Session 4
Domestic Resource Mobilization – Implications of Illicit Financial Flows

Financing for Development Office
Economic Development & Integration Division
Financing SDG’s: Blockchain - Illicit Transactions and the Role of a Parallel Currency

International Conference on Financing Sustainable Development~Curbing Illicit Financial Flows - UN Beirut 2018

Stefan Brunnhuber
How to Finance our Future?

’Why this is so difficult…’

• SDG’s: 5 Trill USD annually in total
• The system is unstable: >10 events annually
• Resistent to change: Multiple Lock-in effects
• Takes a century to balance the world
• SDG’s: 2/3 are global commons
• Shadow Economy - Illicit transactions
• Changing the Mind-set: Additional liquidity required
The global value chain simplified:

‘Central banks - Commercial Banking - Goods and Services - Shadow market and the Rest…’
The Rational of the conventional approach: ‘Redistribute money through taxation - fees - philanthropy in order to finance SDG’s: End-of-Pipe-Financing…’
The Rational Behind The Block Chain Technology:

'Complementary - Parallel - Optional - Regulated - Liquidity Beyond Redistributing Money to Finance SDG’s…’

Shadow economy

Regulatory Corridor

CBDC

CC

0.7-2 %

SDG
Why Blockchain associated Technology?

• **Trust** (Social Capital)

• **Transparency** (Tax Evasion, Fraud, illicit Transactions, Corruption)

• **Targeted** (Ensured investment/consumption - smart contract)

• **Resilience** (anti-cyclical, steering, regional, sectoral wealth)

• **Authentication** (who is who?) - **Authorization** (Permission to do) - **Accountability** (Who did what?)

• **Pareto-superior** (Jobs, negative Externalities, green growth, tax revenues, stabilizing CPI)
A Dual currency Approach: Financing the Future

“What if we rode a Bike with two Wheels?”

Impact on AML/CFT:
reverse human trafficking, income gap
Social capital, productivity

Positive Externalities

Different Channels

Pre-distributive additional Liquidity:
Earmarked for SDGs, running in parallel, using Blockchain, smart social contract: 6-8%

Entropic sector

80 Trill USD/yr

80 Trill USD/yr

4-5 Trill USD

500 Bill USD

Re-distributive ‘End-of-Pipe’ Financing:
Co-financing through taxes, fees, charity, regulation, de- and reinvestment: 0.5-2%
Sustainability Development Solutions

‘No silo - non reductionist - multi-stake and multi level
Don’t miss: Monetary Regulation…’
Summary: Blockchain - Illicit Transactions
Financing the Future:

Parallel - additional - regulated - targeted Liquidity (1 Trill USD/a)

BC ensures a mechanism that enables humans to shift towards SDG’s
(do not rely on CSR, charity, voluntary commitment, resolutions or moral
imperative, taxes or fees)

Traceability - Trust - Tracking - Transparency - Transactions costs

If done in the right way: cheap - fast - resilient - fair

7/24 Mechanism

Pareto-superior
"You never change a system by fighting the existing reality; to change something, build a new one that makes the existing less relevant."

Buckminster Fuller
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CHALLENGES TO DOMESTIC RESOURCE MOBILISATION FOR FINANCING FOR SUSTAINABLE DEVELOPMENT

Jan Kregel
How are we doing sixty years on?

- First UN Development Decade (1961): Mobilise Foreign Resources
  - Low Domestic Savings Made Foreign Resources Necessary
  - 0.7% of Developing Countries’ GDP: Official Development Assistance
  - Sixty + Years later: Objective Never achieved,

- First UNCTAD Conference (1964): Mobilise External Trade
  - Declining Terms of Trade may swamp financial flows
  - Prebisch: Let us “Earn our Way to Development”

- SDTreatmen, GSPreferences, Buffer Stocks
  - Tendency to decline until 1970s then 2004 – 2008

- Monterrey Consensus: Mobilisation of Domestic Resources
  - First Pillar: Supportive enabling environment; Good governance; Control of corruption; Sound macroeconomic policies; Public resources/budgeting; Sound banking systems; Micro-finance/SMEs – including women and rural areas; Capacity building, with special focus on Africa

- FFD Follow-Up: Public Resource Mobilization
Public Sector Resource Mobilisation?

- The “Public Sector” has no Resources to Mobilise
- Government Revenue cannot be a “source” of Financing
- The Government “Budget Balance” is an endogenous variable
  - Determined by: National Income
    - National Income determined by
      - Private domestic expenditure
      - Net foreign expenditure
      - Public expenditure
- It is DOMESTIC Demand that is the problem
  - Government does control Public Expenditure policy
- What Private Resources should it Mobilise
- Employment Policy and Environmental Policy
- Government has little control over Foreign Demand
  - Depreciation of exchange rate, Low wages
- Government Can Attract Foreign Finance
  - Firesale of assets, Low wages, High interest rates
1st Public Expenditure Objective: Employment

