, despite having almost no staff. The fee payments represent the illicit flow here.
Location of intangibles	Firm A in low-tax jurisdiction buys intellectual property rights at a very cheap price from firm B in a high tax jurisdiction. Firm B then pays expensive royalty fees to firm A to use the intellectual property it sold. Both the discounted price and the royalty fees represent illicit flows here.

Note (a): Intra-group refers to something taking place between different entities within the same multinational company. For example, a parent firm in South Africa and its subsidiaries across the Southern African Development Community (SADC) region are part of the same multinational entity. Transactions between these firms are “intra-group” transactions.

Torslov, Wier and Zucman’s method uses “foreign affiliates statistics”, which have recently begun to be published by most developed countries, including the most important tax havens. These statistics

include the wages and profits of foreign firms, usually MNC subsidiaries, and allow the researchers to systematically compare the profitability of domestic versus foreign firms. Their key finding is that in low-tax countries, foreign firms are consistently more profitable than domestic firms; whereas in high-tax countries, domestic firms are more profitable than their foreign rivals. They then compare profitability with wages paid, and find that domestic firms have a similar profit-to-wage ratio in both low- and high-tax jurisdictions, around 30%-40%. Foreign firms, in contrast, show much higher profit-to-wage ratios in low-tax jurisdictions, and much lower ratios in high-tax countries. Torslov et al use the examples of Ireland, a low-tax country where foreign firms' profit-to-wage ratio is 800%, and the UK, a relatively higher-tax country where the ratio is only 26% (Torslov et al, 2020 pp.2-3).⁵ Their study provides robust evidence that MNCs systematically shift profits away from high-tax countries, and declare them in lower-tax ones.

Torslov et al's findings indicate three main points about MNC profit shifting: 1. More detailed statistics are critical for obtaining an accurate picture of the scale of profit shifting and the key beneficiaries involved; 2. Corporate profit shifting by MNCs is taking place at a significant scale, and has a large redistributive effect. They estimate that on average, in 2015, 40% of multinational corporate profits⁶ were shifted away from where they were generated to tax havens, and that the benefits accrue mainly to the shareholders of US multinationals; and 3. These activities are likely to be exacerbating global inequality through reducing the effective tax rate of both corporations and owners of equity, who tend to be wealthier.⁷

This subsection concludes with some key points made by Cobham and Jansky in their review of methods estimating ICTA. First, these types of flows ought to be considered illicit and harmful, even if they are not entirely illegal, and should be stopped. Crucially, there is growing international consensus on this, reflected in the OECD's BEPS initiative, the UN SDGs and the AU/ECA High Level Panel on Illicit Financial Flows. In what has been considered a major breakthrough (Shaxson, 2019), the OECD BEPS Secretariat has formally acknowledged that the "separate entity" and "arm's length" principles of international taxation must be superseded to achieve effective and fair taxation of MNCs (OECD, 2019a). This paves the way for a complete paradigm shift in international taxation, to be discussed further in Section 5.

Second, profit shifting is taking place at a massive scale, implying significant revenue losses. Last, and importantly for this report, there is evidence that appropriate policy interventions can reduce the scale of profit shifting, a key criterion for policy relevancy.

Non-scale approaches to IFFs and tax havens

Non-scale approaches to IFFs are simple those that do not aim to provide a quantitative measure. Calculating such measures is not straightforward. Cobham and Jansky (2020 ch. 5) review two types on non-scale indicators relating to IFFs: policy-based indicators (reflecting global adherence to policies designed to increase transparency and accountability) and risk-based indicators (aiming to measure a country's vulnerability to IFF risks caused by secrecy-facilitating jurisdictions elsewhere).

The core of policy-based assessment has thus far revolved around the policy platform associated with the Tax Justice Network, the "ABC of tax transparency". This platform consists of: A. **Automatic exchange of tax data** between countries; B. Public registers indicating the **beneficial ownership** of companies, trusts and other entities; and C. Public **country-by-country reporting** by multinationals.

⁵ In other words, for every US\$1 spend on wages in Ireland, US\$8 in profit is earned, whereas foreign firms in the UK earn around US\$0,26 in profit.

⁶ 60% for US multinationals.

⁷ Torslov et al's data, methodology and key findings are freely available [online](#) and in an interactive format. Readers are strongly encouraged to explore it.

Automatic exchange of tax data and beneficial ownership registers are aimed at reducing secrecy. The former aims to eliminate secrecy around where multinational entities operate and where they pay tax, and the latter aims to cut through structures such as shell companies and secret trusts, which provide anonymity for the true owners of offshore wealth. Country-by-country reporting would require MNCs to abandon the “separate entity” façade and report sales, employment, profits, tax, sales and employment data of all their various subsidiaries for each jurisdiction they operate in. Substantial progress has been made on all three elements on the ABC platform, although there is some difficulty in aligning it with the UN SDG 16.4 on IFFs, which proposes a quantitative target for IFF reduction, rather than a policy-based one (Cobham and Jansky, 2020 pp.133-4).

Three major risk-based IFF indicators are discussed below. The first is TJN’s FSI, shown in Figure 3.

Figure 3: Key Financial Secrecy Indicators

Ownership Registration	Legal Entity Transparency	Integrity of tax and financial regulation	International Standards and Cooperation
1 Banking secrecy	6 Public company ownership	11 Tax administration capacity	17 Anti-money laundering
2 Trusts and foundations register	7 Public company accounts	12 Consistent personal income tax	18 Automatic information exchange
3 Recorded company ownership	8 Country-by-country reporting	13 Avoids promoting tax evasion	19 Bilateral treaties
4 Other wealth ownership	9 Corporate tax disclosure	14 Tax court secrecy	20 International legal cooperation
5 Limited partnership transparency	10 Legal entity identifier	15 Harmful structures	
		16 Public statistics	

Source: Tax Justice Network (2018)

A score out of 100 is generated for each jurisdiction and combined with a measure of its global share of financial services provided to non-residents to generate a global ranking of financial secrecy. The resulting [Index](#) gives an indication of which jurisdictions are most responsible for creating global IFF risk through the secrecy capabilities they allow non-residents to access. The top 10 worst jurisdictions on the 2020 FSI are: 1. Cayman Islands, 2. US, 3. Switzerland, 4. Hong Kong, 5. Singapore, 6. Luxembourg, 7. Japan, 8. Netherlands, 9. British Virgin Islands, 10. United Arab Emirates.⁸

To maximise the policy relevance of this approach for individual countries, the FSI has also been developed by Jansky, Meinzer and Palansky (2018) into a Bilateral Financial Secrecy Index (BFSI). The BFSI adds a measure of total bilateral portfolio investments between two countries, intended to reflect the extent of the economic relationship (and thus the likely IFF exposure) between each pair. This enables policymakers to establish which specific secrecy jurisdictions are most likely to be affecting their country through IFFs. The data used for this study is [publicly available](#), and it is used in Section 3 to provide an indicator of the most important secrecy jurisdictions for South Africa.

The last risk-based approach discussed here was pioneered by the AU/ECA High Level Panel on Illicit Financial Flows from Africa, and also aims to generate a measure of a given country’s exposure to IFF

⁸ TJN has also developed a new method to complement the FSI – the [Corporate Tax Haven Index](#), which ranks tax havens “according to how aggressively and how extensively each jurisdiction contributes to helping the world’s multinational enterprises escape paying tax”. It is worthwhile to note that four of the top 10 havens on the CTHI are British Overseas Territories or crown dependencies, with the UK itself coming in 13th place. TJN notes that the UK would be No. 1 on the CTHI if these were considered collectively.

risk according to the nature and scale of its economic relations with the rest of the world. It is based on the principle that “the greater the transparency of the partner jurisdiction in a given bilateral transaction, the lower will be the risk of something being hidden” (AU/ECA, 2015 p.106). In this way, it draws on the logic (and indeed the data) of the FSI and BFSI. Its added value is to assess a country’s IFF exposure using data on trade, direct investment and portfolio flows, providing a more granular insight into vulnerability.

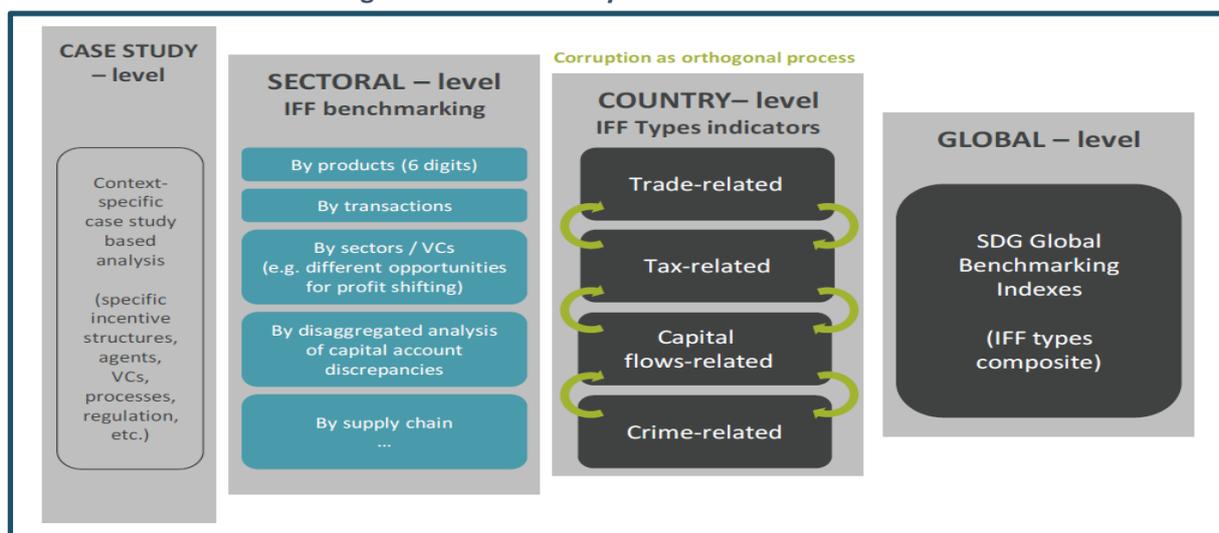
2.4 A policy-relevant approach to IFFs

This section concludes with a brief perspective on IFFs from a policy-relevance standpoint. Drawing on the literature and policy experience on the issue of corruption, Khan, Andreoni and Roy’s (2019) working paper proposes three key criteria that IFF indicators need to meet to be useful for policy purposes. These are restated in full below (2019 p.32):

- a. *It must be possible to estimate the indicator using available statistics and techniques, or using feasible extensions of existing statistics;*
- b. *It must be possible to target the indicator using feasible policies to reduce what the indicator measures; and*
- c. *The indicator must be precise enough in its measurement of damaging flows so that if policies succeed in reducing the value of the indicator, the result will be an improvement in development outcomes or at least development prospects.*

In sum, for a proposed IFF indicator to be policy relevant, the country must have the data and technical capacity required to use it, must have the capability to implement the policies required to curb what it measures, and these efforts need to have a demonstrable link to developmental results. For Khan et al, the complexity inherent in the processes driving IFFs, and in their measurement, strongly suggests that policymakers cannot rely on a single indicator. Instead, they argue, a “battery of different indicators for different levels of aggregation” will be required, and must be complemented by qualitative analysis, including of rents, sectoral value chains and country-specific political economy dynamics (2019, p.32). Their proposed schematic is reproduced in Figure 4.

Figure 4: Multi-level system of IFF indicators



Source: Khan, Andreoni and Roy (2019 p.33)

Khan et al’s schematic clearly illustrates the need for a well-co-ordinated, sophisticated inter-departmental approach to measuring and curbing illicit financial flows, an appropriate point at which to focus our attention more narrowly on the South African context.

3. IFFS, TAX HAVENS AND SOUTH AFRICA

This section begins with a number of case studies on illicit flows and tax havens. These serve to illustrate how a number of the IFF mechanisms discussed in the previous section operate in practice, and how complex the mechanisms, networks and dynamics underlying IFFs can be. In section 3.2, key studies of the scale of IFFs in the South African context are reviewed, alongside a range of approaches to determining which tax havens are especially relevant in this context.

3.1 Case studies

Mispricing of diamonds: De Beers

Khadija Sharife and Sarah Bracking's 2016 study of the pricing and valuation of rough diamonds in South Africa, focused on De Beers, and illustrates the relevance of Khan et al's advocacy for a sophisticated, context-specific approach to IFFs.

The starting point for Sharife and Bracking's analysis is the observation that rough diamonds imported into South Africa between 2005-2012 had a significantly higher price (in US\$ per carat) than those exported out of the country – the US\$/carat price of imported diamonds tended to be five times that of exports. The authors make two key arguments for why this is likely indicative of IFFs via trade mispricing. First, they show that close to 100% of imported diamonds are re-exported. Second, they provide a compelling argument that the difference cannot be explained by a difference in quality between imported diamonds and domestically-produced diamonds, both of which are exported. What then explains the five-fold difference between the high US\$/carat of imported diamonds and the relatively low US\$/carat of diamond exports from South Africa?

