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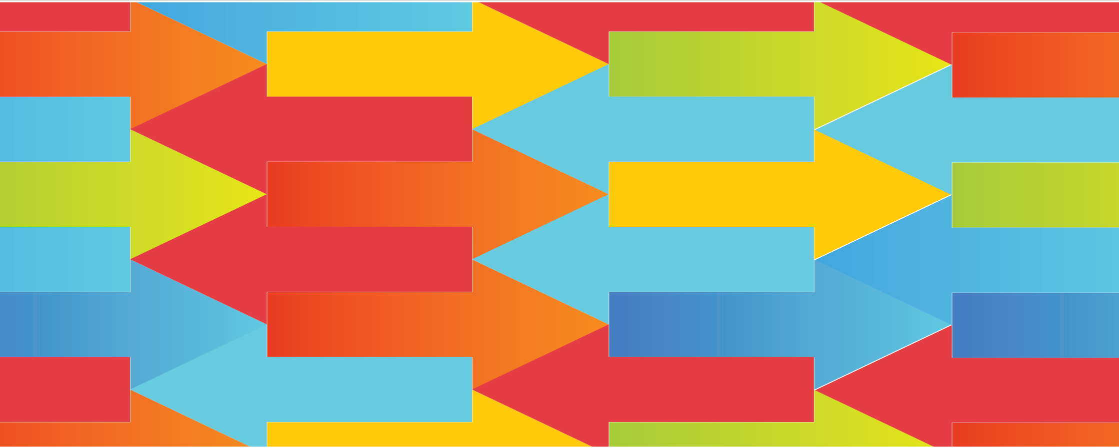

Illicit Financial Flows: An Analysis and some Initial Policy Proposals

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Ilka Ritter*

* The statements above only reflect the opinion of the author.

Preface

The paper „Illicit Financial Flows“, prepared by the Permanent Working Group on Financial Policy, Taxes, Budget and Financial Markets of Managers in the Friedrich-Ebert-Stiftung, is more than a merely political paper on questions of financial policy or the financial markets. In fact, it is a technical publication.

Its author Ilka Ritter points out the variety of ways and methods available and used to transfer financial capital in circumvention of national or international legislation in order to reduce or completely avoid tax payments. Ritter pays particular attention to illegal schemes but discusses ploys that make use of ambiguous legislation, too. In this context, she focuses on cross-border flows, leaving out those on a national basis. However, her concluding recommendations lend themselves to fighting national tax transgressions, as well.

Issues covered by the paper are tax evasion and avoidance including transfer mis-pricing. The publication also looks into methods of transfer as well as the quantities and impact of illicit financial flows. Based on international research and the findings of international institutions and debates, Ilka Ritter advises policy makers to improve the resources for tax audits with regard to both quality and quantity, and to enhance the exchange of information. Special attention is paid to the G20/OECD project that aims to tackle base erosion and profit shifting (BEPS), the EU’s initiative to establish a Common Consolidated Corporate Tax Base, and other European measures.

Ilka Ritter’s paper illustrates that bringing about tax justice poses a significant challenge – both technically and politically.

Dr Harald Noack
Chair of the Permanent Working Group on Financial Policy

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Introduction and Background I.

The 2008 global financial crisis showed vividly how national regulatory tools fail to effectively control global financial flows and brought into question whether and to what extent current regulations are sufficient to deal with prevailing international money flows. The crisis also highlighted a general lack of transparency in cross-border flows including insufficient regulation of so-called secrecy jurisdictions.[1]

While globalization is not a new phenomenon and has, overall, benefitted domestic economies, most notably Germany, a more globally integrated economy has shown to open up opportunities for multinational companies (MNEs) and high net worth individuals to shift large sums of monies to secrecy jurisdictions.

Moreover, the financial pressure on public budgets caused, in part, by the financial crisis has put pressure on governments to scrutinize their tax policies. Further fuelled by journalistic reporting, such as by the International Consortium of Investigative Journalists, the practices of international companies and the complex financial structures they use to create drastic tax reductions are receiving more and more attention by both the public and policy makers.

The concept of "illicit financial flows" has gained currency in the on-going debate surrounding financial flows and companies' quest to evade and avoid taxes. Illicit financial flows seriously undermine countries' efforts to collect taxes. Not only because those flows partially constitute taxes that are avoided or evaded domestically and shifted across borders to be hidden from tax

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1 Reuter, Peter (Ed.). Draining Development? Controlling Flows of Illicit Funds from Developing Countries. Washington: World Bank Group. Available from https://openknowledge.worldbank.org/handle/10986/2242

administrations but also because of their wider impact on economic growth and inequality as well as a country's governance system.

