Title: Institutional Reform Goals: Illicit Trade-Related Flows

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***Abstract**: Reforming the rules and regulations that facilitate illicit financial flows would have a major impact on human development. For this reason, ASAP believes that illicit financial flows is a crucial item for the international community to address in the post-2015 development agenda. This report focuses specifically on the rules and regulations that allow for illicit trade-related flows (as opposed to criminal and corrupt flows), and especially on the practice of corporate tax avoidance. It reviews measures currently in place or under discussion by the international community to address illicit trade-related flows. It then makes five policy recommendations for inclusion in the post-2015 agenda, and proposes one additional initiative, to reform those aspects of economic institutions—financial secrecy regulations—that are one of the greatest facilitators of illicit financial flows in all of its forms.

* **Keywords**: illicit financial flows, corruption, tax, tax havens, trade misinvoicing.

Academics Stand Against Poverty (ASAP)

Institutional Reform Goals: Illicit Trade-Related Flows[1]

(Author: Esther Shubert, Yale University)

There are many features of the international institutional order that (1) contribute to the persistence of global poverty, (2) could be reformed at a reasonable cost by the international community, and (3) would lead to a dramatic reduction in global poverty and human deprivation, if reformed.[2] Academics Stand Against Poverty (ASAP) believes that reforming these institutions is a moral imperative and should play a central role in the United Nations' new development framework, which will succeed the current Millennium Development Goals (MDGs) when they expire in 2015. ASAP is therefore working to develop and advocate for politically feasible MDG successor goals that improve upon those in the original MDG framework—which focused primarily on outcomes for the recipients of aid—by highlighting the responsibilities of affluent states and the donor community to reform those institutions.

ASAP has identified ten aspects of the global institutional order, the reform of which could have a major impact on human development and poverty alleviation. One of these is illicit financial flows. For the purposes of this report, illicit financial flows are cross-border financial flows that leave the developing world and go into the developed world, contrary to (the letter and spirit of) domestic and international laws.[3] There are three broad types of illicit flows: corrupt, including the proceeds of bribery and theft; criminal, including the proceeds of activities such as drug and human trafficking; and trade-related, including

[1] Thank you to Tom Cardamone, Krishen Mehta, Rachel Payne, Thomas Pogge, and Mitu Sengupta for commenting on earlier drafts of this paper.
[2] The term global institutional order is most strongly associated with Thomas Pogge. It refers to, in Pogge's words, "non-domestic social institutions" such as global rules of governance, trade, and diplomacy. See Thomas Pogge, "World Poverty and Human Rights: Cosmopolitan Responsibilities and Reforms" (second edition). Polity Press, Malden, MA, 2008. 33.
[3] This is following Global Financial Integrity, but it is important to note that there is disagreement as to what constitutes illicit financial flows. See, e.g. Peter Reuter, "Introduction and Overview: the Dynamics of Illicit Flows" in *Draining Development?* ed. Peter Reuter. The World Bank, 2012. 7.

different kinds of tax-avoiding activities.[4] This report will look closely at the last of these, and its effects on global poverty.

Illicit trade-related financial flows are the focus of this report for two reasons. First, they account for the large majority of all illicit financial flows, and so curbing them has the greatest potential to generate new resources for the developing world.[5] Second, corrupt and criminal financial flows are the result of *breaking* existing laws and rules. While large sums of money are lost to corruption and criminal activity each year, the existence of these behaviours does not in itself suggest problems with the rules trying to prevent them in the first place (although they may suggest problems with the enforcement of those rules). In contrast, illicit trade-related flows—specifically, the proceeds of corporate tax avoidance—are the result of problems with the structure of financial rules and regulations themselves, and are thus an appropriate subject for institutional reform.

This report will focus on two main elements of corporate tax avoidance: corporate profit shifting and financial secrecy. It will proceed as follows. Section I makes the connection between illicit financial flows and development. It then explains corporate profit shifting and financial secrecy, and shows how they harm the developing world. Section II provides a review of some current measures that have been or are being considered by the international community to reform the rules and practices that facilitate these illicit flows. Section III provides recommendations for a set of politically feasible post-MDG goals and targets aimed at reforming the rules and practices that make corporate tax avoidance possible, specifically those rules and practices relating to corporate profit sifting and financial secrecy, while section IV makes one final recommendation in this area.

I. Illicit financial flows and development

Illicit financial flows drain huge amounts of resources from the developing world.[6] The

[4] Again, following Global Financial Integrity, although GFI has recently stopped focusing on criminal flows.
[5] Dev Kar and Brian LeBlanc, "Illicit Financial Flows from Developing Countries: 2002-2011." GFI, December 2013. x.
[6] More specifically, "it drains hard currency reserves, increases inflation, reduces tax collection, widens income gaps, forestalls investment, stifles competition, and undercuts free trade." See Raymond Baker and Eva Joly, "The Issue of Illicit Financial Flows" in *Commentaire*, Hiver 2008-9, Volume 31, Numero 124, 7-8.

most recent estimates from Global Financial Integrity (GFI), a pioneer in the study and quantification of illicit financial flows, is that illicit flows from developing countries totaled $946.7 billion in 2011 (an increase of 13.7% in their estimates from 2010), and totaled $5.9 trillion cumulatively from 2002 to 2011.[7] Around 80% of this is due to illicit trade-related activities such as corporate tax avoidance through trade misinvoicing.[8] According to a recent United Nations Development Programme (UNDP) report, illicit financial flows are prevalent in the least developed countries (LDCs), where they have increased from $9.7 billion in 1990 to $26.3 billion in 2008.[9]

While there is disagreement over these figures (and the methodology used to generate them), there should be no doubt that the losses to developing countries due to illicit financial flows are substantial. According to University of Maryland professor Peter Reuter, "Even if the correct figure is only a 10th of the often-cited Global Financial Integrity estimates…that is, around US$100 billion, it is large relative to either official development assistance (about US$70 billion) or total foreign direct investment in the developing world (around US$250 billion in 2004 according to UNCTAD 2009)."[10] According to the UNDP report, the LCDs, which receive approximately 24.1% of total official development assistance (ODA), averaged a loss of 60 cents in illicit financial flows for every dollar of ODA.[11] Eliminating these outflows, then, would be of enormous benefit to developing countries.

It is especially important to take account of such outflows at a time when the international community is questioning the effectiveness and sustainability of traditional sources of development finance, such as ODA, and is looking for new and innovative sources of financing for development. In this vein, a lot of emphasis is being placed on domestic resource mobilization within developing countries themselves as the most sustainable way of financing their development and helping to ease aid dependency.[12] The loss of resources through illicit financial flows, including forgone tax revenue and lost

7 Dev Kar and Brian LeBlanc, iii.
8 Ibid, x.
9 UNDP, "Illicit Financial Flows from the Least Developed Countries: 1990-2008." UNDP, May 2011. 3.
10 Peter Reuter, "Policy and Research Implications of Illicit Flows" in *Draining Development?* The World Bank, 2012. 484.
11 UNDP, 18.
12 Eurodad, "Exposing the lost billions: how financial transparency on a country by country basis can aid development." Eurodad, November 2011. 3.

investment capital for the local economy, clearly undermines this goal.[13]

The next two sections describe two of the most important elements of the problem of tax avoidance: corporate profit shifting and financial secrecy.

i. *Corporate profit shifting*

MNCs, corporations with subsidiary companies registered in more than one country, have a variety of strategies available to them for minimizing their tax burden, but the basic idea behind them is to move capital amongst their affiliates in different jurisdictions so that taxable income is reported in places where it is taxed at lower rates and expenses where they are relieved at higher rates. This practice, known as corporate profit shifting, usually involves associating more profits with legal constructs and intangibles such as intellectual property, while reducing the share of profits associated with substantive operations.[14] In other words, it results in fewer profits associated with, and therefore fewer taxes collected by, the source (usually developing) countries where much of the economic activity actually takes place. The following example, from a case study carried out by the South African-based organization Action Aid, will help to illustrate this phenomenon.