Sharife and Bracking argue that the likely explanation is significant import over-pricing or export under-pricing (or both). Either would indicate significant profit shifting, and associated losses in tax revenue. The authors built a dataset comparing the US\$/carat of diamonds entering South Africa, diamonds produced in South African mines, and total diamonds exiting the country as exports. To test whether domestically-produced diamonds are under-priced on export, they developed the following method. First, they excluded imported diamonds from the total export data by assuming: A. That the import prices accurately reflect "arm's length" transactions; and B. That, to make economic sense, imported diamonds would be re-exported out of South Africa at the same price or more than they were imported for. This enabled the authors to derive the US\$/carat price of the domestically-produced portion of exported diamonds, and to compare that with the US\$/carat domestic price of production. Multiplying the difference between these prices by the volume of domestically-produced diamonds exported produced an estimate of mispricing taking place in export transactions.⁹

Sharife and Bracking's method produces an estimate of US\$3,34 billion of outflows due to export under-pricing between 2005-2012, of which US\$2,83 billion is attributable to De Beers alone. This scale of outflow suggests significant tax revenue losses. De Beers' dominance in the value chain means that most of the transactions underlying these outflows take place within the firm's extensive network of subsidiaries and entities under common control; for this reason, the authors categorise these outflows as tax-motivated transfer mispricing (2016 p.564).

This method of controlling for imports, despite the assumption that imports have taken place at an arm's length price, also helps to identify likely instances of import over-pricing. In 2007, for example,

⁹ Importantly, this is likely to be a conservative estimate of total IFF mispricing outflows due to the assumption that import over-pricing is not taking place.

the import US\$/carat price was so high that when the authors' method excludes imported diamonds from the export data, the result implies that domestically-produced diamonds are being exported at less than their cost of production (2016 p.565). The authors suggest that this may be indicative of "round-tripping", in which diamonds are imported at a high price only to be exported back to their source at a lower price, with the result of shifting funds out of the country. The potential effect, they argue, is "externalising profits while discouraging higher wage claims, as higher sales values are realised further up the value chain in other sovereignties" (2016 p.565).

Sharife and Bracking also provide a highly interesting account of the diamond valuation process in the context of a sector characterised by a single, overwhelmingly dominant firm and a commodity with a highly unusual "discursive framing" in which each diamond is notionally unique, thus justifying a wider-than-usual range of prices. They argue that these factors combine to give De Beers great flexibility to price diamonds according to strategic needs, including tax planning and the management of profit flows (2016 pp.567-8).

Critically, Sharife and Bracking argue that the institutional and regulatory environment in South Africa is ill-equipped to curb, and to some extent appears to tolerate, activities that result in these IFF flows. The Department of Mineral Resources and Energy (DMRE) indicated to the authors that, while the company maintained 75% or more of market share, De Beers was empowered to prevent disclosure of any but the most general data about its activities (2016 p.561). This means, for example, that details of De Beers' valuation process for imports and exports are inaccessible, even to the relevant regulatory authority, the Government Diamond Valuator, which is tasked with precisely the role of independently analysing the value and quality of diamond imports and exports. The absurdity of such a scenario is clear. In this context, it is worthwhile to note Bracking and Sharife's (2014 p.7) discussion of tax arrangements that reduce taxes for mining companies with lower profit margins. Such arrangements may well act as an incentive for profit shifting, and may be worth revising in light of evidence that MNCs in commodities sectors (especially in minerals) are often leading actors in illicit financial flows from developing countries (Ndikumana and Boyce, 2019).

Sharife and Bracking's work confirms the importance of sector- and industry-specific studies for policymaking, and of qualitative analysis of the institutional and regulatory environment, the allocation of rents, and the nature of relevant value chains. Their arguments about the importance of the discourse around pricing provides insight into an additional layer of complexity involved in curbing IFFs.

Profit shifting via tax havens in the telecoms sector: MTN

Reporting in 2015 by investigative journalists at amaBhungane, Uganda's [The Observer](#) newspaper (Mbanga 2015) and the London-based journalism network Finance Uncovered 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.

The [reporting](#) focuses on large intra-group transfers from MTN's subsidiaries in Nigeria, Uganda, Ghana and Cote d'Ivoire, towards other MTN entities based in Mauritius and Dubai:

- R3,7 billion paid from MTN Nigeria to MTN Dubai between 2007-2013 (1.75% of revenue), with an unknown share paid on to MTN International in Mauritius.
- R85,6 million paid from MTN Uganda to MTN International in 2009 alone (3% of revenue).
- R3,7 billion paid from MTN Ghana to MTN Dubai between 2008 and 2013 (9.6% of revenue), with an unknown share paid on to MTN International in Mauritius.
- R513 million paid from MTN Cote d'Ivoire to MTN International from 2012-2013 (5% of revenue).

According to [MTN](#), 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 these fees flow to MTN in Mauritius and 45% flow to Dubai (where subsidiaries are subject to a 0% tax rate). However, the Mauritian entity that receives the bulk of these fees “employs no staff and cannot, therefore, physically provide a service” (McKune and Turner, 2015 in [amaBhungane](#)). Further, while MTN entities in Dubai employed around 115 staff providing technical support to various other MTN subsidiaries at the time of reporting, MTN Dubai also received licence fees for trademarks and other intellectual property registered in Mauritius. It is unclear why MTN subsidiaries in Africa would route these payments via Dubai rather than pay them directly to MTN International in Mauritius.

While the reporters are careful to clarify that they make no allegations of illegal tax evasion against MTN, the economic logic underlying these arrangements is difficult to understand. 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 in [Finance Uncovered](#)). Further, amaBhungane reports that, in 2010, MTN’s Mauritian entities received hundreds of millions of rands in management fees from various subsidiaries, but that it could only confirm that R58 million ended up in South Africa, where the management and technical capacity is based.

Importantly, the provision of management services to subsidiaries around the world by MTN employees based in South Africa has been used by the company to lobby government for continued access to tax breaks initially designed to incentivise MNCs to headquarter in South Africa. amaBhungane’s [report](#) on the matter indicates that these employees’ jobs have been used as leverage to prevent government from withdrawing tax credits from which MTN had benefited substantially. Company executives have argued that management fees paid by overseas subsidiaries create jobs in South Africa, and that these jobs would be threatened by the withdrawal of the tax credit. However, as we have seen above, the fees that reach South Africa first travel through Mauritius and Dubai, with an unknown percentage potentially lost to IFFs.

According to the reporting cited above, company documents indicate that the various fees received in Mauritius from various MTN subsidiaries around the world are used to make interest payments on the company’s debt. This raises concern about loan repayments as an additional channel through which tax-motivated profit shifting IFFs may be taking place. While secrecy around company finances means that hard evidence 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) in the form of interest payments.

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

Dick Forslund’s (2014) study of alleged profit shifting by Lonmin Plc in the years leading up to the massacre of striking mineworkers at its Marikana mine near Rustenburg provides a helpful case study for the purposes of this report. The main mechanisms highlighted by Forslund’s research include questionable management fees (as with MTN), 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 the financial statements of one of UK-based Lonmin Plc'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 happened to be 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. There is some evidence suggesting that transfers on this scale happened over a significant period of time, but the exact details are difficult to ascertain due to a lack of transparency in Lonmin Plc's intra-group financial transactions and contestation over the documents submitted by Lonmin Plc to the Marikana Commission of Inquiry led by Judge Ian Farlam. 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 cites a Lonmin press release that appears to indicate that the Bermuda operation that brought in hundreds of millions of rands per annum had no staff. Further, in response to a press enquiry, the company also concedes 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). While the company claimed that WMSL was not incorporated in Bermuda for tax planning purposes, no argument is put forward to back this claim.

Forslund provides an interesting comparative perspective for the sector, showing 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 in Bermuda.

An important point made by Forslund in his study of Lonmin Plc and its subsidiaries is that profit shifting and the IFF mechanisms that enable it do not only affect a country's tax base. He proposes that "wage avoidance" is an important effect of profit shifting arrangements, arguing that "when R100 million is transferred out of the country, the tax authority loses up to 28 percent of the total, namely R28 million. However, workers lose the much greater amount of R72 million that is removed from wage negotiations."¹⁰ This perspective will be discussed further in Section 4.

Under-pricing and confidential distribution agreements: Samancor Chrome

Court proceedings brought in 2019 by the Association of Mining and Construction Union (AMCU) against Samancor Chrome, a key mining and minerals processing company, has revealed a range of IFF mechanisms designed to shift profits out of South Africa. As reported in detail by [amaBhungane](#) (Van Rensburg, 2015) and [New Frame](#) (Webster 2019), these arrangements were revealed in an [affidavit](#) by a key whistle-blower, and suggest that over US\$500 million (R7,5 billion) had been shifted out of Samancor via IFFs and tax havens.

Samancor was bought from BHP Billiton and Anglo American by a company named Kermas South Africa in 2005, with the acquisition partially funded by a Swiss mining company, International Mineral Resources (IMR). Three major areas of profit shifting and, arguable, outright corruption developed thereafter.

First, soon after Kermas SA acquired Samancor, one of Kermas SA's owners, Danko Koncar, set up a trading company in Malta called Samchrome. Samchrome was subsequently made the exclusive global distributor of Samancor products and earned a guaranteed commission of 9%, almost four times the

¹⁰ From an online introduction to his report, available [here](#).

commission earned by Samancor's previous distributors. Samchrome in turn was owned by another Maltese company, which itself was owned by Kermas Ltd (BVI), registered in the British Virgin Islands (BVI). As implied in its name, it is a related entity of Kermas SA, and is technically owned by Koncar's cousin. The whistle-blower affidavit states that Samchrome, despite earning huge commission fees on Samancor sales, had no staff in Malta. It nonetheless proved highly profitable, earning profits of US\$29,9 million in its first year of operation and US\$73,2 million in its second year. These outflows, equivalent to more than a third of Samancor's own profits, imply a significant tax loss in South Africa. When IMR bought Kermas SA's stake in Samancor in 2009, it set up a new Samchrome in Dubai, siphoning off profits using the same 9% commission.

Second, in 2007 Samancor entered into an agreement with an Australian mining company, Sylvania, to extract residual chrome from Samancor's mines. Initially, the price per tonne was between R49,99 and R72; in the second year it was capped at R49,99, and from there the price was cut to R1 per tonne of chrome extracted. When this lucrative agreement was finalised, Sylvania issued 14 million shares to a company named Portpatrick, which managed financial affairs for companies registered in the British Virgin Islands. The transfer to Portpatrick, according to the whistle-blower, was ultimately a mechanism for funnelling the 14 million Sylvania shares to the owners of Kermas BVI. This arrangement amounts to a wholesale extraction of value from a South African chrome mining operation to an offshore tax haven.

The last, and perhaps the least subtle of the three, involved the sale of a 50% stake in a Samancor subsidiary (Tubatse Chrome) to Sinosteel, the Chinese state-owned conglomerate. Sinosteel paid US\$225 million in total for 50% of Tubatse. However, just US\$100 million (less than half) was paid to Samancor for its stake in Tubatse, with US\$125 million transferred from Sinosteel directly into a London bank account belonging to Kermas.

This case study helps to illustrate the overlap between various types of IFF mechanisms (ranging in this case from exorbitant service fees and mispricing to overtly corrupt asset-stripping), as well as the role of a range of secrecy jurisdictions and the capabilities they provide for multinational entities. It also highlights the impact of these types of activities on shareholders. The whistle-blower affidavit suggests that The Ndizani Workers' Trust, a Samancor employee share ownership scheme representing 5 000 workers, has lost out on R1,5 billion in dividends and other benefits due to the extractive activities undertaken by the majority shareholders. Even prior to the economic crisis precipitated by COVID-19, Samancor warned early in 2020 that it may be forced to [shed 2 500 jobs \(Webster, 2020\)](#) due to various factors including low chrome prices; had billions of rands not been extracted from the company via IFFs and tax haven capabilities, it may have entered the year in a less vulnerable state.