An important caveat though is that there is limited discussion on what those flows are and, more importantly, how good policy responses could look like.

Illicit Financial Flows: Concept, Nature and Features II.

The concept of illicit financial flows is characterized by a lack of terminological clarity, which in turn limits effective international discourse and coalition-building as well as the development of adequate policy recommendations.

The OECD defines the term illicit financial flows as being generated by "a set of methods and practices aimed at transferring financial capital out of a country in contravention of national or international laws. In practice an 'illicit financial flow' ranges from something as simple as a private individual transferring funds into his/her account abroad without having paid taxes on the funds, to highly complex money laundering schemes involving criminal networks setting up multi-layered multi-jurisdictional structures to hide ownership and transfer stolen funds".[2]

The term capital flight is often used synonymously for illicit financial flows. Capital flight, however, refers to money flowing out of a country in search for investment opportunities that are both secure and likely to yield a high return on investment. This may be in response to an unfavourable event in the country of origin or in anticipation of such an event. Money leaving developed economies with high saving rates is mostly termed foreign direct investment, while capital flight usually refers to money leaving developing countries. Capital flight might be licit or illicit depending on the source of the capital and the method used to transfer the money. While economists and international organizations have discussed capital flows for decades[3], illicit financial flows have only recently been receiving widespread attention.

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2 OECD (2013). Measuring OECD responses to illicit financial flows. Available from http://www.oecd.org/corruption/Illicit_Financial_Flows_from_Developing_Countries.pdf

3 See for example Kindleberger, Charles (1937). International Short-Term Capital Movements. New York: Augustus Kelley.

In this paper, illicit financial flows refer to money that is 1. illegally earned and/or 2. illegally utilized and, in either case, 3. transferred across borders. By doing so, the focus is on illegal activities and their proceeds as well as methods used to transfer both legal as well as illegal capital. Emphasis is placed on both the origin as well as the destination of such flows. Some definitions of illicit financial flows include money that remains domestic and is either hidden from law enforcement and/or tax administrations or laundered domestically. For the purposes of this paper, illicit money that stays within the borders of an economy is not addressed as policy recommendations would differ.

Illicit Financial Flows: Sources III.

Illicit financial flows have different sources. There are tax-related components such as domestic tax evasion and avoidance, which become an illicit financial flow if the proceeds are transferred across borders. International tax evasion and avoidance is another component of illicit financial flows, i.e. making deliberate use of a mis-match in different countries' tax systems. Transfer mis-pricing is a form of international tax evasion and avoidance while at the same time being a method used to transfer money across borders. Other components such as proceeds from drug trafficking or domestic corruption, that have illegally crossed borders, are also part of these flows.

a. Tax-related components

According to UNCTAD, as the economy became more globally integrated, so did corporations. Globalization has resulted in a shift from country-specific operating models to global business models which make use of integrated supply chains and centralized management and line functions either at the regional or the global level.[4] The growing importance of the service component of the economy, and of the e-economy has made it much easier for businesses to locate many productive activities to geographic locations that are distant from the physical location of their customers. This has facilitated non- or low taxation of economic activity, which artificially segregates taxable income from the activities that generate it.[5]

Comparing firm revenue with gross domestic product, 42 of the 100 largest 'economies' are MNEs. UNCTAD estimates that the value added by MNEs

4 UNCTAD (2013). World Investment Report 2013: Global Value Chains: Investment and Trade for Development. Available from http://unctad.org/en/PublicationsLibrary/diae2013d1_en.pdf

5 OECD (2013). BEPS Action Plan. Available from http://www.oecd.org/ctp/BEPSActionPlan.pdf

make up about eleven per cent of world GDP. The World Investment Report 2011 estimates that there are 103,786 multinational enterprise parent firms (1993: 37,000, 1992: 35,000) and 892,114 foreign affiliates (1993: 170,000, 1992: 150,000).[6] And while it is hard to estimate the relative share of intra-firm trade, which would be the share on which specific forms of tax evasion such as transfer mis-pricing could occur, it is generally regarded as comprising more than 30 per cent of global trade.[7]

Germany is highly integrated into the global economy. UNCTAD's World Investment Report finds that Germany is the seventh largest investor economy with foreign direct investment outflows totaling 58 billion US$ in 2013. Foreign direct investment inflows into Germany have started to slowly recover after the financial crisis and were totaling 27 billion US$ in the same year.[8]

i. Tax evasion and avoidance

Tax avoidance could be a strictly legal arrangement used to lower a taxpayer's tax liability though contradicting the intent of a country's tax law. Tax evasion is an illegal practice where a taxpayer hides income or information from the tax authorities thereby paying less tax than he would be legally obliged to.[9] While tax avoidance may not be illegal, it can be regarded as an abusive tax practice if it clearly violates the intent of tax legislation and thus the will of elected parliaments.