SABMiller is one of the biggest companies in the beer industry. It owns over 200 brands, is the second biggest brewer in the world and the biggest brewer in Africa, owning numerous beer companies there. The following is just one example of a strategy used by SABMiller to shift profits out of Africa, minimizing its tax burden there. Many of the 'local' beer brands that SABMiller sells in Africa are owned by other subsidiary companies in the Netherlands, which has a lower tax rate. African subsidiaries pay millions in royalties to the Dutch subsidiaries for the use of these brands. A large part of the profits, then, are officially made in the Netherlands, rather than in the African countries where the beer is produced

[13] International Bar Association's Human Rights Institute Task Force on Illicit Financial Flows, Poverty and Human Rights, "Tax Abuses, Poverty and Human Rights," International Bar Association, 2013. 23. According to Tom Cardamone at GFI, the potential lost capital is likely even greater than the tax loss. (In conversation.)
[14] OECD, *Addressing Base Erosion and Profit Shifting*. OECD Publishing, 2013. 45.

and consumed. The tax loss to African countries is an estimated £10 million per year.[15]

The current system of corporate tax structures affords MNCs opportunities to minimize their tax burden, sometimes even succeeding in paying no income tax anywhere at all ("double non-taxation"). According to the OECD, this kind of strategic tax planning, or 'tax arbitrage,' is made possible by loopholes resulting from the lack of coordination among different domestic tax rules:

> The interaction of withholding tax rules in one country, the territorial taxation system in another country, and the entity characterisation rules in a third country may combine to make it possible for certain transactions to occur in a way that gives rise to no current tax and have the effect of shifting income to a jurisdiction where, for various reasons, no tax is imposed. Often it is not any particular country's tax rule that creates the opportunity for [profit shifting], but rather the way the rules of several countries interact.[16]

However, according to tax expert Lee Sheppard, corporate tax avoidance is made possible by specific provisions included in bilateral OECD tax treaties: "OECD model treaties give the MNCs' home countries primary tax jurisdiction over income earned by MNCs in source (for which read market) countries. That is, these treaties require source countries to agree to be deprived of legitimate tax jurisdiction over the income earned within."[17]

Either way, tax avoidance, in the sense of minimizing tax burdens, and as opposed to tax evasion, is not technically illegal. However, it may properly be considered illicit for several reasons. Firstly, according to the OECD's analysis, "the overall effect of this type of tax planning is to erode the corporate tax base of many countries in a manner that is not intended by domestic policy."[18] Secondly, however, even if corporate tax planning *is* the intended result of domestic policy, for example, of certain provisions in OECD bilateral tax

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15 Action Aid, "The SABMiller guide to tax-dodging," http://www.actionaid.org.uk/campaign/the-sabmiller-guide-to-tax-dodging For the full report, see Action Aid, "Calling Time" available at http://www.actionaid.org.uk/sites/default/files/doc_lib/calling_time_on_tax_avoidance.pdf
16 OECD, *Addressing Base Erosion and Profit Shifting.* 45.
17 Correspondence, December 9, 2013. According to Sheppard, treaty provisions that substantially limit source countries' tax jurisdiction include separate company accounting, arm's-length transfer pricing, and permanent establishment. Some of these will be discussed below.
18 OECD, *Addressing Base Erosion and Profit Shifting.* 45.

treaties, developing countries often have no choice but to sign such treaties. This background should make us at least question the legitimacy of tax avoidance, despite its legality. Finally, from a development perspective, tax avoidance hurts the developing world by undermining domestic resource mobilization, it could be stopped at a reasonable cost by the international community, and doing so would contribute to a dramatic reduction in human deprivation. While much more needs to be said on this issue, let's set this aside for now and look in more detail at some of the specific mechanisms through which MNCs engage in tax avoidance, in order to see what policies and initiatives could be used to prevent it.

A major instance of corporate profit shifting is the practice of trade misinvoicing, where corporations alter items on an invoice—price, weight, quantity—in order to skirt tax laws and reduce their tax burden. Price is the most complicated of these. Cross-border transactions (of goods, services and intangibles) between subsidiaries of the same company are not subject to normal market forces; they are governed instead by a process known as transfer pricing. The current standard for MNCs to find an appropriate transfer price is the OECD's "arm's-length principle" (ALP).[19] The idea behind the ALP is that the price allocated to an intra-group transaction should reflect the price that would be paid between two different companies on the open market. However, subsidiaries in different countries often charge each other non-APL rates in order to minimize their tax burden. Abusive transfer pricing schemes include, for example, "over-invoicing imported goods and under-invoicing exported goods, so as to minimize income in higher-tax countries and shift unreported profits abroad" and "the (below-market) transfer of intellectual property rights…to low-tax jurisdictions."[20]

A similar misinvoicing scheme to transfer mispricing is falsified invoicing on transactions occurring between two independent companies. For example, companies will

[19] The arm's length principle: "[When] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly." Chapter 1, paragraph 1 of Article 9 of the OECD Model Tax Convention. Quoted in David McNair, Rebecca Dottey and Alex Cobham, "Transfer pricing and the taxing rights of developing countries." Christian Aid, November 2010. 3.

[20] James S. Henry, *The Price of Offshore Revisited.* Tax Justice Network, July 2012. 20.

agree to a false price—deflated export prices, inflated import prices—so as to report lower overall profits and consequently minimize their tax burdens.[21] This practice is thought to be widespread. UK charity Christian Aid reports that "about 45 to 50 per cent of trade transactions in Latin America are falsely priced by an average of more than 10 per cent; while 60 per cent of trade transactions in Africa are mispriced by an average of more than 11 per cent."[22]

Trade misinvoicing is one of the primary means of commercial tax avoidance. GFI estimates that trade misinvoicing accounts for 80% of all illicit financial flows,[23] while for LDCs trade misinvoicing accounts for 65-70% of all illicit flows, according to UNDP.[24] In terms of lost resources, Christian Aid estimates that developing countries lose $160 billion in tax revenues per year due to trade misinvoicing—a total loss of $2.5 trillion for the MDG years (2000-2015).[25] More specifically, they estimate that between 2005 and 2007 Sub-Saharan Africa lost $27 billion through trade misinvoicing, with lost tax revenues of approximately $4.34 billion, while Latin America lost $95 billion through trade misinvoicing, with lost tax revenues of $31 billion.[26] These lost resources have the potential to make a huge difference in the lives of the global poor; for example, Christian Aid estimates that 350,000 children under five could be saved every year if the capital lost to illicit financial flows were available and allocated according to current spending patterns.[27]

ii. *Financial secrecy*

In addition to the tax structures that facilitate corporate tax avoidance through profit shifting, financial secrecy is the other main side of the problem. In this report, secrecy jurisdictions will refer to financial centers with specific types of regulations that—especially when they occur together—attract illicit capital. These include low or zero tax rates,