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

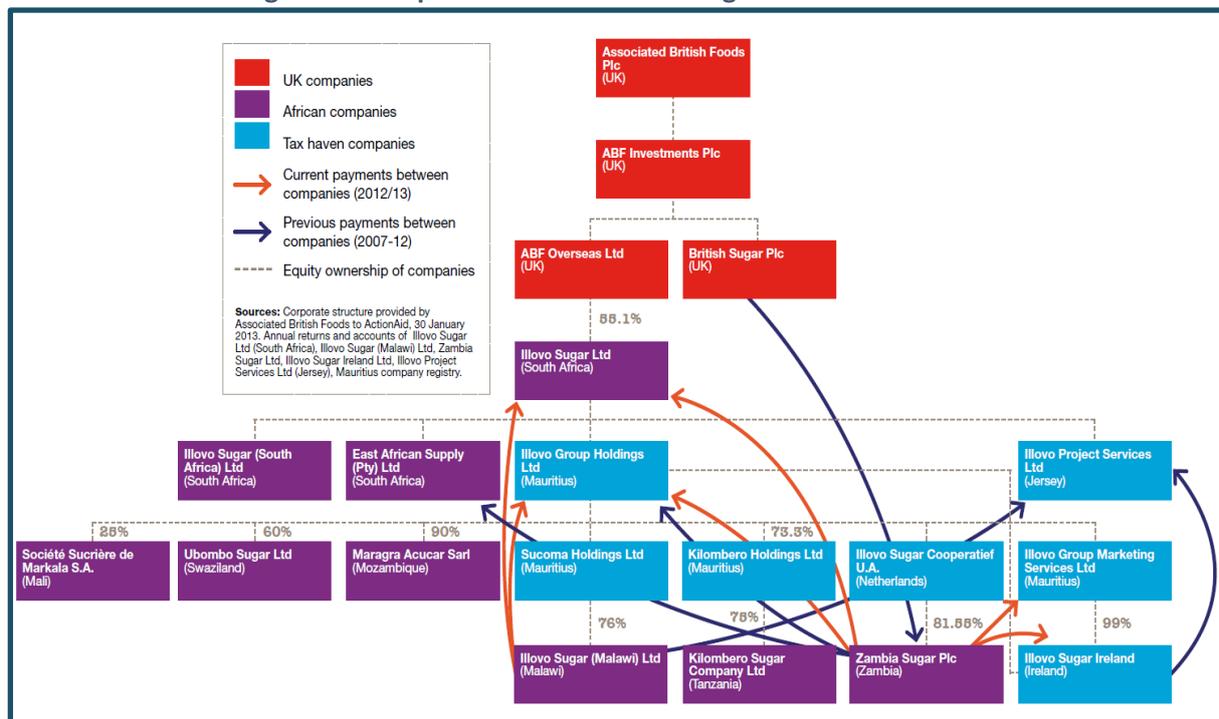
ActionAid's 2013 report by Mike Lewis on the British food conglomerate, Associated British Foods (ABF), provides further helpful examples of how multinational groups can be structured in ways that help them avoid their social responsibilities in the jurisdictions in which they generate their profits.

In 2006, ABF acquired a majority stake in Illovo Sugar, a multinational group based in South Africa and Africa's largest sugar producer at that point, 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 three main 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.

First, although Illovo Sugar Ltd in South Africa houses the group's management and technical capabilities, large "purchases and management services" fees have been paid to another Illovo subsidiary based in Ireland. Lewis calculates that Zambia Sugar paid this Irish subsidiary around US\$47,6 million between 2007-2013, and would have reduced Zambia Sugar's operating profit by around 20% (2013 p.18). 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. Despite ABF claiming that Illovo's Irish subsidiary provides Zambia Sugar with "various services required", Lewis reports that Illovo Sugar Ireland's audited accounts reflected no employees between 2006 and 2013, and that no trace of the company was found at its listed address and phone number in Dublin (2013 p.20). Due to a lack of transparent financial reporting in the various other secrecy jurisdictions where Illovo subsidiaries are registered, it is unclear what proportion of the large fees paid to Illovo Ireland are paid on to other subsidiaries, and thus also unclear what taxes are paid, or where they might be paid. What is clear, however, is that these arrangements cause Zambia a significant loss of tax revenue. In addition, Zambia Sugar also pays further millions of US dollars in "export agency commission" fees to Illovo Group Marketing Service Ltd, which based in Mauritius and consists of a single staff member (2013 p.21). While ABF claims that this Mauritian subsidiary is taxed in South Africa at 28%, the amount of tax paid by Illovo Sugar Ltd in South Africa appears to suggest that a tiny proportion, if any at all, of these fees are actually paid on from Mauritius.

Figure 5: Group structure of ABF holdings in Southern Africa



Source: Lewis (2013 p.9)

Second, in 2007 Zambia Sugar borrowed ZK280,5 billion¹¹ (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

¹¹ ZK refers to Zambian Kwacha.

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. In a similar way to the arrangement described above, 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.

Last, Lewis provides details of arrangements that have the result of reducing the tax paid on the payments of 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 (enabling the avoidance of the 15% withholding tax mentioned previously). 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%.

One of the most striking parts of Lewis’s report compares the tax paid in Zambia by Zambia Sugar Plc with that paid by an informal trader and a cane cutter, each involved at opposite ends of the value chain. Between 2008-2010, a period when the two individuals paid income tax at 4.6% and 1.2% respectively, Zambia Sugar paid 0% income tax, due in part to the arrangements described above, and in part to a range of generous tax breaks offered to the firm to incentivise further inward investment.¹² While the author has stressed, as in the case of MTN, that no illegality is alleged in the report, the comparison above helps to clarify why such arrangements ought to be considered exploitative, harmful and illicit. Last, the fact that a network of tax haven arrangements existed in Illovo Sugar’s corporate structure prior to its acquisition by ABF is worth reflecting on, and highlights that South African investment in the rest of the region can play an extractive and developmentally-harmful role in neighbouring economies.

3.2 Estimates of IFF scale and indicators of key tax havens

The handful of case studies in the previous subsection provide some sense of how various IFF mechanisms and tax haven arrangements operate in practice. This subsection summarises what a number of studies from different methodological perspectives have indicated about the likely scale of various types of illicit financial flows in South Africa, and about which tax havens appear to play an important role in facilitating these flows.

Table 4 summarises the approaches and findings of seven key studies that provide results relevant to the South African context.

¹² Two further case studies, one involving [SABMiller](#) (ActionAid, 2012) and the other [Microsoft](#) (Kiel, 2020) have been excluded for the sake of brevity. Readers are recommended to view them at the links provided.

Table 4: Summary of key studies on IFFs

IFF	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)	Cobham and Jansky (2017b)	Estimate of spillover effects from tax policy, isolating tax-motivated component.	US\$5,8 billion- US\$6,7 billion revenue loss for South Africa in 2013. US\$500 billion global loss, greater in developing countries.	Country-level estimate: useful for scale estimates but not policy- or enforcement-oriented.
Tax abuse (profit shifting through transfer mispricing)	Wier (2018)	Trade-based estimate of mispricing in import of goods, through identification of deviations from “arm’s length” pricing using detailed transaction-level data indicating product, unit price, firms involved and partner jurisdiction.	Annual loss of 0.5% of corporate income tax revenue (between R1 billion and R1,3 billion in 2018/19).	Transaction-level estimate: highly useful for policy and enforcement purposes, method can be used to set up inexpensive automatic flagging system to indicate transfer mispricing at transaction-level, can result in significant tax recovery.
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; ¹³ 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 and capital flow mirror statistics.	US\$327 billion of capital flight from South Africa from 1970-2017, including US\$146 billion misinvoicing from 1998-2017; Misinvoicing in gold,	Country- and commodity-level estimates: useful for scale estimates and highlighting problem sectors, but method is prone to imprecision.

¹³ Much of the data used by Wier and Reynolds (2018) is accessible [here](#).

			silver, platinum, iron is significant.	
Trade misinvoicing	Global Financial Integrity (2018; 2019)	Trade-based estimate of misinvoicing using mirror statistics anomalies in IMF DOTS and UN Comtrade data.	US\$6 billion-US\$10 billion outflow from South Africa in 2015; US\$37 billion revenue loss from 2010-2014; Average outflow of US\$600-US\$800 billion per annum for 148 countries (2006-2015).	Country-level estimate: useful for scale estimates, but method is prone to imprecision and excludes a number of important IFF channels.
Tax abuse (profit shifting)	Torslov, Wier and Zucman (2020)	Estimate of profitability-gap of MNC subsidiaries in havens vs non-havens, used to model tax-motivated profit shifting.	US\$4 billion revenue loss for South Africa in 2015. Global loss of 10% revenue (40% corporate profits shifted to havens), correlated with corporate tax rate.	Country-level estimate: useful for scale estimates and a novel academic contribution and highlights role of foreign affiliates statistics; not policy- or enforcement-oriented.

This summary gives 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. As discussed in Section 2, these challenges include 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 above, along with other non-scale approaches to IFF, 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. Some of the case studies in Section 3.1 indicate a number of relevant tax havens, including Mauritius, Bermuda and Ireland, but a more systematic approach to determining which tax havens are most relevant is clearly required.

While data leaks from a number of tax havens have provided clear evidence of links to South Africa – including in the [Paradise Papers](#), [Panama Papers](#), and the 2019 “[Mauritius Leaks](#)”¹⁴ – these can yield only partial insights. A number of more methodical approaches have been used for this purpose, and their results are discussed briefly below.

GFI’s 2018 South Africa report, shown in Table 3, estimates a total potential revenue loss of US\$37 billion due to trade misinvoicing between 2010-2014, which it suggests is a conservative estimate. The report includes a section on misinvoicing between South Africa and its top 10 trading partners, with their method indicating that import under-invoicing (indicating illicit inflows and the evasion of tariffs via smuggling among other means), is especially prevalent in trade with China and India, and over-invoicing in trade with Nigeria (indicating illicit outflows). China, India and Nigeria are not typically thought of as tax havens or secrecy jurisdictions – none rank especially high in either the Financial Secrecy Index or the Corporate Tax Haven Index – but GFI’s methodology¹⁵ suggests that trade with these countries exposes South Africa to risk of significant revenue loss. Its approach also

¹⁴ Detailed data from the International Consortium of Investigative Journalists on this leak can be accessed [here](#).

¹⁵ Note: The significant weaknesses of this type of methodology are discussed in section 2.3.1. above.

helps to disaggregate potential trade-related revenue losses by partner country and sector: trade in machinery with the US, apparel with India and Hong Kong, and glass with Germany are significant according to the methodology (2018 p.15).

Ndikumana and Boyce's (2019) report estimates US\$327 billion in capital flight from South Africa between 1970-2017, with US\$146 billion in net trade misinvoicing between 1998-2017 alone.¹⁶ Their method finds that this has been driven to a significant extent by export under-invoicing, and that South Africa's exports to China, India, Italy, Turkey and the UK exhibit evidence of a high degree of under-invoicing, equivalent to more than 45% of these countries' imports from South Africa (2019 p.22).

At a commodity-level, exports of silver, platinum and iron ore appear to be important channels for misinvoicing. From a tax haven perspective, Ndikumana and Boyce also find that trade with the Netherlands and Switzerland, two high-ranking secrecy jurisdictions,¹⁷ shows evidence of significant export over-invoicing. It is hard to make a strong argument on this matter due to imprecision inherent in the method and underlying data, but this type of misinvoicing could be indicative of illicit inflows associated with the repatriation of profits previously shifted to these secrecy jurisdictions, as in the Illovo case study discussed previously.

The Wier and Reynolds (2018) study of profit shifting by foreign-owned firms in South Africa examines discrepancies between profit-to-wage (p-w) ratios in foreign firms with parent firms in tax havens versus those with parents in non-tax havens. They find that tax haven-owned firms report systematically lower p-w ratios, with many haven-owned firms reporting extremely low or even negative profits despite their wage bills indicating significant economic activity. By comparing tax haven-owned firms' p-w ratios with a "normal" p-w ratio,¹⁸ they generate results for what these firms would have declared in taxable income if they were displaying "normal" profitability, and from there derive the implied tax revenue loss attributable to profit shifting.

While acknowledging some of the limitations of this method, their results indicate that profit shifting from South Africa is driven overwhelmingly by firms ultimately owned in Switzerland, with a number of other notorious tax havens following behind. The five tax havens to which most profits were shifted in 2014 are as follows: Switzerland (R5,4 billion), Ireland (R1,1 billion), Bermuda (R835 million), British dependencies including Jersey, Guernsey and the Isle of Man (R687 million) and Mauritius (R668 million).