- No matter the level of development,
- Every economy faces the problem of finding employment for Disguised unemployment
  - Because technical innovation reduces labour coefficients as it increases labour productivity
- Reliance on Fiscal Policy a “Blunt Instrument”
- Promoting Private Investment leads to creation of excessive financial liabilities and financial fragility
- If government supports full employment you have a floor on growth equal to the rate of labour force growth
- If there is productivity then this rate is levered up
- Policy Proposal: Government Guaranteed Employment
2nd Objective: Transformation of Productive Structure

- Prebisch, Lewis: Transfer “Underemployed” Agricultural workers to higher productivity occupations
  - Develop Manufacturing to Absorb Agricultural workers
- Higher wages due to higher technical progress in Industry raise living standards and demand for rising domestic manufacturing output
- But Innovation in Manufacturing reduces employment per unit output
  - Creates Unemployment in Industry
- Develop Services to Absorb Unemployed Manufacturing workers
- Innovation produces higher per capita income as it reduces demand for labour per unit of output
- No matter the level of development, the problem repeats: Finding employment for Disguised unemployment
- And this requires sectoral policy and government institutions
- Sectoral Policy: Transformation of Productive Structure
3rd Objective Build Domestic Financial System

- Schumpeter: Finance is the “ephor” of capitalism,
- Innovation by entrepreneurs requires credit creation:
- Banks can create purchasing power “out of nothing”
  - because they operate the payments system
- The Public Sector can do this too: create purchasing power out of nothing
- Requires an Effective Fiscal system:
  - Taxes are a liability that can be extinguished only by means of acquiring government issued promises to pay
  - You can only acquire these IOU’s by selling goods and services to the government
- Efficient Taxation is only required to allow the government to create purchasing power out of nothing to finance development
- Not to **finance** expenditures
- Illicit Flows of Finance – Tax Evasion
- Erodes the Ability of Government to Finance Development
4th Objective: Development Friendly International Financial System

- Bretton Woods commitment to exchange stability placed a limit on Development Finance
- Borrowers had to get export surplus to repay IMF loans
- NEGATIVE NET TRANSFER OF RESOURCES!!
- Post-Bretton Woods: Private Capital Flows – after crisis an IMF program required to guarantee that you would export to repay private lenders
- Manage International Capital Flows
  - Free capital markets determine the domestic structure of production
  - Extractive Industries
  - Soft Commodities
  - Deindustrialisation
International Payments System

- Keynes used “banking principle” for his Clearing Union
  - To create financing for external deficits out of nothing
  - And finance development by preserving global demand
- The IBRD would never do this
- The current proposals for Regional development banks do not do this
- This system is more efficient that supporting international capital flows for development finance
- Create Regional Clearing Unions
- LDC clearing unions
5th Public Expenditure Objective: Sustainable Development

- Public Employment can be directed to Environmental Areas
  - Green Jobs
- Use Capital Account Budgeting
- MACRO Economic Coherence Accounting
- Foreign Finance Relative to Domestic Finance
Summary

- 1 Mobilise Domestic Employment
- 2 Domestic Sectoral Transformation of Production Structure
- 3 Mobilise Domestic Finance: Monetary Sovereignty
- 4 Manage International Financial Flows or Build a Development Friendly International Financial System
- 5 Build an Environmentally Sustainable Development Strategy
THANK YOU

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Financing for Development Office
Economic Development & Integration Division
Illicit Financial Flows and Domestic Resource Mobilization

Manuel F Montes
Conference on Financing Sustainable Development: Curbing Illicit Financial Flows
Beirut, 28-29 November 2018
Outline

• Disciplines from IFF
  o Corporate tax liabilities/behavior
  o IFF Tax avoidance facilities not just evasion

• DRM and sustainable development

• Restricting IFF facilities
Google: Double Irish w/ Dutch Sandwich

Doe mij maar een Double Irish met een Dutch Sandwich

1. Separate entity principle
2. Arms length transfer pricing on goods and services
Google: Double Irish w/ Dutch Sandwich

- Create subsidiaries (separate entities) under control of the Father firm
- Move profits from high tax jurisdictions to low or no-tax jurisdictions
- Avoid withholding taxes on transfers
- Move intellectual property to low tax jurisdiction
- Charge for services on the use of intellectual property by subsidiaries in high tax areas
Google: Double Irish w/ Dutch Sandwich

- **Users of Double Irish w/ Dutch Sandwich**

  1. Abbott Laboratories[15][16]
  3. Apple Inc.[2]
  4. Eli Lilly and Company[17]
  5. Facebook[9]
  6. Forest Laboratories[17]
  7. General Electric[9]
  8. Google[9][17][18]
  9. IBM[19]
  10. Johnson & Johnson[9]
  11. Microsoft[17]
  12. Oracle Corp.[17]
  13. Pfizer Inc.[17]
  15. Yahoo![20]
  16. Medtronic Inc.[21]

- **After 2020, no more double Irish (no new users after 2015) BUT replaced by “Knowledge Development Box”**

- **Separate entity principle practice and arms length pricing reinforced by BEPS**
Characteristics of IFF