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[21] Peter Reuter, "Introduction and Overview: the Dynamics of Illicit Flows" in *Draining Development?* ed. Peter Reuter. The World Bank, 2012. 13.
[22] Christian Aid, "Death and taxes: the true toll of tax dodging." Christian Aid, May 2008. 6.
[23] Dev Kar and Brian LeBlanc, iii..
[24] UNDP, 11.
[25] Christian Aid, "False profits: robbing the poor to keep the rich tax-free." Christian Aid, March 2009. 2-3.
[26] Eurodad, 11.
[27] Christian Aid, "False profits," 2.

favourable regulations for foreigners, and secrecy regulations.[28] Examples of favourable and secretive regulations for international companies include: exemption from paying duties and taxes, exemption from the obligation to prepare accounts, exemption from the obligation to audit, exemption from the obligation to register and publish beneficial ownership,[29] exemption from the obligation to preserve accounting documentation, exemption from the obligation to hold board meetings locally, and the right to redomicile the company.[30]

Companies use secrecy jurisdictions for tax avoidance in two ways. One way is in the trade misinvoicing schemes discussed above: MNCs registering subsidiaries there and then over-reporting profits there while simultaneously under-reporting profits in higher-tax jurisdictions. Additionally, according to Norwegian Government's Commission on Capital Flight from Developing Countries, MNCs use subsidiaries in tax havens as holding companies: income often goes untaxed in secrecy jurisdictions so tax on current profits is avoided.[31] In addition to commercial tax avoidance, however, secrecy jurisdictions also facilitate illicit flows more generally; for example, they enable tax evasion, fraud, bribery, illegal gambling, money laundering and trafficking of contraband goods and services.[32]

The Norwegian Commission details numerous reasons why secrecy jurisdictions are harmful: they increase the risk premium in international financial markets, they increase the inequitable distribution of tax revenues, they reduce the efficiency of resource allocation, they make economic crime more profitable, and they damage institutional quality and growth in developing countries.[33] Most important for our purposes, secrecy jurisdictions undermine tax systems, especially in developing countries. As the Commission explains:

> Tax havens offer secrecy rules and fictional domiciles combined with "zero tax" regimes in order to attract capital and revenues that should have been taxed in other countries… This has made it difficult for other countries to maintain their

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[28] Norwegian Government Commission on Capital Flight from Poor Countries, "Tax Havens and Development," June 18, 2009. 20. The Commission notes that low tax rates are not necessarily in themselves problematic, but have harmful effects on other countries when combined with these other features.
[29] Beneficial ownership refers, in this context, to the natural person(s) "who exercise ultimate effective control over a legal person or arrangement." (See the Financial Acton Task Force Glossary, http://www.fatf-gafi.org/pages/glossary/a-c/)
[30] Norwegian Government Commission, 35.
[31] Ibid, 69.
[32] James S. Henry, 24.
[33] Norwegian Government Commission, 11-13.

> capital taxes, and has thereby contributed to lower taxes on capital. Developing countries have a narrower tax base than rich countries, and also obtain the largest portion of their tax receipts from capital. Accordingly, lower capital taxes mean either a decline in revenue and/or higher taxes on a narrower base. Moderate tax rates on a relatively broad base are preferable to high taxes on few tax objects, because tax efficiency declines more than proportionately with the tax rate. As a result, tax havens help to boost the socio-economic costs of taxation and weaken economic growth in developing countries.[34]

Research on the scope of secrecy jurisdictions is limited, and specific estimates on the proportion of illicit financial flows from developing countries and the proportion of global illicit financial flows that go to tax havens are not publically available.[35] However, what research there is suggests that secrecy jurisdictions house huge amounts of capital that is going untaxed or is only minimally taxed, and which is depriving developing countries of much needed tax revenue. The Tax Justice Network estimates that the global total of accumulated financial wealth in secrecy jurisdictions as of 2010 is between $21 and $32 trillion.[36] The use of secrecy jurisdictions is especially prevalent in and problematic for developing countries. It is estimated that more than 25% of Latin American and 33% of Middle Eastern and African private wealth is invested in secrecy jurisdictions, compared with only about 2% of North American private wealth and 8% of European wealth.[37]

Moreover, the Tax Justice Network reports that, "[s]ince the 1970s, with assistance from international private banking industry, it appears that private elites in [139 low and middle income countries] had accumulated $7.3 – 9.3 trillion of unrecorded offshore wealth … while public sectors were borrowing themselves into bankruptcy."[38] It is also estimated that the capital outflows lost to secrecy jurisdictions (and the future earnings associated with

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[34] Ibid, 11-12.
[35] This data is available at the Bank for International Settlements but Bank rules prohibit the data from being released to researchers in a format that allows for further analysis. Thanks to Tom Cardamone for this point.
[36] James S. Henry, 5.
[37] Stephen B. Cohen, "Does Switzerland's Tax Haven for Offshore Accounts Violate Internationally Recognized Human Rights?" (Georgetown, 2013). 2. Available at http://academicsstand.org/wp-content/uploads/2013/03/Cohen-Presentation-SROP.pdf
[38] James S. Henry, 5-6.

these investments) almost entirely offset ODA and foreign direct investment for some developing countries.[39]

II. Current measures to reform rules and practices that facilitate illicit financial flows

The problems that illicit financial flows create for developing countries—including by hindering domestic resource mobilization—are beginning to be recognized by the international community and high-level policy makers. In the last several years, illicit financial flows have been mentioned in the United Nations's Monterrey Consensus (2002), the World Trade Organization's Doha Declaration (2008), the United Nations Summit on MDGs (2010), and the United Nations Conference on Sustainable Development (2012).[40] It has also been a prominent subject of discussion amongst the G8 and G20 for at least the last five years.

Just this last year, the report of the UN Secretary-General's High Level Panel on Post-2015 emphasized the importance of addressing illicit financial flows and curbing revenue lost to tax avoidance.[41] Tax avoidance was also given extensive attention in the G8 Lough Erne (June 2013) and the G20 St. Petersburg (July 2013) meetings. For example, the G8's Loch Erne Communiqué includes commitments to:

- ensure that domestic and international tax rules do not allow MNCs to reduce their tax burden through profit shifting (§24);
- support the OECD in developing common accounting standards—specifically, country-by-country reporting—for MNCs in order to enhance transparency (§25);
- support and implement OECD efforts on multilateral automatic exchange of information, ensuring that these processes are accessible to developing countries (§26);

[39] Ibid, 7; Norwegian Government Commission, 13.
[40] For the last of these, see §266 of UN, "The Future we Want: Outcome document of the United Nations Conference on Sustainable Development, Rio de Janeiro, Brazil, 20-22 June 2012," available at http://www.uncsd2012.org/

[41] See High-level Panel of Eminent Persons on the Post-2015 Development Agenda, "A new global partnership: eradicate poverty and transform economies through sustainable development." 2013. Available at http://www.un.org/sg/management/pdf/HLP_P2015_Report.pdf

- support OECD efforts with respect to improving the quality and availability of transfer pricing information for developing countries (§29); and
- implement the Financial Action Task Force (FATF)'s standards requiring that companies provide information on their beneficial ownership, and to support the implementation of these standards globally (§31).

The St. Petersburg Communiqué also addresses the problem of tax avoidance, stating that, "Tax avoidance, harmful practices and aggressive tax planning have to be tackled."[42] It commits the G20 leaders to working with the OECD to tackle profit shifting (§18), increase transparency through automatic exchange of information (§19), and address beneficial ownership by implementing FATF standards (§20).