Tax evasion and avoidance in the realm of illicit financial flows can take two different forms. Firstly, companies or individuals might avoid or evade taxes, for example by underreporting of corporate income, which is then

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6 World Investment Reports 1992, 1993, 2010 and 2013. Available from http://unctad.org/en/Pages/DIAE/World%20Investment%20Report/WIR-Series.aspx?Re=1,20,,

7 See for example Antras, Pol (2003). Firms, contracts, and trade structure. Quarterly Journal of Economics, 118(4).

8 UNCTAD (2014). World Investment Report. Available from http://unctad.org/en/PublicationsLibrary/wir2014_en.pdf

9 OECD Centre for Tax Policy and Administration, Glossary of Tax Terms.

transferred across borders. In order for this money to constitute an illicit financial flow, the money may have been illegally earned (tax evasion) and is (illegally) transferred abroad. Secondly, companies can avoid or evade taxes by deliberately mispricing intra-group transactions (“transfer mis-pricing”), making undue use of bilateral tax treaties (“treaty shopping”) or by exploiting mismatches in entity and instrument characterization (“hybrid mismatch arrangement”). The line between legal avoidance and illegal evasion is especially blurry in this second form of tax evasion and avoidance due to increasingly sophisticated and aggressive tax planning schemes. The impacts of both practices in terms of missed tax revenue and with regard to tax justice and their implications for a country’s governance system are very similar though.

Transfer mis-pricing is one specific form of tax evasion as discussed below. Other tax avoidance and evasion schemes used by multinational firms are debt-equity structures for the sole purpose of lowering a MNE’s tax burden well as the relocation of profitable movable assets, such as trademarks and patents, in order to artificially lower the tax owed.[10]

The *Guardian* has undertaken extensive research into tax avoidance and evasion schemes undertaken by British multinationals. One of the schemes that was discovered involved firms that structured themselves so that they became simultaneously a British company but a tax-resident in another country while brands were owned in a third country. In a further example a company deliberately accrued enormous amounts of debt so that it no longer has any profits to pay tax on. Some companies were found to have moved control to foreign countries in which they have, in fact, little real economic presence.[11] While these practices were uncovered with regard to companies from the United Kingdom, similar practices are likely to be used by MNEs from other countries.

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10 Eden, Lorraine (2012). Transfer Price Manipulation. In Reuter, Peter (Ed.). Draining Development? Controlling Flows of Illicit Funds from Developing Countries. Washington: World Bank Group. Available from https://openknowledge.worldbank.org/handle/10986/2242

11 The Guardian (2009). Firms’ secret tax avoidance schemes cost UK billions. Available from http://www.guardian.co.uk/business/2009/feb/02/tax-gap-avoidance

Recent reports by the International Consortium of Investigative Journalists that shed light on secret deals by international companies routing their money through Luxembourg with the goal to reduce their effective tax rate involved many German companies, including Deutsche Bank and Reckitt Benckiser.[12] The media coverage of Luxembourg's tax practice eventually brought Jean-Claude Juncker, then newly-elected President of the European Commission and former Prime Minister of Luxembourg, into political distress. Accordingly, the European Commission stressed its ongoing efforts to tackle tax evasion and avoidance followed by an Op-Ed jointly written by Pierre Moscovici, the EU Commissioner for Economic and Financial Affairs, Taxation and Customs and Margrethe Vestager, EU Commissioner for Competition reviving plans for a European Common Consolidated Corporate Tax Base (CCCTB).[13] The CCCTB is a harmonized system for calculating the tax base, tax rates would still remain the sole sovereignty of every EU member country.[14]

ii. Transfer mis-pricing[15]

Transfer pricing refers to the mechanism by which cross-border intra-group transactions are priced. This is in itself a normal part of how an MNE operates. However, if the price that is charged between different companies belonging to the same group does not reflect their true economic value, and is thus not at arm's length[16] , profits might effectively be shifted to low-tax or

12 See for example: http://www.icij.org/project/luxembourg-leaks/leaked-documents-expose-global-companies-secret-tax-deals-luxembourg; https://www.ndr.de/nachrichten/investigation/Reckitt-Benckiser-Saubermaenner-in-Luxemburg,reckitt102.html

13 Moscovici, Pierre and Vestager, Margrethe (2015). Fuer ein faires Steuerrecht in Europa. Available from http://www.sueddeutsche.de/wirtschaft/eu-kommission-fuer-ein-faires-steuerrecht-in-europa-1.2308482

14 More information available from http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm

15 This paper assumes that a country has basic transfer pricing legislation or provisions dealing with gratuitous transfer/transfer with unreasonable low consideration in place. As domestic transfer pricing legislation, as practiced for example by India and China, wouldn't constitute an illicit financial flow, this paper only refers to cross-border transfer pricing.