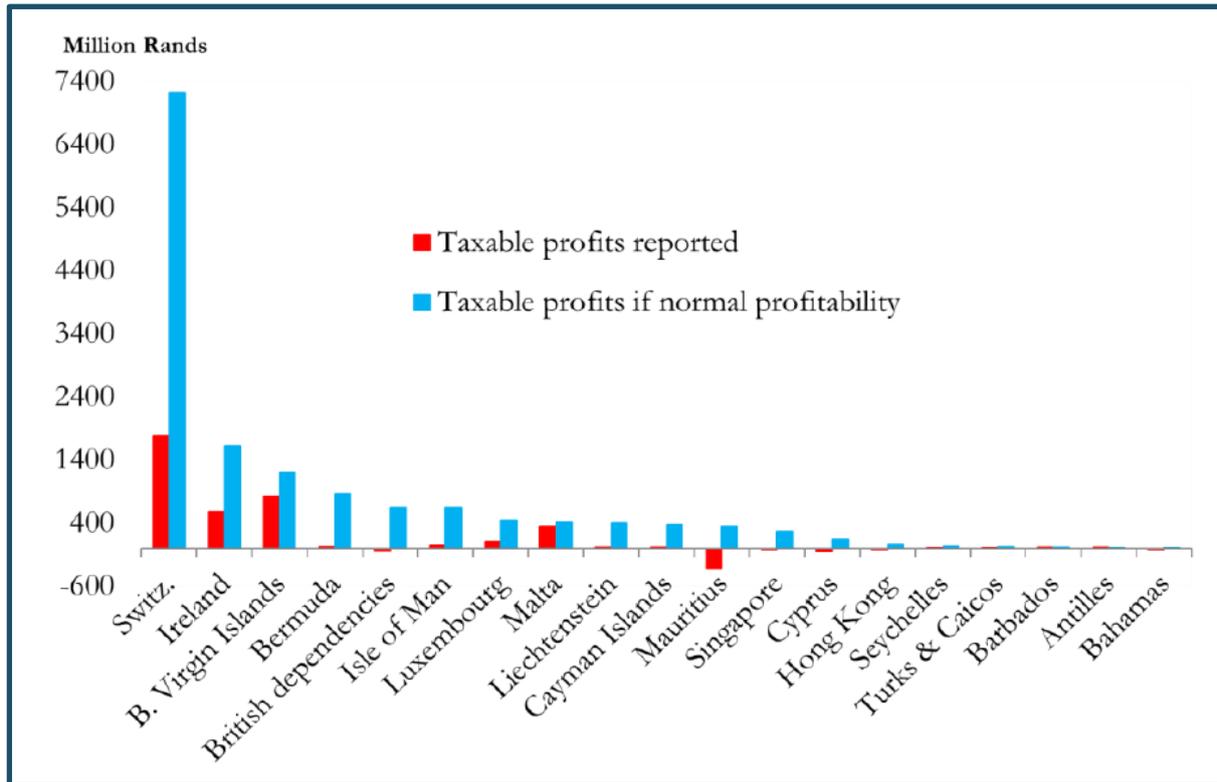
This is reflected in Figure 6 in the difference between the blue and red bars for each jurisdiction. Total profits shifted to the 19 jurisdictions defined by Wier and Reynolds as tax havens amount to R11,4 billion, implying a revenue loss of R3,2 billion on the assumption that these would all be subject to Company Income Tax at 28%.

¹⁶ Ndikumana and Boyce associate the increased rate of capital flight in the post-apartheid era with rapid growth in external debt and increases in international private capital flows, especially via portfolio investment (2019 p.17).

¹⁷ Both in the top 10 of the FSI and CTHI.

¹⁸ Defined as the average p-w ratio found in non-haven-owned firms, 85% of the wage bill.

Figure 6: “Normal” vs. actual profits reported by tax haven-owned firms



Source: Wier and Reynolds (2018, p.18)

As noted by Zucman (2013), the routing of inward investment through tax havens has a significant distorting effect on global statistics on FDI. As noted previously in the introduction to this paper, Zucman estimates that as much as 40% of global FDI is channelled through tax havens, generating strange anomalies: “In 2011 for instance, 30% of India’s inward direct investments came from Mauritius; 25% of Brazil’s came from The Netherlands; 60% of China’s came from Hong Kong and the British Virgin Islands” (2013 p.1325). A brief scan of the statistical annexes of the South African Reserve Bank (SARB) March 2020 Quarterly Bulletin indicates some similarly unexpected sources for large stocks of direct and portfolio investment in South Africa (SARB, 2020a):

- By the end of 2018, 44% of total European direct investment (R621 billion) and 51% of portfolio investment (R731 billion) in South Africa had come from the Netherlands, Belgium and Luxembourg. Luxembourg, a country of just over 600 000 people, accounts for around five times the inward investment of Italy, a major trading partner with a population of 60 million.
- Bermuda (population 64 000) and Canada (population 38 million) have the same stock of direct investment in South Africa (R8,2 billion).
- Mauritius (population 1.3 million) is Africa’s largest direct investor in South Africa by an overwhelming margin, with 30% (R24 billion) of the total. Nigeria’s (population 200 million) direct investment in South Africa, by contrast, is just R2,5 billion.

The above exercise is clearly a very blunt one; some of the direct investment in South Africa from Mauritius surely comes from companies with actual operations there. However, Cobham (2014)¹⁹ ranks South Africa’s IFF risk exposure via inward direct investment as high, and Abugre et al (2019 pp.47-48) provide a systematic account of the types of IFF risks that come with direct investment. Further, as per Zucman’s (2013) approach, the figures do seem to indicate a significant

¹⁹ Figure from Cobham (2014) reproduced in Cobham and Jansky (2020 p.142).

proportion of inward investment in South Africa is routed through tax havens from elsewhere, rather than actually originating there.

The case studies on MTN and Illovo Sugar illustrate how profits generated in neighbouring African countries flow back to South Africa via tax havens and a range of indirect mechanisms that rob these countries of much-needed tax revenue. It is plausible that some portion of these profits enter South Africa as direct investment from tax havens, potentially benefiting from a range of FDI incentives. The case studies show that challenging such behaviour is extremely difficult; the combination of tax havens' secrecy capabilities and the opacity of MNC operations can mean there is no way to establish whether these flows enter South Africa legitimately, or indeed to determine what proportion of these profits are shifted on from intermediary to destination havens.

A similar exercise was conducted by Isaacs (2018) using IMF data, finding that a whole 35% of South African assets held abroad were located in low-tax jurisdictions. Table 5 reproduces Isaacs' results in full.

Table 5: Top 10 countries in which South African assets are held abroad

	COUNTRY	AMOUNT (US\$ MILLIONS)	PERCENTAGE OF TOTAL
	Value of total investments	154,865	
1	United Kingdom	62,920	41%
2	United States	25,638	17%
3	Luxembourg	22,740	15%
4	Ireland	15,727	10%
5	Bermuda	9,851	6%
6	Guernsey	3,592	2%
7	Jersey	1,728	1%
8	Canada	1,394	1%
9	Malta	1,325	1%
10	India	964	1%
	Low-tax jurisdictions	54,963	35%

Source: Isaacs (2018 p.208)

Last, the Tax Justice Network's [Bilateral Financial Secrecy Index](#) (BFSI), derived from Jansky, Meinzer and Palansky's (2018) method and described in Section 2.3 (*Non-scale approaches to IFFs and tax havens*), provides 86 countries with "a breakdown of the greatest suppliers of financial secrecy to its jurisdiction." A non-scale method, the BFSI does not aim to quantify IFFs actually taking place, instead providing a measure of exposure to the risks created by the provision of financial secrecy, of which IFF risks are a key part.

The top 10 jurisdictions to which South Africa is exposed are shown in Table 5, and these include several familiar to readers from the case studies and earlier in this section. As noted, Crown Dependencies and Overseas Territories of the UK (itself ranked No. 12) including Bermuda, Guernsey and Malta, play a major role in providing secrecy for South Africa, as they do globally.

Table 6: Top 10 jurisdictions supplying financial secrecy to South Africa (2018)

RANK IN 2018 BFSI 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

Source: Tax Justice Network (2018)

3.3 Summary

The aim of this section has been to provide the reader with a sense of how a range of different IFF and tax haven arrangements have worked in the South Africa context, a range of quantitative estimates of how much South Africa loses to IFFs of various types and, with several different approaches, to determine which tax havens are most relevant for such flows.

The case studies in Section 3.1 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. This variation strongly reinforces Khan et al's (2019) argument that country-level responses to the issue cannot rely on single indicators for policy and enforcement purposes, and must shift toward developing multi-level systems of indicators supported by qualitative analyses at sector- and commodity-level. Financial, resource extractive and commodities sectors appear to drive IFFs in South Africa, and policy responses should be tailored accordingly.

Different approaches to determining the relevance of specific tax havens for South Africa show that, as with scale indicators, results vary according to approach. From another perspective, however, this means that policymakers have a range of tools on which to draw in deciphering which flows tend to flow where. Important trading partners including the US, UK, China and India appear important for trade-related IFFs specifically. A number of jurisdictions, including Switzerland, Mauritius, Luxembourg and a range of British territories including Bermuda, Guernsey and Malta, appear important across several IFF types and likely deserve special attention from policymakers.

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 concerned policymaker's task an unenviably difficult one (Torslov, Wier and Zucman, 2020, Cobham and Jansky, 2020).

4. IFFS, TAX HAVENS AND INDUSTRIAL DEVELOPMENT IN SOUTH AFRICA

Gauging the impact of illicit financial flows and tax havens on industrial development is not an exercise for which clear data or methodologies appear readily available. As has been shown in previous sections, the overlapping and hidden nature of IFFs makes estimation of scale extremely difficult. This applies also 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 specific topic addressed in this paper appears distinctly underexplored. This section makes a start at developing a framework for understanding the likely impact of IFFs and tax havens on industrial development.

For these reasons, the approach in this section relies on extrapolation from existing work on other topics, and is therefore necessarily speculative. However, its core argument is straightforward and provides, arguably, a reasonable starting point in light of existing constraints. Simplified, this argument is as follows: 1. IFFs involving tax havens have taken place at a significant scale in the South African context; 2. These activities are likely to have impacted the country's industrial base via a number of channels; and 3. It is therefore important that government departments and agencies with the authority to act on these channels, including via industrial, competition and procurement policy among others, develop the capability to do so.

The five channels described in this section are as follows: macroeconomic impact on investment and demand; impact on linkages in the local production system; competitive distortions affecting downstream industries; draining of strategic developmental resources; and subversion of the state's capacity to promote industrial development and implement a national growth strategy.

4.1 Context: Decline and stagnation in South Africa's industrial base

Prior to an exploration of the channels via which IFFs and tax havens may affect the industrial base, a number of important contextual points help to clarify why this line of enquiry is worthwhile in the South African context. First, despite consistently strong profitability across sectors (Bosiu et al, 2017, p.17), domestic investment remains low relative to other upper middle-income developing countries.

This prolonged period of low fixed investment has coincided with important structural changes in the economy. Manufacturing has been a major casualty of this process.

The relative decline of South African manufacturing has led Rodrik (2006), and Andreoni and Tregenna (2018), more recently, to diagnose the country as suffering from "premature deindustrialisation". The importance of manufacturing for developing economies is well-established: the production of tradable goods, the development of high productivity capabilities, the provision of well-paying jobs and the potential for strong backward and forward linkages with other sectors are a few key points. Bell et al (2018, pp.8-9) provide evidence that manufacturing jobs paid significant higher average real wages and exhibited consistently higher labour productivity between 1994-2016. For these reasons, a strong and growing manufacturing sector is considered a critical prerequisite for structural transformation and inclusive economic growth in developing countries (Andreoni and Tregenna, 2018; Goga et al, 2019).

Rodrik notes that premature deindustrialisation and a range of other undesirable results have materialised in spite of the post-apartheid government’s commitment to a set of “sound” economic policy positions, including “cautious fiscal and monetary policies”, inflation targeting, and trade and capital account liberalisation. Ndikumana, Naidoo and Aboobaker’s (2020) recent case study on capital flight from South Africa note that one of the major arguments for post-apartheid capital account liberalisation was the notion that it would deliver a “democratic dividend” in the form of increased private investment from both domestic and international sources (pp.22-23); this investment has not materialised to the extent required.

4.2 The macroeconomic impact of IFFs and tax havens

In this subsection on the macroeconomic impact of illicit financial flows and tax havens, we are concerned primarily with investment and demand. Sufficient levels and the productive channelling of these resources are critical for industrial development, and the overseas shifting of profits clearly represents a drain on resources that could otherwise be invested or spent domestically in ways that support industrialisation.

South Africa’s chronic investment deficit, and the concurrent decline of manufacturing subsectors, has been addressed in some detail above. To highlight the importance of demand for industry, the results of Statistics South Africa’s surveys of production capacity utilisation from 2010-2020 are presented in Table 7. These clearly indicate that insufficient demand accounts for the overwhelming portion of under-utilisation in large manufacturing firms.²⁰ Establishing that illicit flows and tax haven capabilities affect levels of investment and demand thus establishes their relevance for South Africa’s industrial development.

Table 7: Under-utilisation of production capacity in large manufacturers, 2010-2020

YEAR	TOTAL UNDER-UTILISATION OF PRODUCTION CAPACITY (%)	REASONS FOR UNDER-UTILISATION				
		SHORTAGE OF:			INSUFFICIENT DEMAND	OTHER
		RAW MATERIALS	SKILLED LABOUR	SEMI/UNSKILLED LABOUR		
2010	20.0	2.3	1.0	0.2	12.0	4.5
2011	20.6	2.2	0.9	0.3	12.3	4.9
2012	18.1	2.0	1.3	0.2	10.6	4.1
2013	18.5	1.9	1.3	0.2	10.6	4.7
2014	19.2	1.9	1,3	0.2	11.7	4.1
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

Source: Statistical Release P3043, Statistics South Africa (2020).

²⁰ Turnover above R100 million per annum.

As stated in the introduction to this section, a measure of extrapolation is necessary for the development of an account of how IFFs and tax havens affect industrial development. Ajayi and Ndikumana's 2015 volume, *Capital flight from Africa: Causes, Effects and Policy Issues*, includes a number of contributions that discuss the impact of capital flight on investment and demand, and are well-suited for this purpose. Indeed, Fofack and Ndikumana (2015 p.130) remind us that capital flight is an important subset of illicit financial flows:

"The growing global concern about capital flight is also due to its illicit nature. Indeed, the bulk of the unrecorded outflows are illicit because they were acquired illegally, transferred abroad illegally, held abroad illegally, or all of the above."