Beyond these public declarations, there has also been some concrete action toward addressing illicit financial flows, and preventing tax avoidance in particular. Most of the work on this front has been through the OECD. The Financial Action Task Force (FATF), created by the G7 (within the OECD) in 1989 to combat money laundering, expanded its scope in 1998 to facilitate "increased transparency and strengthened arrangements for information exchange between national authorities."[43] The FATF's mandate was originally set to expire in 2012, but was extended until 2020.[44]

The OECD's work under the expanded mandate initially focused on tax havens. In 2000, the OECD published a report containing a comprehensive list of tax havens, including uncooperative jurisdictions in non-compliance with OECD standards.[45] Since then, the list has been updated numerous times, and in 2006 the final countries originally designated as

[42] Communiqué, Meeting of Finance Ministers and Central Bank Governors, Moscow, 19-20 July 2013. §18
[43] FATF, 'Ministers renew the mandate of the Financial Action Task Force until 2020' (20 April 2012), available online at http://www.fatf-gafi.org/documents/repository/ministersrenewthemandateofthefinancialactiontaskforceuntil2020.html
[44] Ibid.
[45] OECD, "Towards Global Tax Cooperation." OECD Publishing, 2000. Available at http://www.oecd.org/ctp/harmful/2090192.pdf

non-compliant were removed from the list, having committed to negotiating Tax Information Exchange Agreements (TIEAs).[46]

Additionally, as a result of a call from the G20 in 2009, the OECD restructured the Global Forum on Transparency and Exchange of Information for Tax Purposes (Global Forum) in order to increase transparency and strengthen exchange of information between countries. It was mandated to put in place a peer review mechanism for all Global Forum members to evaluate their exchange of tax information systems. According to the Global Forum, these peer reviews will happen in two phases: "Phase 1 is a review of each jurisdiction's legal and regulatory framework for transparency and the exchange of information for tax purposes and Phase 2 involves a survey of the practical implementation of the standards."[47] Reporting on its progress, the Global Forum states that since 2009 it has completed 100 peer reviews and issued over 600 recommendations for improvement on transparency and exchange of information, more than 300 of which are already being acted upon.[48]

In 2011 the OECD also updated and expanded its Convention on Mutual Administrative Assistance in Tax Matters. The Convention "provides for a multilateral basis to counter international tax evasion and avoidance providing for a wide variety of administrative assistance, including information exchange on request, automatic information exchange, participation in tax examinations abroad, simultaneous tax examinations, joint audits and assistance in the collection of tax debts."[49] The Global Forum reports that since it began its work in 2009, more than 50 countries have signed the Convention or have committed to doing so, and the number of Exchange of Information agreements (both bilateral and multilateral) has increased by around 1,100.[50]

Finally, in addition to its work on transparency and exchange of information, the OECD has also been working on the issue of corporate profit shifting, or Base Erosion and

[46] Norwegian Government Commission, 124-6.
[47] The Global Forum on Transparency and Exchange of Information for Tax Purposes, "Frequently Asked Questions." Available at http://www.oecd.org/tax/transparency/46615395.pdf
[48] The Global Forum on Transparency and Exchange of Information for Tax Purposes, "Progress Report to the G20 Finance Ministers and Central Bank Governors: Global Forum Update on Effectiveness and Ongoing Monitoring. 5. Available at http://www.oecd.org/tax/2013-OECD-SG-Report-to-G20-Heads-of-Government.pdf
[49] Ibid, 35.
[50] Ibid, 7; 35.

Profit Shifting (BEPS). Its "Action Plan on Base Erosion and Profit Shifting" was released earlier this year and presented to the G20 Finance Ministers in July 2013.[51] According to the OECD, the "Action Plan" identifies "15 specific actions needed in order to equip governments with the domestic and international instruments to address this challenge. The plan recognises the importance of addressing the borderless digital economy, and will develop a new set of standards to prevent double non-taxation. This will require closer international cooperation, greater transparency, data and reporting requirements."[52]

Although a lot has happened over the last decade or so to combat illicit financial flows in general, and tax avoidance and bank secrecy in particular, much more needs to be done. With the MDGs set to expire in 2015, discussions are currently underway to develop a new development framework, so there exists now a unique opportunity for the international to take coordinated action on this front. The following section makes recommendations for post-MDG targets aimed at reforming rules and practices relating to illicit financial flows, with the goal of ending illicit trade-related flows from developing countries.

III. Recommendations for goals and targets

Goal: end illicit trade-related financial flows from developing countries.

Targets:

The following are some of the initiatives most discussed and advocated for by tax experts, international organizations and governments concerned with ending illicit flows from developing countries.

i. Reform the arm's-length pricing system

As discussed above, abusive transfer pricing—intra-group transfers at below-market rates—is one of the biggest causes of lost tax revenue for the developing world. In response,

[51] Ibid, 3.
[52] OECD, Base Erosion and Profit Shifting, http://www.oecd.org/ctp/beps.htm

numerous experts, including those at the Tax Justice Network, argue for eliminating the ALP system by getting rid of separate company accounting, and instead treating all entities of an MNC as a single unit. This would make intra-group transactions irrelevant from the point of view of income taxation because income would be reported and taxed without reference to how the MNC is organized internally.[53]

Combined reporting and unitary taxation of this sort would require something known as the Global Formulary Apportionment Method (GFAM). As Christian Aid explains, GFAM allocates the global profits of an MNC "on a consolidated basis among the associated enterprises in different countries using a predetermined formula. The formula weights relative activity measures in each tax jurisdiction as follows: the proportion or a multiregional firm's income earned in a given state is expressed as a weighted average of the proportion of the firm's total sales, property and payroll in that state."[54] Despite the merits of this approach, however, many experts point out that getting international consensus on the necessary predetermined formula is extremely unlikely.

A less ambitious proposal that has also been suggested as a response to the problem of tax avoidance through transfer mispricing is to reform the current ALP system so that regard is given to actual economic activity and value creation (substance) rather than just the legal structure of the company (form) for the purposes of identifying the arm's length conditions for intra-group transactions.[55] In theory this would make tax avoidance more difficult because MNCs could not rely on their complex web of legal structures to the same extent as under the current ALP system (although a lot depends on the details of the proposal). Moreover, this approach is more politically feasible than the GFAM since it keeps the status quo largely intact.

In addition to these 'substance over form' considerations, the ALP system should also be simplified to make it more accessible for developing countries. The OECD is working on updating and simplifying its Transfer Pricing Guidelines to this end. The OECD has also

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53 Sol Picciotto, "Towards Unitary Taxation of Transnational Corporations." Tax Justice Network, December 2012.
54 Christian Aid, "Transfer Pricing," 12.
55 OECD, *Action Plan on Base Erosion and Profit Shifting*. OECD Publishing, 2013. 14.

established a Global Forum on Transfer Pricing in order to facilitate international cooperation on transfer pricing. The UN Committee of Experts on International Tax Matters is also working with the OECD in this issue, and is developing new guidelines for revenue authorities seeking to design and implement tax policies for MNCs.[56] The international community should seize this current momentum on tax avoidance and commit to these reforms in the post-2015 development agenda.