16 The arm's length principles stipulates that commercial and financial transactions between related companies should be valued as if they had been carried out between unrelated parties.

no-tax jurisdictions and losses and deductions to high-tax jurisdictions. This practice, commonly referred to as transfer mis-pricing, unfairly deprives a country of tax revenues thus reducing the amount of resources available for funding public goods and services.

Transfer mis-pricing most often makes use of differences in corporate tax rates by over-invoicing tax-deductible inbound transfers into high-tax countries or under-invoicing taxable outbound transfers from high-tax countries. If the residence country of the cross-border investment allows deferrals of corporate income taxation, MNEs may decide not to repatriate foreign source earning to the home country. Withholding taxes, if they are levied on repatriated profits of foreign affiliates and are not fully creditable against the home country tax, may thus be circumvented by MNEs. If withholding taxes vary according to the form of repatriation (many countries have different tax rates for royalties, management fees and dividends), as is often the case, MNEs may decide to move funds in the form that incurs the lowest tax burden. Some forms of intra-firm transfers such as management fees and payments for intangibles as well as patents and trademarks, are especially notorious for deliberate transfer mis-pricing as arm's length prices are difficult to establish and comparables are often impossible to find. It is important to note that intra-firm trade is only an illicit financial flow if, and with the amount, that is mis-priced.

Apart from diverging corporate income tax rates, transfer mis-pricing is also motivated by avoiding or minimizing trade taxes, circumventing foreign exchange risks and controls and by responses to political risk.[17]

b. Proceeds from illegal activities

Proceeds from illegal activities is money earned from illicit activities. The activities that give rise to such proceeds can be purely domestic activities, such as theft or corruption. However, as the world has globalized, so has

17 Eden, Lorraine, op cit.

crime. The proceeds from transnational organized crime such as trafficking of humans, drugs, firearms and environmental resources (for example wildlife and timber); product counterfeiting, maritime piracy, migrant smuggling and cybercrime are both a source as well as a method of an illicit financial flow. The activities giving rise to such proceeds will often take place in developing countries but the proceeds will only materialize once the products of such economic activity crosses borders (with the exception of maritime piracy, where ransom is extorted).[18]

18 Describing the complex nature, extent and methods of transnational organized crime in detail is not within the scope of this paper. For more information please refer to UNODC (2010). The Globalization of Crime. A Transnational Organized Crime Threat Assessment. Available from http://www.unodc.org/documents/data-and-analysis/tocta/TOCTA_Report_2010_low_res.pdf

Illicit Financial Flows: Methods of Transfer IV.

In order for domestic tax evasion and avoidance and proceeds from illegal activities to constitute an illicit financial flow, a vehicle or method in order to cross borders is needed. Methods of transfer can be transfer mis-pricing, transnational organized crime, trade mis-pricing (but not all forms of trade mis-pricing are illicit financial flows) and international money laundering. The first two methods of transfer, which can also constitute the source of an illicit financial flow, have been described above. Two additional methods to facilitate the illicit transfer of capital will be discussed below.

a. Trade mis-pricing

Nitsch finds that "a potential vehicle to move capital unrecorded out of a country is the mis-invoicing of international trade transactions. Exporters may understate the export revenue on their invoices, and importers may overstate import expenditures, while their trading partners are instructed to deposit the balance for their benefit in foreign accounts".[19] Thus, trade mis-pricing is clearly an illegal arrangement, often measured by assessing discrepancies in trade statistics. However, not all discrepancies in trade statistics are necessarily trade mis-pricing. The value of imports often includes insurance and freight costs but exporting countries assess the value of goods at the initial point of departure. Other reasons for the divergence in trade statistics are time lags between the departure of goods and their arrival so that imports and exports are valued in different (financial) years; differences in exchange rates; the exclusion of certain products from trade statistics, for example for reasons of confidentiality for military products and differences in commodity classification. Intended mis-declaration of trade activities such as smuggling recorded by either import or export authorities or by neither is