The Weeks (2015) chapter on the macroeconomic impact of capital flight in Sub-Saharan Africa, while explicitly excluding South Africa from its empirical analysis, provides a number of relevant insights. His headline finding is that, through depleting domestic investment resources, capital flight had a major effect on growth from 1980 to 2010, and that curbing illicit outflows may be "the most important growth-generating policy available to governments of Sub-Saharan African countries".

Weeks notes that there is a common mainstream economics argument to the effect that capital flight is caused by "irresponsible" macroeconomic policy, and that governments' best course of action for reducing illicit flows would be to liberalise and deregulate capital markets so as to allow the notional "free market" to operate unimpeded. Rejecting this argument as reductive and essentially ideological, Weeks argues that retaining and increasing the resources available for both investment and consumption ought to be a key priority for stimulating development. Doing so may well require significant departure from conventional prescriptions, and overcoming a policy approach that is based on a "fear of capital flight" (p.257). Weeks suggests that governments explore capital flow regulations and exchange rate management to reduce the volatility that destabilises tradable sectors,²¹ as well as moving away from a single-minded focus on low inflation and deficit reduction toward an approach that addresses employment and structural transformation (p.257). This argument has strong resonance in the South African context (Bell et al, 2018 p.vi).

Fofack and Ndikumana (2015) address the impact of capital flight from a monetary policy perspective, finding evidence that capital flight has a negative effect on monetary policy targets, constraining investment and reducing output. Critically, their econometric analysis also finds that conventional monetary policy tools are ineffective in curbing capital flight, implying important weaknesses in its ability to drive demand and growth. The two key arguments for the purposes of this report are as follows (p.132): 1. Fofack and Ndikumana's empirical results indicate that the high interest rates prescribed by conventional monetary policy have not deterred capital flight, but have raised the cost of capital, constraining domestic investment and growth; and 2. Growing capital flight, irrespective of monetary policy stance, has depleted savings and has had a strong negative effect on domestic investment. From a policy perspective, they argue convincingly that strengthening regulations on financial transactions and increasing enforcement capabilities will be far more effective at curbing capital flight than maintaining high interest rates, and without the latter's negative effects on domestic investment, demand and development.

²¹ In doing so, he also raises an important political economy consideration, namely that responses to exchange rate and other measures will vary according to the respondent's material interests, not according to some disembodied notion of rationality: "...those holding highly liquid assets such as domestic currency or quickly negotiable domestic bonds prefer appreciating and stable nominal and real exchange rates. This especially would be the case for those asset holders planning a quick turnaround of their funds. The preferences of companies considering direct investments would be quite different, as in the obvious case of a company planning a new investment that would involve the export of a natural resource whose international price is specified in a hard currency" (p.243).

Ndikumana, Naidoo and Aboobaker (2020) make a similar point on capital flight and investment: “By draining domestic savings, capital flight erodes investable capital and slows capital accumulation in the source country” (p.79). They cite Forslund (2014), noting that the profit shifting strategies utilised by Lonmin result not only in tax revenue losses, but also in “wage avoidance” and “dividend avoidance”. When profits are underreported due to various IFF types, workers are placed in a weaker negotiating position in regard to their wages and shareholders are deprived of dividends they might otherwise have received. These two dynamics can combine. The case study on Samancor in Section 3.1 illustrates how the company’s worker share ownership scheme lost out on billions of rands in dividends, and how a significant number of workers there are likely to lose their jobs entirely, partially due to the weak position that illicit profit shifting has left Samancor in.

Reduced wages and dividends imply a negative impact on savings, investment and demand, and thus on industrial development. This channel is a plausible one, but clearly requires more systematic empirical investigation, particularly in the size and significance of the IFF impact.

However, as noted, the capital flight literature establishes an empirical link between capital flight and domestic investment. Since capital flight is a key component of IFFs, this helps to establish a clear link between IFFs, levels of domestic investment and South Africa’s industrial development. Further exploration and empirical work on the macroeconomic effects is clearly required; however, this channel it is worth taking seriously. As a country with a negative balance on primary income of almost R160 billion despite a positive net international investment position, South Africa can scarcely afford further outflows. These exacerbate an already challenging state of affairs, and may further entrench a seemingly structural misalignment between key areas of economic policy as high interest rates are maintained to attract the inflows required to cover outflows, but at the cost of raising the capital for domestic investment and thus industrial development.

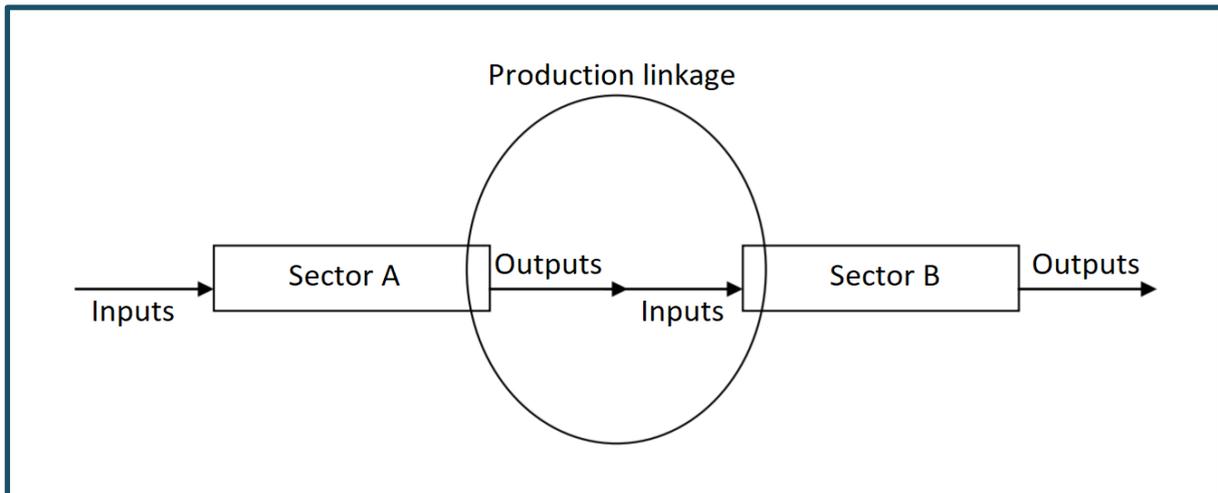
4.3 Profit shifting and the impact on linkages in the local production system

A strong theme emerging from the literature in Section 3 on IFFs and tax havens in the South African context is that illicit flows have been driven to a significant extent by large multinational firms in mining and other resource extractive industries (AU/ECA, 2015; Wier and Reynolds, 2018; Ndikumana and Boyce, 2019). The case studies presented in the section show that significant profit shifting activities appear to take place within other important sectors such as telecommunications. Both mining and telecommunications have tended to be relatively profitable and highly concentrated, and therefore ought to be leveraged to play a more active and strategic role in stimulating broader industrial development in other subsectors (Bosiu et al, 2017; Fotoyi, 2016).

This section argues that illicit outflows undermine their capacity to play this developmental role.

Fotoyi (2016) and Andreoni (2019) both draw on the “generalised linkage approach” associated with development economist Albert Hirschman in ways that help to illustrate how strategic sectors like mining and telecommunications can play an important developmental role, and why they ought to be made to do so. Hirschman described three main linkages: production linkages, consumption linkages and fiscal linkages. Production linkages describe an input-output relationship between two firms or sectors where, as shown in Figure 7, the output of Sector A is the input of Sector B. A linkage from A to B is described as a forward linkage, and B to A is a backward linkage. For example, a forward production linkage exists between Firm B that produces machine tools and Firm C that uses these tools to produce an automobile; a backward linkage exists between Firm B and Firm A, which produces inputs for the production of machine tools.

Figure 7: Stylised diagram of a production linkage



Source: Adapted by author from Romero and Hewings (2009).

Consumption linkages refer to the ways in which new incomes generated by a given productive enterprise are spent, the processes induced by the spending of these incomes and the developmental implications of these (Andreoni, 2019 p.23). If wages earned by workers employed in a given sector are spent largely on imported goods, this represents a consumption linkage that may have negative developmental outcomes. If profits generated by a given firm are ploughed back into buying equipment from a domestic supplier, this represents a consumption linkage that is more likely to have positive developmental results.

Fiscal linkages describe the potential for the state to appropriate a portion of incomes generated in a given sector via taxation, and to redirect revenues into other productive investments. This introduces a range of important political economy dynamics into the analysis. The nature of the relationship between the state and the owners of private enterprises, the balance of power between the two and indeed within the governing coalition, discourse on what the state should and shouldn't do in the economy, and the capacity of the state to tax and allocate resources productively are some of the highly political and overlapping sites of contestation on this front. An understanding of the incentives and the balance of power underlying a given system of rents allocation, distribution and capture is considered critical from a generalised linkage perspective (Makhaya and Roberts, 2013; Andreoni, 2019).

Adding a fourth linkage to Hirschman's framework, Andreoni (2019) introduces the concept of "technological" linkages, describing the "direct and indirect transfer of technological capabilities from both within and across sectoral value chains" (p.25). In essence, this describes the ways in which interactions between firms act as channels for learning and the development of new capabilities. As with consumption and fiscal linkages, the nature and quality of technological linkages may have positive outcomes ("opening up new productive opportunities") or negative ones ("slowing/closing down technology adoption") (Hirschman, 1977, quoted in Andreoni, 2019 p.24).

Andreoni proposes that an understanding of the system of linkages existing in a given economy – referred to as the "local production system" (LPS) – is critical for driving industrial development. Applying this approach to the question of illicit flows in the mining sector, Fotoyi (2016) illustrates that backward and forward production linkages between mining and manufacturing subsectors, measured by mining industry demand for the outputs of domestic manufacturing and vice versa, has weakened significantly in the post-apartheid period (pp.8-9). Fotoyi argues further that a weakened industrial sector is unlikely to be able to benefit from potential consumption linkages arising from mining

incomes, and that while fiscal linkages exist and the state is able to collect resource rents from extractive industries, these have not as yet been applied in ways that have strengthened the industrial base. In terms of production and technological linkages, Zalk's (2017) research provides a stark account of the extent to which key technical capabilities and manufacturing linkages were permanently destroyed in the post-apartheid restructuring of the steel and engineering industries. Processes of deconglomeration in mining and other heavy industries, similarly "unguided by national strategies and performance requirements" (2017 p.3), are likely to have precipitated similar destruction of productive capacity in the South African LPS.

A number of other authors have pointed to how mining and other heavy industries, including steel and chemicals, have benefited a great deal from direct and indirect state support and investment both before and after 1994. This support, referred to by Kaplan (2007) as a "hidden" industrial policy, was given seemingly without key conditionalities and appears to have generated few benefits relative to the costs involved, and weak linkages with the rest of the economy (Roberts, 2007; Roberts and Rustomjee, 2009; Ashman et al, 2011; Zalk, 2014; Bell et al, 2018; Mondliwa and Roberts, 2019). That mining and other capital-intensive industries appear to have driven capital flight and other illicit outflows from South Africa in the post-apartheid period makes the outcomes discussed above all the more damaging.

Naturally, there is no guarantee that curbing further illicit outflows from key sectors and recovering resources that have been offshored will automatically result in transformative developmental outcomes, or even be invested in productive activity at all. A great deal depends on the challenges and opportunities arising in a highly uncertain international environment; the state's capacity to allocate and manage rents in service of developmental goals, and successfully negotiate a joint growth strategy with private enterprise; and on the potential for stronger forward and backward linkages between profitable lead firms in concentrated sectors and the rest of the economy, especially manufacturing subsectors. However, it is clear that profit shifting through misinvoicing, transfer pricing and other illicit strategies disrupts and undermines the diversification, domestic supply chain integration and upgrading required to improve domestic value addition and build a robust local production system (Andreoni and Tregenna, 2018 pp.42-43). Further, government ought to recognise that 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. Stricter local content requirements may therefore have a role to play in reducing IFFs as well as in promoting local production.

Stemming illicit outflows and recovering shifted profits, at the very least, can increase the base of resources available for productive investment and industrial development. Further, since illicit outflows serve to extract and protect rents associated with market dominance by artificially lowering profits (by as much as 80%, according to Wier and Reynolds, 2018), reducing these outflows may help make productive fiscal linkages more likely.

4.4 Competitive distortions caused by profit shifting outflows and illicit inflows

Appropriate alignment between industrial, trade, regulatory and competition policy are important for inclusive and robust industrial development in any setting (Banda et al, 2015 p.3). In the South African context, where high levels of concentration in a number of key industries (including mining, energy, telecoms and financial services) have been identified as having a negative impact on downstream firms in particular, and industrial development in general (Goga et al, 2019). Bell et al (2018 p.22) note further that, by some measures, market concentration is getting worse: "data on concentration levels within manufacturing indicates that the proportion of subsectors in which the biggest five firms held 70%+ market share has increased from 16 subsectors in 2008 to 22 of the 80 subsectors in 2014".

Illicit financial flows – both inbound and outbound – are increasingly considered to provide an unfair competitive advantage to the firms involved in such flows, especially since the available evidence suggests that these activities are mainly undertaken by the largest firms.