Finally, to help ensure that ALP guidelines are followed once implemented, the Financial Transparency Coalition proposes that "parties conducting a sale of goods or services in a cross-border transaction sign a statement in the commercial invoice certifying that no trade mispricing in an attempt to avoid duties or taxes has taken place and that the transaction is priced using the OECD arms-length principle."[57] This same proposal is made and endorsed by other organizations and experts.[58] A related idea could also be useful for false invoicing; specifically, requiring signatures on commercial invoices from both importers and exporters confirming that "prices accord to world market norms…and contain no element of mispricing for the purpose of manipulating [taxes]."[59] This is a simple and low-cost way to address tax avoidance.

ii. Reform international accounting standards: country-by-country reporting

An additional reform measure that would improve the current system of separate company accounting, and that is supported by numerous organizations and experts, is country-by-country reporting (CBCR).[60] Currently, corporations are only required to account for trade with unrelated companies and are therefore able to conceal trade between

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56 Christian Aid, "Transfer Pricing," 11.

57 Transparency Coalition, "Transfer Pricing,' http://www.financialtaskforce.org/issues/trade-mispricing/ The Financial Transparency Coalition was formerly the Task Force on Financial Integrity and Economic Development.

58 See, e.g UNDP, 22; Baker and Joly, 10-11; Christian Aid, "Death and Taxes," 27.

59 Baker and Joly, 10-11.

60 CBCR is supported by the UNDP (see UNDP, 4), the European Economic and Monetary Affairs Committee of the EU Parliament and The UN Conference on Trade and Development (see Baker and Joly, 10), Eurodad (see Eurodad, 8), the Task Force on Financial Integrity and Economic Development (see Richard Murphy for the Task Force on Financial Integrity and Economic Development), and the Tax Justice Network (see Richard Murphy for the Tax Justice Network).

affiliates of the same company. CBCR calls on MNCs to report all sales, profits, and taxes paid in all jurisdictions in their audited annual reports and tax returns—including those belonging to the same parent company—, providing a global picture of an MNC's activities. As a result, CBCR would make profit shifting easily identifiable and would provide some of the data needed for transfer mispricing investigations. There are likely to be two important outcomes: first, CBCR will help deter MNCs from engaging in abusive transfer pricing or other illicit forms of profit shifting in the first place,[61] and second, the data needed to resolve disputes in favour of the tax jurisdiction raising a transfer pricing inquiry will be available for the first time.[62]

Implementing CBCR should be relatively easy since it is just a matter of disclosure. According to Raymond Baker, "Corporations currently compile these figures for internal control but do not report such information to state regulators. Country-by-country accounting for revenues, costs, and profits is thus of no burden to corporations but hugely beneficial to tax authorities and goes far toward reducing the usefulness of tax havens."[63] Given this, CBCR is a very important item to include on the post-2015 development agenda.

A related area for reform is the International Accountants Standards Board (IASB). This organization is currently privately controlled and comprised of members from the "Big Four" accounting firms (Deloitte, PwC, Ernst & Young, and KPMG) who represent the interests of the financial community. This is problematic as the accounting standards developed by IASB are passed into law in many countries. Christian Aid therefore urges "reform of the International Accounting Standards Board so that it is taken out of private control and given international agency status, and so that it includes members who do not represent the interests of the financial community."[64]

iii. Implement universal automatic exchange of information

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[61] Richard Murphy, "Country-by-country reporting: Holding multinational corporations to account wherever they are." Task Force on Financial Integrity and Economic Development, June 2009. 21.

[62] Richard Murphy, "Country-by-country reporting: accounting for globalization locally," Tax Justice Network, 2012. 40.

[63] Raymond Baker and Eva Joly, "Illicit Money: Can it be Stopped?," *New York Review of Books*, December 3, 2009. http://www.gfintegrity.org/content/view/277/72/

[64] Christian Aid, "Death and Taxes," 27.

A common thread in the discussions on illicit financial flows is the need for greater transparency regarding international financial structures. Automatic exchange of tax information between all jurisdictions is an important goal in this respect. As discussed in section II, there are several initiatives promoting multilateral exchange of information, including especially recent work by the OECD's Global Forum. These efforts are important first steps towards the ultimate goal of universal automatic exchange of information.

By providing timely, targeted and comprehensive information to tax authorities, automatic exchange of information, like CBCR, will both have deterrent effects with respect to the use of secrecy jurisdictions for tax avoidance and tax evasion, and will enable authorities to detect and act upon cases of non-compliance with international standards.[65] Automaticity is important as it can facilitate early detection of tax avoidance.[66]

The G8 stressed the importance of global exchange of information in its Lough Erne Communiqué: "We see recent developments in tax transparency as setting a new standard and commit to developing a single truly global model for multilateral and bilateral automatic tax information exchange building on existing systems. We support the OECD report on the practicalities of implementation of multilateral automatic exchange and will work together with the OECD and in the G20 to implement its recommendations urgently."[67] Automatic exchange of information is also supported by international agencies such as the UN (in its Model Income Tax Treaty) and the UNDP, and tax justice organizations such as the Tax Justice Network.[68] The G20 also endorsed automatic exchange of information during the St. Petersburg Summit; they pledged to implement automatic exchange of information among their members by 2015, and called on all jurisdictions to follow suit.

The international community should seize this current momentum and take this one step further by committing to *universal* automatic exchange of information in the post-2015 development agenda. To be effective, as the OECD has emphasized, there must be a common model for reporting, and they are currently working on creating a standardized

[65] Global Forum report, 36.
[66] OECD, *Action Plan on Base Erosion and Profit Shifting*. 14.
[67] Communiqué, G8 Meeting, Lough Erne, June 2013. §26
[68] See UNDP, 4; James S. Henry, 44.

model of automatic exchange that is secure and cost-effective.[69] One further issue that will need to be addressed, however, is how to respond to cases of non-compliance with international standards. It will be important for the international community to consider this unanswered question in order for this initiative to be as effective as possible.

iv. Repatriate illicit funds

In addition to these preventative and transparency measures meant to curtail future illicit flows, a different type of initiative that has been raised by various organizations, including the UN Office of the High Commissioner for Human Rights (OHCHR) and Christian Aid, is the restorative one of asset repatriation. In 2011, the UN OHCHR released a report arguing that non-repatriation affects the country of origin's ability to secure human rights (especially economic, social and cultural rights), and making various recommendations to facilitate repatriation of illicit finds.[70] The findings of this report and the UN Convention against Corruption could serve as useful models for international efforts to repatriate wealth that is the result of tax evasion.[71]

The World Bank, in partnership with the UN Office on Drugs and Crime, already has a repatriation initiative: the Stolen Asset Recovery (StAR) Program. Unfortunately, only about $5 billion of the $300-600 billion, or around 1%, of stolen assets from the last 15 years were successfully repatriated during that time period.[72] Increased political pressure and greater international cooperation, however, can help make this and similar initiatives more effective.[73] And the opportunity exists now, with the creation of the post-2015 development agenda, for the international community to commit to scaling up its efforts on this front, and ensuring that a much greater percentage of stolen funds are recovered and returned to their country of origin.

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[69] OECD, "Automatic Exchange of Information" http://www.oecd.org/tax/exchange-of-tax-information/automaticexchange.htm

[70] OHCHR, "Comprehensive study on the negative impact of the non-repatriation of funds of illicit origin to the countries of origin on the enjoyment of human rights, in particular economic, social and cultural rights" (A/HRC/19/42), 14 December 2011. 16-17.

[71] Christian Aid makes directs this same proposal directed specifically at the governments of the UK and Ireland. See Christian Aid, "Death and Taxes," 27.