19 Nitsch, Volker (2012). Trade Mispricing and Illicit Flows. In Reuter, Peter (Ed.). Draining Development? Controlling Flows of Illicit Funds from Developing Countries. Washington: World Bank Group. Available from https://openknowledge.worldbank.org/handle/10986/2242

not trade mis-pricing but can be an illicit financial flow even though it may influence trade statistics. Not all trade mis-pricing is an illicit financial flow as over-invoicing does not, in and of itself, result in a cross-border flow of money but may result in an illicit financial flow if the money illicitly earned by capturing export subsidies is repatriated. Likewise, under-invoicing of exports may be undertaken to evade import tariffs thus not necessarily resulting in a cross-border movement of money.[20]

b. International Money Laundering

Reed and Fontana define money laundering as "a process to disguise the source of criminally derived proceeds to make them appear legal."[21] Money laundering is ordinarily divided into three phases; namely, placement, layering and integration. Placement, i.e. the placing of illicit funds into the financial system, may take the form of breaking large sums of illicitly earned money into smaller parts in order to be able to circumvent anti-money laundering laws, which usually set a threshold for deposits into the banking system after which documentation about the source of the money is needed. Alternative methods of depositing criminal proceeds into the financial system are currency smuggling, changing currency, transportation of cash or traveller cheques or gambling. Layering is done with the goal to conceal the criminal origin of the proceeds. Examples of how this takes place are through fictitious sales and purchases, shell companies, wire transfers, splitting and merging of bank accounts or by using underground banking. The last phase, integration, can take the form of buying luxury goods, such as metals/diamonds or real estate and consumer goods for export purposes. Alternatively, money could be claimed to have been earned in apparently legitimate transactions, mainly those that are cash-intensive. Money laundering techniques range in their complexity from simple wire transfers to banks in secrecy jurisdictions to schemes involving shell banks.

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20 Nitsch, Volker (2012): Op cit.

21 Reed, Quentin and Fontana, Alessandra (2011). Corruption and Illicit Financial Flows. The Limits and possibilities of current approaches. U4 Issue. Available from http://www.u4.no/assets/publications/3935-corruption-and-illicit-financial-flows.pdf

Quantities V.

Closely related to the lack of clear terminology are greatly varying figures that try to quantify the actual amounts that can be attributed to illicit financial flows. Different estimates of national, regional or global volumes of illicit financial flows exist but have to be analyzed closely. By its very nature, illicit financial flows are clandestine activities. As a consequence, they are poorly captured in official statistics – if at all. Moreover, the methods used to calculate such flows differ in concept, scope and the kind of data that is relied upon. Different models may rely on balance of payments data, trade data or focus on funds that flow through the banking system[22] and capture different aspects and components of illicit financial flows. The ensuing models, i.e. the World Bank Residual Model, the Hot Money Model and a Composite Model all have weaknesses such as the reliance on official statistics, disregarding illegal proceeds and thus not measuring all components of illicit financial flows.[23] Among researchers and practitioners there is widespread agreement though that tax-related components, i.e. tax evasion and avoidance including transfer mis-pricing, make up the bulk of such flows.

The figures produced by different scholars and non-governmental organizations vary widely and often focus on developing countries.[24] Remarkably, calculations and estimates presented as to the magnitude of illicit financial flows are exclusively provided by non-state actors and academia. There are

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22 The "Walker-Gravity Model" is different in that country-level estimates on the amount of proceeds from illegal activities are generated as well as the extent to which those proceeds are being laundered. In a second step, the model then estimates the flow of money by considering the distance between countries and their attractiveness for money-laundering. For more details Walker, John and Unger, Brigitte (2009). Measuring Global Money Laundering: The Walker Gravity Model. Review of Law and Economics, 5 (2).

23 Fontana, Alessandra (2010). What does not get measured does not get done. The methods and limitations of measuring illicit financial flows. U4 Brief. Available from http://www.u4.no/publications/what-does-not-get-measured-does-not-get-done-the-methods-and-limitations-of-measuring-illicit-financial-flows-2/

24 Christian Aid states that developing countries lose $160 billion annually from transfer mispricing and falsified invoicing alone. Global Financial Integrity, a non-governmental organization based in Washington, D.C., estimates that the developing world lost US$991.2 billion in illicit outflows in 2012.

no official statistics by international organizations on illicit financial flows. This reflects, in part, the above-mentioned lack of terminological clarity and the difficulty of measuring clandestine activities but also points to a lack of political will associated with quantifying the amount of money lost to illicit financial flows.