Illicit inflows, in addition to a range of other harmful effects, may allow firms to circumvent regulations and taxation aimed at ensuring fair competition as well as allowing these firms to benefit unfairly from investment incentives in some cases (Cobham and Jansky, 2020 p.67). Illicit outflows, especially those allowing firms to underreport their profits and pay less tax, enable multinational groups in particular to gain a competitive edge over rivals not involved in such activities.

Thus, 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. In addition, a 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. The largest corporations and multinational groups appear to benefit most, including in the South African context. Wier and Reynolds drive this point home in their study of profit shifting in South Africa: “Inequality in profit shifting... shows how profit shifting creates competitive distortions by granting an uneven tax benefit to the largest of firms. ... [O]ur results imply that tax havens create competitive distortions as larger firms benefit more. ... A concentrated tax benefit given to a few large firms distorts competition and as a result may create an efficiency loss” (2018 pp.1, 24 and abstract).

Also emphasising the point Wier and Reynolds make about inequality in profit shifting, Cobham and Gibson make a direct link to the services and capabilities that tax havens provide to the most powerful MNCs: “The crimes that tax haven secrecy enables give rise, therefore, to greater economic inequality and to less well functioning and competitive markets, and to greater political inequality through the corruption of systems of democratic representation” (2016 p.14).

Fundamentally, IFFs and access to tax haven capabilities rewards the largest and least compliant firms with unearned and systematic competitive advantages over their smaller rivals. Note that Wier and Reynolds’ finding that South African-based subsidiaries of tax haven-based parent firms appear to underreport their profits by as much as 80%, thereby avoiding taxation on an overwhelming majority of profits generated in the country (2018). Another aspect of how profit shifting impacts industry in South Africa is that new entrants may be discouraged from investing and competing in industries that are made to appear less profitable than they actually are.

Having made clear that profit shifting should be seen as fundamentally anti-competitive in the South African context, Wier and Reynolds also make the important observation that competition authorities elsewhere have already begun to intervene in a number of large companies’ tax shifting arrangements on this basis (2018, p.1). The EU’s competition authorities have investigated a number of major MNCs, including [IKEA](#), Amazon, [McDonald’s](#) and [Fiat](#), fining a number of them (European Commission, 2017). Importantly, many of these investigations have involved tax havens and secrecy jurisdictions with which South Africa has strong links, including [Ireland](#), [Belgium](#), the Netherlands and [Luxembourg](#), and have uncovered benefits given to a large number of MNCs amounting to hundreds of millions of euros in tax benefits.²²

Critically, as Kiel’s (2020) article on profit shifting by [Microsoft](#) through the strategic relocation and transfer pricing of intangible assets to a tax haven-based subsidiary (highly valuable intellectual property in this case) shows, state capacity to discipline and regulate powerful MNCs is an important

²² “In August 2016, the Commission concluded that Ireland granted undue tax benefits of up to €13 billion to Apple. In October 2017, the Commission concluded that Luxembourg granted undue tax benefits of up to €250 million to Amazon.” ([European Commission](#), 2017).

factor in reducing illicit flows to tax havens. Kiel's account also powerfully demonstrates how skilful MNCs like Microsoft are in their lobbying efforts, effectively insulating themselves from accountability. Both Sharife and Bracking (2014) and Ndikumana et al have provided some insight into what the latter refer to as "regulatory capture" by dominant firms and industry associations in the South African context (2020 p.33), and this way well hamper efforts to reduce IFFs and intervene in tax haven arrangements that drain resources from the country.

In sum, while clear evidence has recently emerged that IFFs and tax havens produce anti-competitive outcomes, further investigation is required into the exact scale of these effects, and which sectors and industries are most affected. As shown in the previous section, large illicit outflows from key sectors that could be investing resources and capacity in building linkages with the rest of the industrial base are relevant for South Africa's broader industrial development, especially manufacturing. Even if the majority of the anti-competitive effects of IFFs are found to be in non-manufacturing subsectors, there could be similarly relevant effects on manufacturing. A critical assessment of the capacity of the Competition Commission and other relevant agencies to pursue investigations into the scale and nature of the anti-competitive effects of IFFs and tax haven arrangements in South Africa may therefore be a useful point of departure for efforts to reduce such activities.

4.5 IFFs and tax havens as leakages of strategic developmental resources

This section considers the effect that IFFs and tax havens may have on the industrial base through the draining away of resources that could otherwise provide much-needed investment in productive capacity. In contrast to section 4.2, which focused on IFFs and investment at a macro level, this section focuses on potential leakages of resources from the Industrial Development Corporation (IDC) and the Public Investment Corporation (PIC). The former is explicitly mandated with financing investment in industrial development, and the latter, as the largest asset manager on the continent, has a massive base of resources that could be directed more strategically in expanding the industrial base.

Andreoni and Tregenna's (2018) case study section, which includes a number of key examples showing the importance of the industrial finance component of industrial policy in Brazil, China and Malaysia, makes clear how pivotal a role strategic and well-coordinated industrial finance can play in developing countries. These examples indicate that industrial financing ought to be large in scale, long-term (or "patient") in outlook, tailored to specific sectoral needs and dynamics, guided by a diversification strategy, and targeted at upgrading technological, innovation, and other high value-adding capabilities. Andreoni and Tregenna also note that industrial policy in general should aim at fostering a robust local production system. The impact of IFFs on the linkages that comprise the local production system have already been addressed in Section 4.3.

The literature and case studies discussed in Section 3 illustrate the ways in which IFFs and tax havens drain resources from firms, deprive shareholders of dividends, and the country of investment generally. It is argued in this section that the IDC and the PIC are both unnecessarily exposed to IFFs due to the profile of their investments, and that they ought both to take steps to minimise these risks.

As has been noted in Section 4.3, there is no guarantee that resources recovered from illicit extraction or prevented from leaving the country in the first place will be invested in productive activity. However, it is proposed that resources drained from firms in which the IDC and PIC are invested should be considered especially harmful due to the strategic importance of these institutions for industrial development in South Africa.

Previous sections of this report also indicate that the IDC's lending and investment profile is likely to expose the institution and its precious developmental resources to IFFs and tax haven arrangements to an unnecessary degree. To recap, the 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. Simply put, by diversifying its funding and redirecting critical resources towards downstream and especially manufacturing industries, the IDC's funding would be both better able to support structural transformation and less exposed to leakages through profit shifting and other IFF and tax haven activities.

While the PIC, which manages over R1,8 trillion in assets for the [Government Employees Pension Fund \(GEPF\)](#) alone, doesn't have an industrial development mandate as such, its [website](#) explains that it "seeks to generate social returns by investing in projects that ensure inclusive growth". A strong argument could be made that this should entail a stronger industrial development and structural transformation mandate for the PIC, but this is not developed further here. The specific point argued here is that post-[Commission of Inquiry](#) changes to the way that the PIC operates should include provisions to protect against exposure to illicit flow and tax havens.

The recent Commission of Inquiry uncovered a range of improprieties, and provided a number of case studies where investments resulted in massive losses. One of these investments, into [Erin Energy \(Bloomberg 2019\)](#), resulted in a US\$333 million loss for the PIC. For the purposes of this report, it is noteworthy that the firm appears to have had clear links with tax havens, including through a loan from a Mauritian bank (guaranteed by the PIC) and a registration in the Cayman Islands. Had these links disqualified Erin Energy from receiving investment from state entities, these losses would likely have been avoided.

A further brief exploration of the PIC's investments indicate at least one other case, about which no illegality is implied, that raises a concern around potential IFFs. Smile Telecoms Holdings Ltd (Smile), which operates mobile broadband networks in Nigeria, Tanzania, and the Democratic Republic of Congo, was founded in 2007. From the volume of its submissions to the Independent Communications Authority of South Africa (ICASA) on various regulatory matters, the company's managerial, legal and other capabilities are based in South Africa. However, it is incorporated in Mauritius, and is majority-owned by [Al Nahla Technologies](#), a subsidiary of the Al Nahla Group. It appears from the online profiles of a number of its board members that Al Nahla Technologies is headquartered in the [Cayman Islands](#). The Al Nahla Group's CEO also serves as Smile's Chief Financial Officer and Vice Chairperson, and appears to have links with both the [Cayman Islands](#) and [Malta](#).

According to a [2015 press statement](#) and [reporting](#) (Shu, 2015) at the time, the company raised over US\$365 million to finance the expansion of its 4G network in Nigeria, Tanzania and Uganda. This included US\$50 million of equity from the PIC, and a US\$315 million "multi-tranche, multijurisdictional debt facility" from the Development Bank of South Africa (DBSA) and the IDC, among a number of other partners including the African Export-Import Bank and Standard Chartered Bank. The PIC's 2018 [Unlisted Investment Schedule](#) reflects US\$100 million (R1,14 billion) invested in Smile, implying a doubling of the 2015 investment. The [annexures](#) to the GEPF's 2018 Annual Financial Statements describe an equity stake of R532 million in Smile, as well as a direct loan made to Smile of R452 million. Worryingly, however, the GEPF's 2019 [Annual Report](#) shows an impairment of R542 million for the GEPF's investment in Smile, but no detail is given of what motivated the impairment.²³ No further detail on the apparent joint investment in Smile by the PIC, IDC and DBSA – including the nature or size of the DBSA and IDC investments – appears to be readily available.

Whether or not any illegal, illicit, or other harmful outcomes have resulted from the PIC, DBSA and IDC's joint investment in Smile Telecoms, at least two issues appear worth considering. First, the

investment appears to be potentially exposed to at least three tax havens – Mauritius, where Smile is incorporated, and Malta and the Cayman Islands, where its majority owners appear to have extensive links. Second, and related, the lack of information about these investments of public resources, and about potential losses, is concerning in and of itself.

To revisit a quote from the AU/ECA High Level Panel on Illicit Financial Flows from Africa, “the greater the transparency of the partner jurisdiction in a given bilateral transaction, the lower will be the risk of something being hidden” (AU/ECA, 2015 p.106). 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. Whether this is fully rectifiable in the context of an extremely large asset manager like the PIC is debatable, but at the very least a review of the tax haven and IFF exposure of key public institutions such as the PIC, IDC and DBSA ought to be undertaken. Such a review may well find that an explicit ban on state finance being provided to companies with tax haven networks is in order.

4.6 IFFs, tax havens and the role of the state in industrial development

The importance of the state in driving industrialisation, especially “late industrialisation” in developing countries, is well-established. The argument put forward in this section is that IFFs and access to tax haven capabilities are likely to undermine the state’s capacity to play the coordinating and managing role in relation to capital that has been so critical in successful cases of late industrialisation.

For a wide array of reasons, the South African state has largely failed to assert itself vis-à-vis the most powerful fractions of capital in the post-apartheid era. Without dismissing the importance of the achievements of some key redistributive and poverty-reducing measures,²⁴ structural transformation of the South African economy is still required to drive inclusive economic growth. The various forms of support that dominant upstream industries have been able to extract from the state – tax breaks, industrial finance, discounted electricity – have been secured largely without conditionalities linked to promoting the diversification and structural transformation of the industrial sector (Zalk 2014, p.333).

The history of late industrialisation suggests that such conditionalities and, critically, the capacity to enforce them, disciplining and withdrawing support from firms that fail to meet agreed standards, are both important factors in successful late industrialisation (Chang 1993, p.149). Mondliwa and Roberts (2019, p.12) argue that the post-apartheid state’s engagement with powerful resource-based industries has essentially relied on exposing them to international competition via liberalisation. These dynamics provide a strong indication of the state’s relative weakness.²⁵

In previous sections, it was established that the available evidence as well as a number of prominent case studies indicate that these same upstream, highly-concentrated and capital-intensive sectors have been at the heart of driving IFFs and accessing tax haven capabilities in the post-apartheid era. This adds a number of concerns to the discussion of the relative weakness of the post-apartheid state.

The involvement of South African firms in IFFs and tax havens clearly relies on, and facilitates, the violation of laws, regulations and principles that the state is mandated to uphold. Illicit outflows facilitate the avoidance and evasion of tax, provide an outlet for the proceeds of crime, as well as for the proceeds of corruption, receipts of which are often safer offshore. Illicit inflows can generate unfair benefits for powerful firms against their competitors, dodge tariff and duties, undermine

²⁴ See Ndikumana et al (2020 p.79) for an important and concise summary of the literature on these redistributive policies.

²⁵ This weakness is further confirmed by Ashman et al’s (2011) and Ndikumana et al’s (2020) analyses of tax amnesties on funds held offshore illicitly by South African residents.

industries vulnerable to cheap competition from smuggled goods,²⁶ and be used directly to fund political activities, bribe officials and pay kickbacks. The potential for illicit flows to play a role in corrupting, subverting and lobbying the state and its various agents is widely recognised; indeed, Kar and Freitas (2012)²⁷ suggest that bribery, kickbacks, and the proceeds of corruption have been a “primary driver” of illicit flows in some regions.