[72] Kevin M. Stephenson et al, "Barriers to Asset Recovery," World Bank, 2011. 186.

[73] Ibid.

v. Increase ODA for capacity-building in developing countries

These international-level efforts to address tax avoidance must be complemented by domestic-level capacity-building efforts in developing countries that are more limited in their ability to respond but that are far more greatly affected by it. For example, as the African Tax Administration Forum states: "The taxation of international transactions, in particular transfer pricing, has become increasingly difficult. Transfer pricing today typically involves huge and expensive databases and high-level expertise to handle, which developing countries cannot match."[74]

Moreover, several of the international policy initiatives just discussed—country-by-country reporting, automatic exchange of information—will result in making more financial information available to governments. This is a necessary step for reducing tax avoidance but is insufficient insofar as developing countries' technical and administrative capacities are not adequate for both implementing these measures and effectively using the resulting information. International efforts in developing these policies should therefore be complemented by international efforts to help build up the local infrastructure needed to successfully detect illicit behaviour and undertake effective enforcement actions against it, e.g. holding MNCs accountable for transfer misinvoicing. Strengthening the capacities of developing countries in both respects should be a priority for the international community.

On these fronts, a promising initiative is the OECD's proposal for Tax Inspectors Without Borders (TIWB): "The TIWB objective is to facilitate the transfer of tax audit knowledge and skills through a real-time, 'learning by doing' approach. Matched through the TIWB mechanism, tax audit experts would work directly with local officials on current audits concerning international tax issues and to share general audit practices." [75] The feasibility study for TIWB was welcomed in the Lough Erne G8 Leaders Communiqué."[76] In a similar vein, the UNDP suggests that developing countries would benefit from "systematic customs reform and the adoption of transfer pricing regulations with

[74] Quoted in Eurodad, 12.
[75] OECD, "Tax Inspectors without Borders," OECD Publishing , July 2013. 1. Available at http://www.oecd.org/ctp/tax-global/TIWB-Q&A.pdf
[76] Communiqué, G8 Meeting, Lough Erne, June 2013. §28

commensurate increase in enforcement capacity. The implementation of specialised software which helps governments to identify possible incidences of transfer pricing may also be useful to some governments."[77] Finally, the international community should also help build up existing domestic efforts at capacity-building, including institutions like the African Tax Administration Forum (ATAF), and "home-grown" knowledge-sharing platforms, such as the African Union Commission's Africa Platform for Development (APDev).[78]

Lack of capacity is an extremely important dimension of the problem of tax avoidance and while OECD research has shown that the return on investment on ODA targeted towards capacity building of developing countries' tax administrations is very high, currently only a fraction of ODA is dedicated to this purpose.[79] Development cooperation in this area should be scaled up, and committing a greater portion of ODA towards supporting tax administration in developing countries is a feasible and high-impact way for the post-2015 development agenda to address tax avoidance.

This section has considered recommendations for institutional reforms and additional measures that should be included in the post-2015 development agenda in order to end illicit trade-related flows from developing countries. The final section proposes one additional initiative to combat illicit flows, but that is likely outside the scope of the post-2015 development framework.

IV. Additional recommendation: Ratify a convention on transparency in international economic activity

Some of the proposals in the previous section, including country-by-country reporting and automatic exchange of tax information, are distinct but related attempts to promote financial transparency. The Norwegian Government Commission has proposed the creation of a Convention on Transparency in International Economic Activity with the goal of

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77 UNDP, 3.

78 Thanks to Michael Sudarkasa of the Africa Business Group for this point. (Correspondence, September 17 and September 20, 2013)

79 Thanks to Gail Hurley of the UNDP for this point. (Correspondence, September 19, 2013)

"prevent[ing] states from developing secrecy structures which are likely to cause loss and damage to other jurisdictions."[80] According to the Commission, the Convention would:

> First…bind states not to introduce legal structures that, together with more specifically defined instruments, are particularly likely to undermine the rule of law in other states. Second, states which suffer loss and damage from such structure must have the right and duty to adopt effective countermeasures which will prevent structures in tax havens from causing loss and damage to public and private interests both within and outside of their own jurisdiction.[81]

Unlike these other responses to financial secrecy, the Convention aims to get to the root of the problem by getting rid of secrecy regulations in the first place by, for example, requiring the publication of beneficial ownership of companies, trusts and foundations.

Because this is a more ambitious goal, however, it is likely to face much more political resistance, not least of all from secrecy jurisdictions themselves who profit from providing this type of financial service, and some of which are located in politically powerful places (e.g. Switzerland, the city of London, the US state of Delaware, etc), while others rely on providing financial secrecy as the primary source of their own development (e.g. the Cayman Islands, the Cook Islands, Mauritius, etc). Beyond the question of achieving political consensus, there are also further issues to be worked out concerning, for example, the exact content of the Convention. This proposal continues to be explored by the Norwegian Government.

The targets discussed in Section III and the final recommendation proposed in Section IV, if implemented, would go a long way toward stopping illicit financial flows from developing countries. ASAP will advocate for the international community to take up these initiatives and commit to ending illicit financial flows in the post-2015 development agenda, and beyond.

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[80] Norwegian Government Commission, 16.
[81] Ibid, 144-5.

Academics Stand Against Poverty

POLICY BRIEF

Illicit financial flows and the post-2015 development agenda

(Author: Esther Shubert, Yale University)

Executive Summary: Reforming the rules and regulations that facilitate illicit financial flows would have a major impact on human development. For this reason, ASAP believes that illicit financial flows is a crucial item for the international community to address in the post-2015 development agenda. This brief will focus specifically on the rules and regulations that allow for illicit trade-related flows (as opposed to criminal and corrupt flows), and especially on the practice of corporate tax avoidance. It asks about what reforms the international community should commit itself to in the post-2015 agenda in order to end illicit trade-related flows from developing countries, and makes five policy recommendations to this end: i) reform the arm's length transfer pricing system, ii) implement country-by-country reporting, iii) implement universal automatic exchange of information, iv) repatriate illicit funds, and v) increase ODA for capacity-building in developing countries.

What reforms should the international community commit itself to in the post-2015 development agenda in order to end illicit financial flows from developing countries?

Background on illicit financial flows and development:

Illicit financial flows are cross-border financial flows that leave the developing world and go into the developed world, contrary to (the letter and spirit of) domestic and international laws.[82] There are three broad types of illicit flows: corrupt, including the proceeds of bribery and theft; criminal, including the proceeds of activities such as drug and human trafficking; and trade-related, including corporate tax avoidance.[83] Illicit financial flows drain huge amounts of resources from the developing world. The most recent estimates from Global Financial Integrity (GFI) is that illicit flows from developing countries

[82] This is following Global Financial Integrity, but it is important to note that there is disagreement as to what constitutes illicit financial flows. See, e.g. Peter Reuter, "Introduction and Overview: the Dynamics of Illicit Flows" in *Draining Development?* ed. Peter Reuter. The World Bank, 2012. 7.
[83] Again, following Global Financial Integrity, although GFI has recently stopped focusing on criminal flows.

totaled $946.7 billion in 2011, and totaled $5.9 trillion cumulatively from 2002 to 2011.[84] Around 80% of this is due to illicit trade-related activities such as corporate tax avoidance through trade misinvoicing.[85]

It is especially important to take account of such outflows at a time when the international community is questioning the effectiveness and sustainability of traditional sources of development finance, such as ODA. For this reason, a lot of emphasis is being placed on domestic resource mobilization within developing countries themselves as the most sustainable way of financing their development and helping to ease aid dependency. The loss of resources through illicit financial flows, including forgone tax revenue and lost investment capital for the local economy, clearly undermines this goal.[86]

ASAP and the post-2015 development agenda:

There are many features of the international institutional order that (1) contribute to the persistence of global poverty, (2) could be reformed at a reasonable cost by the international community, and (3) would lead to a dramatic reduction in global poverty and human deprivation, if reformed.[87] Academics Stand Against Poverty (ASAP) believes that reforming these rules and regulations is a moral imperative and should play a central role in the United Nations' new development framework, which will succeed the current Millennium Development Goals (MDGs) when they expire in 2015. ASAP is therefore working to develop and advocate for politically feasible MDG successor goals that improve upon those in the original MDG framework—which focused primarily on outcomes for the recipients of aid—by highlighting the responsibilities of affluent states and the donor community to help reform those institutions.