While there are no official estimates regarding illicit financial flows, a report by the European Parliament on the Fight against Tax Fraud, Tax Evasion and Tax Havens, in citing a study commissioned by the Group of the Progressive Alliance of Socialists and Democrats in the European Parliament, estimates that 1 trillion € in public money is lost due to tax fraud and tax avoidance every year in the EU. Accordingly, "this alarming size of the tax gap represents a rough yearly cost of 2000 € for every European citizen. The average of the tax lost in Europe today exceeds the total amount that Member States spend on healthcare, and it amounts to more than four times the amount spent on education in the EU."[25]

25 Report on the Fight against Tax Fraud, Tax Evasion and Tax Havens available from http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+REPORT+A7-2013-0162+0+DOC+PDF+V0//EN and Murphy, Richard (2012). Closing the European Tax Gap. Available from http://europeansforfinancialreform.org/en/system/files/3842_en_richard_murphy_eu_tax_gap_en_120229.pdf

Impact of Illicit Financial Flows VI.

The evidence presented and discussed suggests that illicit financial flows are a problematic phenomenon. Due to these flows, countries forfeit large amounts of money. In fact, illicit financial flows drain resources and tax revenues as well as foreign reserves.

However, the long-term effects of such flows on economic growth may be just as problematic. Lower levels of investment and a low capital stock, due to money illicitly leaving the country, could hamper economic development in the medium and long term. Money held in secrecy jurisdictions that was moved to be hidden from local tax authorities is no longer available for investments in the real economy and subsequently distorts investment patterns. Commercial activities providing, due to their illegal nature, high returns crowd out other economic activities and entrepreneurial ventures.[26]

Another long-term consequence of illicit financial flows is the impact that such flows have on a countries' governance system. The illegal activities that give rise to parts of illicit financial flow and/or the illegal activities that are used to transfer the money across borders undermine both the institutions that are responsible for curtailing such flows (such as anti-money laundering units, central banks, financial intelligence units, tax administrations) and the democratic institutions that – willingly or due to a lack of capacity – fail to hold those responsible accountable. Inevitably, tax revenues that are "lost" as companies are shifting their profits and/or other illicit activities have to be compensated through higher taxes on compliant taxpayers, such as small and medium-sized companies and individuals, severely compromising tax justice and thus further damaging a country's governance system.[27]

26 Norwegian Government Commission on Capital Flight from Poor Countries on "Tax Havens and development". Available from http://www.regjeringen.no/pages/2223780/pdfs/nou200920090019000en_pdfs.pdf

27 Reed, Quentin and Fontana, Alessandra , op cit. UNECA (2013). The State of Governance in Africa: The Dimension of Illicit Financial Flows as a Governance Challenge. Available from http://www.uneca.org/sites/default/files/uploaded-documents/CGPP/cgpp-3_illicit-financial-flow-english_final.pdf

The aim of an illicit financial flow is to move money across borders to escape or hide from local authorities. In order to effectively hide money, a jurisdiction with a regulatory regime that enables companies and individuals to circumvent private and public interest in the state from which the money is expatriated is needed. Effectively, this means that illicit financial flows will move to jurisdictions with no or very low taxes on capital income, special tax regimes for shell companies, lack of transparency on ownership, lack of effective supervision and reluctance to exchange tax information. Such jurisdictions, in the different forms they take, are often termed "tax haven", "offshore financial centre" or "secrecy jurisdiction".[28] Given the clandestine nature of illicit flows paired with the convoluted nature of the concept, there is no comprehensive overview of where money actually goes to and what is done with it.[29]

Germany is affected by illicit financial flows twofold: Germany is likely to lose money through illicit financial flows in the form of tax evasion and avoidance. Next to the evidence presented above as to Germany's integration into the world economy, it is also the home of six of the 100 largest companies in terms of market capitalization[30] and is additionally home to a large number of export-oriented industries. Additionally, given the fact that Germany is a key financial centre in the world, it is likely that Germany is a host for illicit financial flows originating in other countries. In fact, the Financial Action Task Force (FATF) concluded in their 2010 Mutual Evaluation Report: "Many indicators suggest that Germany is susceptible to money laundering and terrorist financing, including because of its large economy and financial centre, as well as its strategic location in Europe and its strong international linkages. Substantial proceeds of crime are generated in Germany, estimated to be € 40 to € 60 billion, inclusive of tax evasion, annually."