Besides subverting and breaking laws, regulations and principles, it is argued in this report that IFFs and tax haven activities are similarly likely to subvert institutions and agencies that are empowered to curb them. Naturally, no empirical evidence of this is presented in this report; instead, this argument turns on a theoretical point drawn from Mushtaq Khan’s (2000) work on rents, rent-seeking and the political economy of institutions.

Khan defines rents simply as “incomes which are above normal in some sense” (2000 p.5). As seen in previous sections, IFFs and tax havens create new incomes that would not exist and enlarges existing income streams that would be smaller without them. The arguments made in previous sections allow us to define the resources lost to IFFs and tax havens as **growth-constraining rents** in the South African context.²⁸ The estimates of the scale of IFFs from South Africa and the case studies presented above illustrate clearly that the size of the rents associated with IFFs are large – Wier and Reynolds (2018) estimated under-reporting of 80% of foreign-owned firms’ profits, and Ndikumana et al (2020) estimated US\$327 billion of capital flight from South Africa between 1970-2017.

If we accept that “institutional change almost always involves the creation or destruction of rents” (Khan, 2000 p.3), we ought to conclude that the beneficiaries of IFFs and tax haven flows will expend significant effort and resources to prevent the relevant South African institutions from changing in ways that destroy the large rents associated with IFFs. 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 the institutions and agencies mandated with reducing IFFs.

The great success of the dominant upstream industries in securing support and forbearance from the state throughout the post-apartheid period suggests that they retain significant political influence and capabilities in regard to lobbying for support and against regulation and reduction of rents. In the event that the state launches major initiatives to curb IFFs and access to tax havens, the analysis above suggests that these are likely to be met with significant resistance from the major beneficiaries of such activities, aimed at further reducing the state’s ability to regulate and discipline capital.

4.7 Summary

The argument set out at the beginning of this section was that IFFs and involvement with tax havens appears to be happening on a large scale in South Africa, that this is likely to be having a negative effect on the country’s industrialisation efforts, and that the relevant authorities ought to intervene to protect the industrial base. Five channels through which this effect is likely to take place have been presented: a negative impact on levels of investment and demand at a macroeconomic level; the undermining of linkages in the local production system; anti-competitive distortions placing small, compliant, downstream and domestic firms at a systematic disadvantage; leakages from critical developmental sources of finance; and the undermining of the state’s capacity to regulate and discipline capital in accordance with national developmental strategies.

²⁶ The labour-intensive clothing sector, among others, may be especially vulnerable to competition from smuggled goods.

²⁷ Cited in Cobham and Jansky 2020, p.67.

²⁸ Khan argues that some rents can be growth-promoting, and so it is important to make this distinction clear.

5. CURBING IFFS AND EXPOSURE TO TAX HAVENS: CURRENT MEASURES

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 (SARS) prominent among these, there is a great deal to be positive about and a strong foundation on which to build further interventions specifically aimed at protecting the industrial base.

While not a member of the OECD, South Africa has been a member of the joint OECD/G20 [Base Erosion and Profit Shifting](#) initiative from its inception in 2013, and has successfully aligned domestic policy with a number of the minimum standards and best practices agreed on in the initiative's fifteen actions (OECD, 2019b).²⁹ This includes being a signatory to the 2017 [Multilateral Convention](#), which will streamline the renegotiation of bilateral tax treaties to prevent "treaty shopping" (as discussed in the case study on ABF/Illovo) and other profit shifting arrangements. Indeed, some BEPS Actions were already in place in South Africa prior to the launch of the OECD/G20 initiative, including rules on transfer pricing, exchange of tax information, and limits on excessive offshore interest payments (National Treasury, 2014).³⁰ South Africa is also an active participant in the OECD's Forum on Tax Administration and the Joint International Tax Shelter Information and Collaboration Network.

In terms of the "ABC" of tax transparency discussed in section 2.3,³¹ South Africa performs reasonably well. As Abugre et al note, South Africa "is the country in Africa most actively engaged in the automatic exchange of information... it has activated exchange relationships with 9 out of the top 10 countries contributing to [its] vulnerability" (2019 p.75). On beneficial ownership, the Financial Intelligence Centre Act No. 1 of 2017 (FICA) was amended in 2017 to include a definition for what a beneficial owner is and to create obligations for banks, financial intermediaries and other "accountable institutions" to identify and verify the beneficial owners of entities they provide services to (Parliament, 2017; Corruption Watch, 2017). Regulations on country-by-country reporting for MNCs were issued in 2016 as amendments to the Tax Administration Act, following the signing of the Multilateral Competent Authority Agreement, which facilitates the automatic exchange of CBC reports between signatories (Thiart and Nel, 2018).

There has also been important progress in building institutional capacity and inter-departmental coordination aimed at IFFs and tax haven exposure. Submissions to Parliament's Standing Committee on Finance by SARS (2014) and the National Treasury (2014) indicate a long-standing appreciation of the importance of protecting the tax base from IFFs and tax haven exposure. SARS (2017 response to the Panama Papers leaks indicate its willingness to take the initiative to match leaked information on offshore entities with South African taxpayers (1 666 residents were linked to 620 offshore companies), investigate the nature of the offshore structures used by these taxpayers, and to pursue enforcement efforts. The establishment of an Inter-Agency Working Group on Illicit Financial Flows (IAWG) is another positive development. The IAWG includes SARS, SARB, the Financial Intelligence Centre (FIC), the National Prosecuting Authority (NPA) and a number of other regulatory and law enforcement agencies, and reports having recovered around R400 million in IFFs between 2018-2019, with billions more targeted in pending cases ([IAWG](#), 2020; [Ensor](#), 2020). The SARB's Financial

²⁹ A helpful summary by Deloitte can be accessed [here](#).

³⁰ See Kumar (2014 ch.2.3, 3) and Chizokho (2018) for helpful reviews of the evolution of South Africa tax policy in relation to illicit flows.

³¹ A. Automatic exchange of tax data between countries; B. Public registers indicating the beneficial ownership of companies, trusts and other entities; and C. Public country-by-country reporting by multinationals.

Surveillance Department reports IFFs as a “strategic focus area” and describe a number of new initiatives to develop sophisticated, data-driven tools to pro-actively “detect, deter and disrupt” illicit cross-border financial flows (SARB, 2016). Lastly, the National Treasury’s 2020-2025 Strategic Plan makes the development of a “national policy approach” to prevent and recover resources lost to IFFs one of its key priorities (2020 p.40).

The case of the SARS Large Business Centre (LBC) illustrates that building capacity and coordination to tackle IFFs and tax havens has not been an entirely smooth process. The LBC was established in 2004 to deal with large corporations and ultra-wealthy individuals, with dedicated units for dealing with “aggressive tax planning, transfer pricing, offshore arrangements and the use of trusts” (Kumar 2014, p.56). The LBC developed highly-specialised capabilities and established a reputation for being a highly effective revenue generator, contributing around a third of total annual revenue at its height, with its transfer pricing unit alone generating billions of rands a year (Umraw, 2018). However, from 2014 onward the LBC’s capabilities were fragmented and split as part of a SARS restructuring process so catastrophic for the organisation’s effectiveness that it has since been subject to a judicial Commission of Inquiry, which described it as having been “eviscerated” (Nugent, 2018 p.25). The LBC, following the recommendations of the Commission of Inquiry, has since been re-established by SARS in more or less its original form (SARS, 2019). However, the loss of several highly-skilled senior staff and a great deal of political contestation have left their mark on the organisation, and illustrate the difficulty of building effective institutions and protecting them against interference by the powerful interests they are mandated to regulate (Nugent, 2018 p.91; Umraw, 2018).

5.1 Outstanding issues in current government responses

While it is clear that significant progress has been made with the legislation, institutional capacity and coordination required to address IFFs and tax haven exposure, a number of issues remain. First, and unsurprisingly given the scale of the challenges involved, capacity building within and coordination between government agencies needs further development. Capacity issues are noted in presentations to Parliament by SARS, the FIC, the NPA and the SARB. Without adequate capacity and effective coordination, legislative and policy progress is unlikely to result in implementation or successful reduction in IFFs; for example, Wier’s (2018) study illustrates clearly that legislation without effective enforcement does not deliver sustained reductions in tax-motivated transfer mispricing (p.19).

Second, public engagement and disclosure appears to be a significant shortcoming in government’s current approach. A key element of TJN’s ABC of tax transparency is that there ought to be public disclosure of country-by-country reports for MNCs, and publicly-accessible registers indicating the beneficial owners of companies, trusts and other entities. There appear, at present, to be no plans or provisions for the publication of this kind of information in South Africa.

Third, there are a number of important gaps and loopholes in the existing framework for dealing with IFFs and tax havens. For example, the IAWG’s presentation to parliament reflects that its definition of IFFs and case selection criteria are based on illegality alone, rather than the broader definition proposed in this paper that, following Khan et al (2019), defines IFFs by harm instead of illegality (IAWG 2020, p.9). While there may be reasonable grounds for an inter-departmental structure made up largely of law enforcement agencies to focus only on the illegal component of IFFs, previous sections have illustrated clearly that this approach excludes a range of important and harmful IFFs. Another example is evident in Thiart and Nel (2018), who point out significant ambiguities in South Africa’s country-by-country reporting regulations, resulting in a lack of clarity on questions as fundamental as which firms qualify as MNCs and are thus bound by the regulations. As a final example, the NPA reports that “there is no electronic, searchable, centralised system” for beneficial ownership

information, and suggests that government's exchange control regime is a source of "systemic weakness" in regard to IFFs (2017).

Fourth, it appears that even when government agencies obtain clear evidence of residents' involvement in profit shifting (as in the SARS Panama Papers investigation), audits and criminal investigations have been put on hold to allow those with undisclosed offshore assets to regularise their affairs through voluntary disclosure tax amnesty programmes (SARS, 2017). The academic literature on capital flight in South Africa suggests that it is extremely difficult to establish whether or not such there is a compelling economic case for such tax amnesties, and notes the potential political costs of dealing so lightly with illicit offshore wealth accumulated by powerful corporations and the wealthiest individuals (Ashman et al, 2011; Ndikumana et al, 2020 section 7). Further, the international evidence suggests that enforcement efforts are effective at reducing tax evasion, Having revealed offshore assets not declared in voluntary disclosure programmes, this resulted in sustained rises in taxes collected from those previously evading them (Johannesen et al, 2018; Alstadtsaeter et al, 2019). In light of this, it appears that SARS may have been overly generous in not pursuing audits and criminal investigations more expeditiously following its Panama Papers investigation.

Fifth, as shown by Wier (2018) and Wier and Reynolds (2018), a great deal of sophisticated analysis and even enforcement can be achieved through use of the SARS/National Treasury firm-level databases on company income tax, employee income tax, value-added tax and customs records.³² In particular, Wier and Reynolds note that, from 2013, firms operating in South Africa that are owned by a foreign parent (ownership stake above 70%), have been required to disclose that fact as well as the location of their parent firm (2018 p.6). This allows Wier and Reynolds to identify firms operating in South Africa that are owned by a parent firm in a tax haven. However, this data does not allow authorities or researchers to identify or locate other foreign affiliates of firms operating in South Africa; therefore, "any profit shifting via sister firms and from a South African parent to a foreign subsidiary is disregarded" (2018 p.7).

The implication is that, with some minor technical adjustments to the data that firms are required to submit and to the SARS/National Treasury database, the data available for research and enforcement efforts related to sophisticated IFFs such as those taking place through transfer mispricing could be hugely improved at a relatively small cost. Wier (2018) notes that it took him about two weeks to set up an automatic flagging system for transfer mispricing, and in his words: "The cost of doing this is in the thousands of dollars while the potential tax gain is in the tens of millions of dollars" (2018 p3). Expanding the SARS/National Treasury database to include more detailed information on foreign affiliates of firms operating in South Africa could massively expand the returns to these types of data-driven IFF detection techniques.

Last, and by way of introduction to the next section, an important shortcoming in existing responses to IFFs and tax havens in the South Africa context is the absence of an industrial development perspective on these challenges, and of an industrial policy response.

³² Described in Pieterse et al's (2016) extremely helpful introductory article.

6. RECOMMENDATIONS ON INDUSTRIAL POLICY MEASURES

This section presents a number of policy proposals that the DTIC and its various agencies could consider developing as part of joint efforts to reduce illicit flows and tax haven exposure. It also emphasises the need for co-ordination and policy alignment on this issue, and highlights complementarities between the co-ordination needed to reduce IFFs and tax haven exposure, and what is needed to promote industrial development more effectively. Last, areas for further research aimed at supporting policy are discussed.

Section 4 of this paper sought to establish that there are a number of channels through which IFFs and tax havens are likely to have a negative impact on South Africa's industrial base, and that the DTIC and other relevant departments ought therefore to intervene to protect it. Industrial policy interventions, driven by the imperatives to protect the industrial base and promote structural transformation, could play a powerful role in disincentivising IFF and tax haven activities, and channelling state support of various kinds and precious resources toward firms uninvolved in these. Since the latter tend to be smaller and domestically-owned, such measures could also support other developmental objectives. This subsection sets out a number of interventions aimed at integrating policies aimed at reducing IFFs and tax haven exposure with those aimed at promoting structural transformation.