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84 Dev Kar and Brian LeBlanc, "Illicit Financial Flows from Developing Countries: 2002-2011." GFI, December 2013. iii.
85 Ibid, x.
86 International Bar Association's Human Rights Institute Task Force on Illicit Financial Flows, Poverty and Human Rights, "Tax Abuses, Poverty and Human Rights," International Bar Association, 2013. 23. According to Tom Cardamone at GFI, the potential lost capital is likely even greater than the tax loss. (In conversation.)
87 The term global institutional order is most strongly associated with Thomas Pogge. It refers to, in Pogge's words, "non-domestic social institutions" such as global rules of governance, trade, and diplomacy. See Thomas Pogge, "World Poverty and Human Rights: Cosmopolitan Responsibilities and Reforms" (second edition). Polity Press, Malden, MA, 2008. 33.

The rules and regulations that facilitate illicit financial flows is one area where institutional reform could have a major impact on human development. For this reason, ASAP believes that illicit financial flows is a crucial item for the international community to address in the post-2015 development agenda. This brief will focus specifically on the rules and regulations that allow for illicit trade-related flows (as opposed to criminal and corrupt flows), and especially on the practice of corporate tax avoidance. There are two reasons for this. First, tax avoidance accounts for the large majority of all illicit financial flows, and so curbing it has the greatest potential to generate new resources for the developing world.[88] Second, corrupt and criminal financial flows are the result of *breaking* existing laws and rules. While large sums of money are lost to corruption and criminal activity each year, the existence of these behaviours does not in itself suggest problems with the rules trying to prevent them in the first place (although they may suggest problems with the enforcement of those rules). In contrast, corporate tax avoidance is made possible by the structure of financial rules and regulations themselves. They are thus appropriate subjects for institutional reform.

Policy Recommendations:

The following are some of the initiatives most discussed and advocated for by tax experts, international organizations and governments concerned with ending illicit flows from developing countries. ASAP supports the incorporation of these items into the post-2015 development agenda.

i. Reform the arm's-length pricing system

One of the most common means of corporate tax avoidance by multinational corporations (MNCs) is abusive transfer pricing. Cross-border transactions (of goods, services and intangibles) between subsidiaries of the same company are not subject to normal market forces; they are governed instead by a process known as transfer pricing. The current standard for MNCs to find an appropriate transfer price is the OECD's "arm's-

[88] Dev Kar and Brian LeBlanc, x.

length principle" (ALP).[89] The idea behind the ALP is that the price allocated to an intra-group transaction should reflect the price that would be paid between two different companies on the open market. However, subsidiaries in different countries often charge each other non-APL rates in order to minimize their tax burden, e.g. though "over-invoicing imported goods and under-invoicing exported goods, so as to minimize income in higher-tax countries and shift unreported profits abroad" and "the (below-market) transfer of intellectual property rights…to low-tax jurisdictions."[90]

In response, numerous experts argue for eliminating separate company accounting and instead treating all entities of an MNC as a single unit. This would eliminate the need for the arm's-length system because income would be reported and taxed without reference to how the MNC is organized internally.[91] Combined reporting and unitary taxation of this sort would require something known as Global Formulary Apportionment (GFA), which would consolidate an MNC's global profits according to a predetermined formula. Despite the merits of this approach, however, many experts point out that getting international consensus on a predetermined formula is extremely unlikely.

A less ambitious proposal is to reform the current ALP system so that regard is given to actual economic activity and value creation (substance) rather than just the legal structure of the company (form) for the purposes of identifying the arm's length conditions for intra-group transactions.[92] In theory this would make tax avoidance more difficult because MNCs could not rely on their complex legal structures to the same extent as under the current ALP system (although a lot depends on the details of the proposal). This approach is more politically feasible than GFA since it keeps the status quo largely intact.

In addition to these 'substance over form' considerations, the ALP system should be simplified to make it more accessible for developing countries. The OECD and the UN Committee of Experts on International Tax Matters are working on updating and simplifying transfer pricing guidelines to this effect.[93] Finally, to help ensure that ALP

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89 David McNair, Rebecca Dottey and Alex Cobham, "Transfer pricing and the taxing rights of developing countries." Christian Aid, November 2010. 3.

90 James S. Henry, *The Price of Offshore Revisited*. Tax Justice Network, July 2012. 20.

91 Sol Picciotto, "Towards Unitary Taxation of Transnational Corporations." Tax Justice Network, December 2012.

92 OECD, *Action Plan on Base Erosion and Profit Shifting*. OECD Publishing, 2013. 14.

93 David McNair, Rebecca Dottey and Alex Cobham, 11.

guidelines are followed once implemented, the Financial Transparency Coalition proposes that "parties conducting a sale of goods or services in a cross-border transaction sign a statement in the commercial invoice certifying that no trade mispricing in an attempt to avoid duties or taxes has taken place and that the transaction is priced using the OECD arms-length principle."[94] This same proposal is made and endorsed by other organizations including UNDP and Christian Aid.[95] This is a relatively simple and low-cost way to address tax avoidance.

ii. Require country-by-country reporting

An additional reform measure that would improve the current system of separate company accounting is country-by-country reporting (CBCR). Currently, corporations are only required to account for trade with unrelated companies and are therefore able to conceal trade between affiliates of the same company. CBCR calls on MNCs to report all sales, profits, and taxes paid in all jurisdictions in their audited annual reports and tax returns—including those belonging to the same parent company—, providing a global picture of an MNC's activities. As a result, CBCR would make profit shifting easily identifiable and would provide some of the data needed for transfer mispricing investigations. There are likely to be two important outcomes: first, CBCR will help deter MNCs from engaging in abusive transfer pricing or other illicit forms of profit shifting in the first place,[96] and second, the data needed to resolve disputes in favour of the tax jurisdiction raising a transfer pricing inquiry will be available for the first time.[97] CBCR is already supported by numerous organizations.[98]

Implementing CBCR should be relatively easy since it is just a matter of disclosure. According to Raymond Baker, "Corporations currently compile these figures for internal control but do not report such information to state regulators. Country-by-country

94 Financial Transparency Coalition, "Trade Mispricing," http://www.financialtransparency.org/issues/trade-mispricing/

95 UNDP, "Illicit Financial Flows from the Least Developed Countries: 1990-2008." UNDP, May 2011, 22; and Christian Aid, "Death and taxes: the true toll of tax dodging." Christian Aid, May 2008. 27.