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28 For an overview about the difference between these terms, please refer to the report on "Tax Havens and development" by the Norwegian Government Commission on Capital Flight from Poor Countries at page 15ff. Available from http://www.regjeringen.no/pages/2223780/pdfs/nou200920090019000en_pdfs.pdf

29 The IMF estimates that offshore financial centers held assets in the amount of US$ 5 trillion at the ende of 2009.

30 PWC (2014). Global Top 100 Companies by market capitalization. Available from http://www.pwc.com/gx/en/audit-services/capital-market/publications/assets/document/pwc-global-top-100-march-update.pdf

Effective Policy Responses VII.

To summarize, illicit financial flows have two components; namely, tax evasion and avoidance, including transfer mis-pricing and trade mis-pricing, as well as proceeds from illegal activities. Given their prominence in both the make-up of illicit financial flows and national and international policy debate, the following section will focus on curbing tax-related illicit financial flows.

Tax evasion and avoidance thrives on tax administrations which lack resources and specialized skill sets needed to conduct tax audits. Well-resourced tax administrations are thus one essential component of a country's fight against illicit financial flows. In 2012, 13,300 auditors raised an additional 19 billion € in tax revenues in Germany. That means that, on average, every auditor realized 1,43 million € in tax revenues with average annual salary costs of 75,000 €. Moreover, only 2,3 per cent of Germany's 8.5 million companies were audited in 2012. The German Labour Union for Tax Administrators (*Deutsche Steuer-Gewerkschaft*) estimates that ten to twenty per cent more staff is needed to effectively deal with tax evasion and avoidance.[31] As Germany's tax administration is constitutionally vested solely with the states, there is often little interest in properly auditing companies for fear that they move to a *Bundesland* with a more lenient tax authority. Moreover, due to the financial equalization scheme between the *Bundesländer*, there is little incentive for the richer *Länder* to invest in their tax administration, as the additional revenue would not benefit them. In terms of effectively dealing with tax planning schemes by multinational companies, Germany's tax administration is lacking personnel with experience working in the private sector. A recent study attests that there is very little labour mobility between the public and the private sector in Germany.[32]

31 Sueddeutsche Zeitung (2013). Jeder Betriebspruefer bringt 1,4 Millionen. Available from http://www.sueddeutsche.de/wirtschaft/finanzamt-jeder-betriebspruefer-bringt-millionen-euro-1.1756314

32 Hertie School of Governance (2014). Wettbewerb und Zusammenarbeit zwischen Privatwirtschaft und öffentlichem Sektor: Erfahrungen, Erfolgsfaktoren und Perspektiven. Available from http://www.hertie-school.org/fileadmin/images/Downloads/egon_zehnder_international/HertieSchool_EgonZehnder_Studie_2014_final.pdf

However, there are limits to what countries are able to achieve on their own and there is the need for international tax cooperation to fully address tax evasion and avoidance, including profit shifting and aggressive tax planning. In fact, the OECD finds that "there is a need to complement existing standards that are designed to prevent double taxation with instruments that prevent double non-taxation in areas previously not covered by international standards and that address cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it. Moreover, governments must continue to work together to tackle harmful tax practices and aggressive tax planning."[33]

One essential component to fight the tax-related components of illicit financial flows is the exchange of tax information. It is widely acknowledged that given the increased levels of cross-border economic activity, national tax administrations are confronted with information asymmetry vis-à-vis multinational enterprises. In July 2014, the OECD has published a new standard for automatic exchange of financial information. Under this standard, jurisdictions obtain information from their financial institutions and automatically exchange information with other jurisdictions on an annual basis. It determines the financial account information to be exchanged, the financial institutions that need to report, the types of accounts and types of taxpayers covered as well as due diligence procedures that need to be followed. Over 50 jurisdictions, among them Germany, have committed to implement this standard until 2017 with additional countries adhering to this new standard until 2018.[34]

In response to the fiscal pressures that many OECD and G20 countries are facing and the public outcry over the low effective corporate tax rates that some multinational companies are paying, the G20 has mandated the OECD to tackle base erosion and profit shifting (BEPS), i.e. tax planning strategies that exploit gaps and mismatches in tax rules which make it possible for profits to "disappear" for tax purposes resulting in very low corporate tax

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33 OECD (2013). Action Plan on Base Erosion and Profit Shifting. Available from http://www.oecd.org/ctp/BEPSActionPlan.pdf

34 http://www.oecd.org/tax/transparency/automaticexchangeofinformation.htm

rates, in their so-called BEPS project. With very tight deadlines, the OECD is thus discussing the following issues:

- How to properly tax the digital economy. Current tax rules were developed with bricks-and-mortar business models in mind and tax administrations thus encounter problems in taxing business models that, as their man value driver, rely on information and communication technologies.
- How to ensure that companies cannot rely on hybrid mismatch arrangements, i.e. the practice of profiting from differences in the way in which transactions are treated for tax purposes.
- How to strengthen Control Foreign Corporation (CFC) rules, that are designed to limit artificial deferral of tax by using offshore low taxed entities.
- How to prevent, for example, the use of related-party and third-party debt to achieve excessive interest deductions.
- How to ensure that taxation is aligned with the substance of economic activity by countering harmful tax practices.
- How to prevent the abuse of double taxation treaties, so-called “treaty shopping”.
- How to ensure that companies don’t artificially circumvent taxation by avoiding to create a permanent establishment, i.e. a fixed place of business which gives rise to tax liability.
- How to improve transfer pricing by ensuring that intellectual property isn’t mispriced to circumvent taxation; by preventing base erosion and profit shifting through the transfer of risk or the allocation of excessive capital to group members; by preventing abusive transactions which would not, or would only very rarely, occur between unrelated companies and by improving transfer pricing documentation requirements by companies.
- How to establish methodologies to collect and analyze data on the extent of base erosion and profit shifting that is being undertaken.

- How to ensure that taxpayers are disclosing their aggressive tax planning arrangements.
- How to make dispute resolution mechanisms concerning tax matters more effective.
- And lastly, how to ensure that various tax treaty-related measures that will be developed over the course of the BEPS project are properly implemented through a multilateral instrument.

While the G20/OECD BEPS project is a very welcome initiative, the devil is in the details. Criticism has, inter alia, focused on the following aspects of the BEPS project:

- Country-by-country reporting of multinational companies and a corresponding template have been agreed upon. However, this template will only apply to companies with annual turnover above € 750 million and will be held by the tax authority of the country in which the company is headquartered, which reduces the utility of this tool.
- A proposal was adopted on how to deal with preferential tax regimes, such as those related to income from intellectual property. The so-called nexus-approach has, however, attracted criticism as it is suspected to legitimize preferential tax regimes and thus provide a legal mechanism for profit shifting.
- Tax incentives, such as those discovered by the International Consortium of Investigative Journalists, are not currently discussed as part of the G20/OECD project but continue to contribute to a "race to the bottom" in terms of corporate taxation.
- The business community has been criticizing the uncertainty that is being created by the BEPS project given possible inconsistencies in the application of the newly developed rules that are likely to lead to an increase in tax disputes between multinational and tax authorities.
- Moreover, there is growing concern by the business sector and some tax

administrations that several solutions that are currently under discussion, notably on hybrid mismatch arrangements, are very complicated and costly to implement and/or audit.

- There is concern that while the G20/OECD project intends to re-define international tax rules, there is limited engagement with countries that aren't members of the G20 or the OECD. However, varied and effective participation in norm development will be a key to broad acceptance of the outcomes.
- Even if the BEPS project is successful in developing new international rules that aid in countering base erosion and profit shifting and hence illicit financial flows, it is ultimately up to countries to fully implement these newly developed rules. In this respect, the outcome of the discussions on a multilateral instrument will be especially interesting.

As mentioned above, the European Union is also working on international tax issues and thus on curbing illicit financial flows. The EU has been endorsing the work undertaken by the OECD on behalf of the G20 and the European Commission has been trying to revive the Common Consolidated Corporate Tax Base (see above). Recently, the European Council has amended the EU's parent-subsidiary directive, adding a binding anti-abuse clause to prevent tax avoidance and aggressive tax planning by corporate groups and preventing the double non-taxation of dividends distributed within corporate groups deriving from hybrid loan arrangements. Moreover, the European Commission has opened formal investigations into tax practices of EU member states concerning the compliance with EU state aid rules in the context of aggressive tax planning by multinationals, inter alia in Ireland, the Netherlands, Luxembourg and Belgium.[35]

While countries have the capacity to tackle illicit financial flows, including immoral tax practices and/or loopholes in their national tax systems, tax

35 For more in-depth information on the EU's efforts in tackling tax evasion and avoidance please refer to http://ec.europa.eu/taxation_customs/taxation/tax_fraud_evasion/index_en.htm

evaders thrive on countries focussing on their own sovereignty and firming up their own tax base but taking less interest in preserving the tax base of other countries. Constructive engagement, working cooperatively on curbing illicit financial flows and carefully considering the spillover effects of national tax policies on other countries, will ensure a global response that sends a clear message to tax evaders and avoiders, and confirms the faith of honest taxpayers in tax systems.

About the Author

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