Andreoni and Tregenna (2018) provide a helpful framework for organising these interventions. They propose five key policy areas relevant for the challenges faced by middle-income countries as they seek to promote structural transformation and prevent premature deindustrialisation (2018 p.22): 1. Production, technological and organisational capabilities building; 2. Innovation and technological change; 3. Global value chain integration, LPS development and industrial restructuring; 4. Demand and trade; and 5. Industrial finance.

6.1 Information, platform and methodology to support industrial policy measures

For industrial policy to accommodate measures aimed at protecting the industrial base from IFFs and tax havens, relevant agencies need to have access to a great deal of specific information about which sectors, firms, individuals and overseas jurisdictions may present a plausible risk of exposure. To provide this access, at least three elements are required: provisions for obtaining the relevant information; an institution with the capacity to collate and provide a platform for this information; and a methodology for gauging risk exposure.

As discussed, South Africa already requires MNCs to submit country-by-country reports and certain information on foreign affiliates, and there are provisions in the law that enable the collection of information on beneficial ownership. Gauging risk exposure, also discussed in previous sections, is a fairly well-established albeit recent methodological development, and there appear to be no inherent barriers to reformulating and applying the methodologies used in the FSI, CTHI and the AU/ECA Report to multinational groups, firms and individuals.

It is recommended that the [Companies and Intellectual Property Commission](#) (CIPC), which is already tasked with "monitoring compliance with and contraventions of financial reporting standards" and the maintenance of a number of companies registers, obtain information through companies annual filing on possible exposure to IFFs and tax havens. This recommendation would see companies registered with the CIPC being required to disclose their full 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. The CIPC could also help to operationalise the definition of beneficial ownership in the recently amended Financial Intelligence Centre Act by requiring full disclosure on the identities and locations of the beneficial owners of companies and

other entities registered in South Africa. Co-ordination with the relevant state institutions working in this area would be required in order to develop a methodology for flagging companies and individuals who present IFF or tax haven exposure risks.

As it already has the infrastructure for publishing electronic, publicly-accessible and searchable companies registers, it would appear feasible for the CIPC to collate and publish this information, which could be used by policymakers to establish IFF and tax haven exposure risk. This type of resource would be an indispensable asset for the industrial policy measures described below. The collation of the above information could also enhance efforts at curbing IFFs more broadly, which Khan et al (2019) argue must involve the development of a multi-tiered system of indicators, analysis and benchmarks, all of which require basic information which is currently very difficult to access.³³ It would also have the benefit of providing public access to information on IFF and tax haven exposure, potentially aiding workers, shareholders and civil society organisations in their efforts to hold powerful corporations and individuals to their social obligations.

6.2 Industrial policy measures

Production, technological and organisational capabilities building, and innovation and technological change are recognised as being core elements of industrial policy (Andreoni and Tregenna, 2018). To ensure that policy initiatives in these areas are not compromised by IFFs, it is recommended that eligibility criteria and conditionalities ought to be introduced to ensure that the firms that benefit from state support for R&D, joint ventures with public universities and research institutes, and capabilities and technological upgrading, are required to disclose their full corporate structure, foreign affiliates and beneficial owners. The CIPC registration process described above would enable this detection and reduce the compliance costs. These criteria would aim to fully exclude firms with tax haven affiliates and prior involvement with IFFs from state support.

Other industrial policy support instruments include competition policy, FDI incentives, and Special Economic Zones (SEZs). It is recommended that greater space is created through the Competition Act No. 89 of 1998 for competition authorities to investigate and intervene in IFF- and tax haven-related competitive distortions, particularly where off-shore companies based in tax havens are involved.

It is further recommended that when market inquiries are undertaken, industries that have been identified as having high potential for IFFs include assessments of the nature and scale of the competitive distortions generated by transfer pricing, misinvoicing, and other forms of profit shifting. If an adverse effect on competition is identified, the Competition Amendment Act empowers the Competition Commission to “take action to remedy, mitigate or prevent the adverse effect on competition”, make recommendations to any Minister, regulatory authority or affected firm in respect of such remedies, and requires that it publish its findings in the Government Gazette (Parliament, 2019 section 43D, E).³⁴ 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.

FDI incentives and SEZs may provide another policy lever with which to reduce South Africa’s IFF and tax haven exposure. The DTIC’s Export Marketing and Investment Assistance scheme, Foreign Investment Grant, and the wide range of benefits available to firms operating in SEZs (including a 13% reduction on corporate income tax, expanded employment tax incentives and reduced customs,

³³ As reflected in comments by the NPA, discussed in the previous section.

³⁴ According to Naidu and Tzarevski (2019), the Competition Amendment Act has also “lowered the threshold for intervention” by competition authorities in important ways, perhaps expanding the scope for a relatively speculative inquiry such as the one proposed here.

excise and value-added tax (VAT) charges) could all be reformulated for this purpose (DTIC, 2018b; SARS, 2020). As with the recommendation above, these could be configured to exclude firms with tax haven affiliates and involvement with IFF transactions entirely.

A further industrial policy area relates to demand and trade, with procurement policy key among these. It is recommended that the reformulation of public procurement policy should aim to provide the state with an important policy lever in reducing IFF and tax haven exposure. New legislation on public procurement is being promulgated, and this may present an opportunity to ensure that public funds behind this powerful source of demand are insulated from IFF and tax haven exposure. 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 these arrangements, and could channel demand toward compliant firms. Disqualifying criteria could include tax haven affiliates, corporate structures that facilitate treaty shopping, a record of transfer pricing in violation of the arm's length principles, underreported profits in relation to activity, prior involvement in IFFs, failure to disclose information to the CIPC, and a range of other indicators of exposure risk. As with previous proposals, effective implementation of such an intervention would depend on the development of a centralised and searchable electronic database from which an indication of a tendering firm's IFF and tax haven exposure risk could be derived, as has been proposed in Section 6.1.

It is further recommended that trade-related industrial policy measures aimed at helping firms tap into external demand could also be reformulated to insulate state resources from IFF and tax haven exposure. Middle-income countries like South Africa already face an uphill battle in export markets dominated by low-wage and large-scale exporters (Andreoni and Tregenna, 2018). In that context, 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 tariff application process should empower the International Trade Administration Commission to undertake investigations into trade arrangements that have been abused for the purposes of shifting profits offshore. As such, firms engaged in such behaviour would be excluded from tariff support measures.

For example, the case studies of Samancor, Lonmin and ABF/Illovo all featured arrangements which saw goods produced in South Africa and other African countries exported and marketed exclusively through entities registered in various tax havens. In all three cases, it appeared as if the actual technical and managerial capacities behind the overseas marketing of these goods were not located in the tax haven at all. Roberts and Rustonjee describe a similar arrangement in their study of Iscor (2009). With the assistance of SARS, an audit of these types of arrangements would represent a useful first step. This could include assessments to help policymakers determine the scale of goods traded through these and other arrangements; the sectors, firms and tax havens most involved; and the risks associated with providing industrial policy support to exporters that market their goods through them.

Finally, with regard to industrial finance – it is recommended that firms with head offices located in tax havens or linked to IFFs are not able to access industrial finance from the South African government in any form, including incentive support from the DTIC.

Furthermore, institutions involved in public investment and lending ought to undertake audits of their current investments and loans with the aim of gauging their exposure to IFFs and tax havens. Once the proposed audits have established the extent of risk exposure and the scale of the resources at stake, measures to reduce exposure ought to follow. 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 success of industrial policy responses to the challenges posed by IFFs and tax havens will depend to a large extent on co-ordination and policy alignment across a range of government departments and agencies. The literature and case studies presented in this paper provide evidence that mining, energy, telecommunications, financial services and certain other commodity-producing industries account for a significant proportion of South Africa's IFF and tax haven risk exposure. As responsibility for and oversight of these industries is split between the DMRE and the Department of Communications and Digital Technologies it is critical for effective implementation of a strategy to limit IFFs that there is co-ordination and collaboration between these players.

Similarly, co-ordination is required between the line departments responsible for technology and innovation support, as well as for industrial finance and public procurement. Policies designed to insulate public procurement from IFF and tax haven exposure would require co-ordination across almost all departments.

The need to co-ordinate new initiatives across so 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. As noted in Section 4.6, 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 in these activities.

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. As discussed, a range of promising opportunities for developing a co-ordinated, "whole of government" approach to these issues has, however, emerged recently. Treasury's commitment in its most recent Strategic Plan to the development of a "national policy approach" on IFFs, the passage of the draft Public Procurement Bill, the rebuilding of capacity with SARS for tackling IFFs, and the growing inter-departmental co-ordination evident in the work of the IAWG on illicit financial flows all reflect important opportunities to protect South Africa's vulnerable industrial base from harm.

However, in their current forms, these and other promising developments reflect a distinct lack of input from an industrial policy and structural transformation-driven perspective. This report has highlighted the importance of a growing industrial base for inclusive economic growth; the threats that IFF and tax haven exposure pose to this imperative; and the possibilities for protecting and promoting industrial development through reconfiguring existing industrial policy instruments and developing new ones. It is further proposed in this report, as in much of the literature on these topics, that IFF and tax haven exposure negatively impacts the majority of individuals, firms and institutions in any given society, while benefiting only the wealthiest and most powerful. This suggests that there is great potential for a broad coalition of interests to be mobilised in support of greater regulation of and more transformative intervention against these harmful activities.

6.3 Research initiatives in support of anti-IFF and tax haven industrial policy

This section provides the framework for a research agenda to provide further information for policymakers to support industrial policy interventions that limit the impact of IFFs and tax havens. At present this framework has five elements.

First, further research to go deeper into the analysis covered in this paper on the channels through which IFFs and tax havens impact industrial development. Each of the five channels discussed in this paper (macroeconomic impact on investment and demand; impact on linkages in the local production system; competitive distortions; leakages of strategic developmental resources; and impact on the state's role in development) should be considered in-depth. More systematic investigation of each channel could yield valuable insights for policymakers. Empirical work on the scale and nature of the effects of these channels on industrial development, exploration of sectoral and geographic heterogeneities, a better understanding of value chain dynamics, and a range of other initiatives could be undertaken.

Second, to enable the industrial policy measures proposed in this paper is the recommendation for CIPC to require filing of relevant information by companies. This requires organising and publishing data that could be used to gauge IFF and tax haven risk exposure. Research and data gathering exercises may be required to support the implementation of this recommendation. A research agenda could include adapting the methodologies of the FSI, CTHI and AU/ECA Report for use to gauge firm-level exposure risk. This would entail developing indicators, collecting data to which these could be applied, and designing and implementing a testing phase that would aim to establish how these indicators can gauge IFFs and tax haven exposure risk. Such work would build on the research by Wier (2018) and Wier and Reynolds (2018) on the SARS/National Treasury database, which could be invaluable to the CIPC proposal; including an exploration of exactly what adjustments are needed in this database (and the data firms are required to submit to SARS and others agencies in the first place) to more systematically establish the economic impact of various types of foreign affiliates.

Third, detailed information on firms' IFF and tax haven exposure could help to more accurately gauge whether and how such exposure influences the efficacy of industrial policy measures, and to better understand the value chains, financial arrangements and offshore networks that beneficiary firms are integrated into. Given how prominently beneficiation and other activities linked to mining and various heavy industries feature in the 2018/19-2020/21 Industrial Policy Action Plan (IPAP) (DTIC, 2018), using information on the connections between firms involved in IFFs and beneficiaries of industrial policy support may help prevent these resources being exposed to IFFs and tax havens.

Fourth, a review of international practices on how policymakers in the world's leading developing country industrialisers are able to integrate measures protecting against IFFs and tax havens into the implementation of their industrial policies would help to support such efforts in South Africa.

Last, further research is required around the banks, legal firms, accounting companies and management consultancies that help large corporations and wealthy individuals to shift resources offshore and benefit from tax haven capabilities. Already, a growing body of investigative journalism, legal advocacy and public campaigning is emerging and should be supported. An important South African example is the work done by [Open Secrets](#), a Cape Town-based research, advocacy and legal organisation that specialises in investigating private sector economic crimes. The two volumes of their Corporations and Economic Crime Report³⁵ provide a critical resource that policymakers could draw on to inform efforts to reduce IFF and tax haven exposure.

³⁵ The first, on the role of banks and other financial service providers in economic crime, is available [here](#). The second, on the role of the "Big Four" auditing firms (PWC, KPMG, Deloitte and Ernst & Young), is available [here](#).

7 CONCLUSION

This report has set out to provide an overview of the mechanisms through which IFFs take place, the capabilities associated with tax havens, and further to highlight how these measures have a negative impact on economic development in general, and on industrial development in particular.

As has been shown, with reference to a wide-ranging of literature and a number of case studies, the negative impact of IFFs and tax havens on economic development is now well-established, and the subject of a number of internationally co-ordinated initiatives aimed at curbing this impact. The main contribution of this report has therefore been to make a start at exploring a number of channels through which these activities negatively affect industrial development specifically, and to make a number of recommendations for bringing industrial policy measures to bear against IFF and tax haven exposure.

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

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