96 Richard Murphy, "Country-by-country reporting: Holding multinational corporations to account wherever they are." Task Force on Financial Integrity and Economic Development, June 2009. 21.

97 Richard Murphy, "Country-by-country reporting: accounting for globalization locally," Tax Justice Network, 2012. 40.

98 These include the UNDP (see UNDP, 4), the Task Force on Financial Integrity and Economic Development (see Richard Murphy for the Task Force on Financial Integrity and Economic Development), the Tax Justice Network (see Richard Murphy for the Tax Justice Network), to name but a few.

accounting for revenues, costs, and profits is thus of no burden to corporations but hugely beneficial to tax authorities and goes far toward reducing the usefulness of tax havens."[99] Given this, CBCR is a very important item to include on the post-2015 development agenda.

iv. Implement universal automatic exchange of information

By providing timely, targeted and comprehensive information to tax authorities, automatic exchange of information, like CBCR, will both have deterrent effects with respect to the use of secrecy jurisdictions for tax avoidance and tax evasion, and will enable authorities to detect and act upon cases of non-compliance with international standards.[100] Automaticity is important as it can facilitate early detection of tax avoidance.[101]

Automatic exchange of information is supported by international agencies such as the UN (in its Model Income Tax Treaty) and the UNDP, and tax justice organizations such as the Tax Justice Network.[102] The G20 also endorsed automatic exchange of information during the St. Petersburg Summit; they pledged to implement automatic exchange of information among their members by 2015, and called on all jurisdictions to follow suit. The international community should seize this current momentum and take this one step further by committing to *universal* automatic exchange of information in the post-2015 development agenda.

v. Repatriate illicit funds

In addition to these preventative and transparency measures meant to curtail future illicit flows, a different type of initiative that has been raised by various organizations, including the UN Office of the High Commissioner for Human Rights (OHCHR) and Christian Aid, is the restorative one of asset repatriation. The World Bank, in partnership with the UN Office on Drugs and Crime, already has a repatriation initiative: the Stolen Asset Recovery (StAR) Program. Unfortunately, only about $5 billion of the $300-600 billion, or around 1%, of stolen assets from the last 15 years were successfully repatriated

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99 Raymond Baker and Eva Joly, "Illicit Money: Can it be Stopped?," in *The New York Review of Books*, December 3, 2009. http://www.gfintegrity.org/content/view/277/72/

100 The Global Forum on Transparency and Exchange of Information for Tax Purposes, "Progress Report to the G20 Finance Ministers and Central Bank Governors: Global Forum Update on Effectiveness and Ongoing Monitoring. 36.

101 OECD, *Action Plan on Base Erosion and Profit Shifting*. OECD Publishing, 2013. 14.

102 See UNDP, 4; James S. Henry, 44.

during that time period.[103] Increased political pressure and greater international cooperation, however, can help make this and similar initiatives more effective.[104] And the opportunity exists now, with the creation of the post-2015 development agenda, for the international community to commit to scaling up its efforts on this front, and ensuring that a much greater percentage of stolen funds are recovered and returned to their country of origin.

vi. Increase ODA for capacity-building in developing countries

These international-level efforts to address tax avoidance must be complemented by domestic-level capacity-building efforts in developing countries that are more limited in their ability to respond but that are far more greatly affected by it. OECD research has shown that the return on investment on ODA targeted towards capacity building of developing countries' tax administrations is very high; currently, however, only a fraction of ODA is dedicated to this purpose.[105] Development cooperation in this area should be scaled up, and committing a greater portion of ODA towards supporting tax administration in developing countries is a feasible and high-impact way for the post-2015 development agenda to address tax avoidance.

103 Kevin M. Stephenson et al, "Barriers to Asset Recovery," World Bank, 2011. 186.
104 Ibid.
105 Thanks to Gail Hurley of the UNDP for this point. (Correspondence, September 19, 2013)

Academics Stand Against Poverty (ASAP)

MEDIA BRIEF

Illicit financial flows and the post-2015 development agenda

- Illicit financial flows drain huge amounts of resources from the developing world.[106]
- According to Global Financial Integrity, illicit flows from developing countries totaled $946.7 billion in 2011, and totaled $5.9 trillion cumulatively from 2002 to 2011.[107]
- According to the UNDP, illicit financial flows from the least developed countries totaled $26.3 billion in 2008, up from $9.7 billion in 1990.[108]
- UK charity Christian Aid estimates that 350,000 children under five could be saved every year if the capital lost to illicit financial flows were available and allocated according to current spending patterns.[109]
- Reforming the rules and regulations that facilitate illicit financial flows would have a major impact on human development.
- Moreover, the effectiveness and sustainability of traditional sources of development finance, such as ODA, are being question. A lot of emphasis is therefore being placed on domestic resource mobilization within developing countries themselves as the most sustainable way of financing their development and helping to ease aid dependency.
- The loss of resources through illicit financial flows, including forgone tax revenue and lost investment capital for the local economy, clearly undermines this goal.[110]

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[106] Illicit financial flows are cross-border financial flows that leave the developing world and go into the developed world, contrary to (the letter and spirit of) domestic and international laws. They are usually categorized into three types: corrupt, including the proceeds of bribery and theft; criminal, including the proceeds of activities such as drug and human trafficking; and trade-related, including corporate tax avoidance.

[107] Dev Kar and Brian LeBlanc, "Illicit Financial Flows from Developing Countries: 2002-2011." Global Financial Integrity, December 2013. iii.

[108] UNDP, "Illicit Financial Flows from the Least Developed Countries: 1990-2008." UNDP, May 2011. 3.

[109] Christian Aid, "False profits: robbing the poor to keep the rich tax-free." Christian Aid, March 2009. 2.

[110] International Bar Association's Human Rights Institute Task Force on Illicit Financial Flows, Poverty and Human Rights, "Tax Abuses, Poverty and Human Rights," International Bar Association, 2013. 23.

- For these reasons, it is crucial to take action on illicit financial flows.

- Around 80% of illicit financial flows are due to illicit trade-related activities such as corporate tax avoidance.[111]

- Given the magnitude of corporate tax avoidance compared to other types of illicit flows, this is an especially important problem to address.

- An example of corporate tax avoidance through a practice known as corporate profit shifting: SABMiller is one of the biggest companies in the beer industry. It is the biggest brewer in Africa and owns numerous beer companies there. Many of the 'local' beer brands that SABMiller sells in Africa are owned by other subsidiary companies in the Netherlands, which has a lower tax rate. African subsidiaries pay millions in royalties to the Dutch subsidiaries for the use of these brands. A large part of the profits, then, are officially made in the Netherlands, rather than in the African countries where the beer is produced and consumed. In this way SABMiller shift profits out of Africa, minimizing its tax burden there. The tax loss to African countries is an estimated £10 million per year.[112]

- The problem of corporate tax avoidance has recently been raised by various organizations, including the OECD and the G20.

- The international community has the opportunity seize this momentum and take coordinated action on tax avoidance and other illicit financial flows when the Millennium Development Goals expire in 2015, by including them as an item on the post-2015 development agenda.

- This is an extremely important opportunity that should not be squandered.

[111] Dev Kar and Brian LeBlanc, x.

[112] Action Aid, "The SABMiller guide to tax-dodging," http://www.actionaid.org.uk/campaign/the-sabmiller-guide-to-tax-dodging For the full report, see Action Aid, "Calling Time" available at http://www.actionaid.org.uk/sites/default/files/doc_lib/calling_time_on_tax_avoidance.pdf