- **Involve multiple jurisdictions**
  - Facility only available to multinationals and individuals in highest income levels (individuals that can identify and undertake SDG investments)
  - Companies that do not have foreign subsidiaries and Ordinary workers have no choice but to pay their taxes.
  - Average rate of VAT – a tax that falls hardest on the poor – has climbed from 17.6% in 2008 to a record high of 19.2% at the start of 2015. In sub-saharian Africa, 67% of tax collection falls on indirect taxation.
Characteristics of IFF

• Involve multiple jurisdictions
  
  – Multinational corporations legally pay very little by aggressively avoiding or evading their corporate tax responsibilities by using low tax jurisdictions, where up to 40% of their profits are shifted
  
  – Multinationals are paying significantly lower tax rates than before the 2008 financial crisis, with effective reported corporate tax rates falling nearly one third since 2000, from 34 to 24%
Characteristics of IFF

• Mostly legal (65% in Africa)
  o If one can reduce taxes paid using existing legal facilities, not need to use illegal channels
  o 2/3 world trade is intra-firm trade: facility for Mis-invoicing
  o Headquarters charges on subsidiaries in developing countries reduce their taxable profit and thus erode their tax base
IFF (trade mis invoicing) & capital inflows

(Billions of United States dollars)

Source: UN/ECA calculations.
Note: Chart shows the aggregated net outflows for bilateral
Main Vehicles for IFFs in Lebanon

- Services,
- Oil & Gas,
- Vehicles,
- Pearls and precious metals,
- Pharmaceutical products,
- Electrical machines

Source: Ajaka (2017)
Characteristics of IFF

• IFF Facilities feed financialization
  o IFF needs to be invested in assets with secure property rights (why crown territories)
  o IFF invested in other financial assets (securitization)
  o Trading of existing Assets => Short-term credit facilities – portfolio flows
  o Driven by search for asset price appreciation and short-term gains
Inverted pyramid of global liquidity

- **Power money**: 10% of world GDP, 1% of liquidity
- **Broad money**: 122% of world GDP, 11% of liquidity
- **Securitised debt**: 142% of world GDP, 13% of liquidity
- **Derivatives**: 802% of world GDP, 75% of liquidity
SDGs: From Billions to Millions

• World Bank & other IFIs: SDGs need from Billions to Trillions in financial flows

• Corporations earning billions of dollars of revenues and paying only millions of dollars in taxes. That is basically a tax rate, compared against revenues, that is less than 10 per cent or even less than that.

• Between 2009 and 2011, McDonald’s in Europe reported a cumulative revenue of €3.7 billion and tax payments of €16 million. On revenues of $11.9 billion, Amazon paid $16 million tax last year in Germany.
SDGs: Investment Creates Debt

• Investment depends on upfront costs whose benefits return in future => Creates debt.

• Debt repayment requires increasing government revenue matching increasing GDP
  o Private I: long-term projects (a) too risky (b) too long-term > 5 yrs and (c) too large for private sector.
  o World Bank will insist on government guarantees; will not be paid back if borrowing governments tax effort do not increase with increased economic activity
Race to the Bottom: Statutory Corporate Income Tax Rates

Source: IMF 2014
Poorer Countries More Dependent on Corporate Income Tax \( (\text{per cent of total revenue}) \)

Source: IMF 2015
## Comparative Distribution of Government Revenues (per cent of GDP)

<table>
<thead>
<tr>
<th></th>
<th>All</th>
<th>High Income OECD</th>
<th>High Income Non-OECD</th>
<th>Upper Middle income</th>
<th>Lower Middle Income</th>
<th>Low Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Govt revenue</td>
<td>28.7</td>
<td>41.5</td>
<td>33.8</td>
<td>28.5</td>
<td>26.4</td>
<td>18.4</td>
</tr>
<tr>
<td>Govt revenue, excl grants</td>
<td>27.8</td>
<td>41.4</td>
<td>33.7</td>
<td>27.9</td>
<td>25.6</td>
<td>15.2</td>
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<tr>
<td>Government taxes</td>
<td>20.5</td>
<td>35.4</td>
<td>15.7</td>
<td>20.7</td>
<td>17.7</td>
<td>13.0</td>
</tr>
<tr>
<td>Income tax</td>
<td>6.9</td>
<td>12.9</td>
<td>5.9</td>
<td>5.4</td>
<td>5.0</td>
<td>3.5</td>
</tr>
<tr>
<td>VAT revenue</td>
<td>5.9</td>
<td>6.8</td>
<td>6.2</td>
<td>5.2</td>
<td>5.0</td>
<td>4.9</td>
</tr>
<tr>
<td>Trade taxes</td>
<td>3.6</td>
<td>0.6</td>
<td>2.7</td>
<td>4.6</td>
<td>4.9</td>
<td>3.7</td>
</tr>
</tbody>
</table>

Source: IMF 2011
Spillovers from OECD standards

- IMF (2014, p. 12) study observes that “the network of bilateral double taxation treaties based on the OECD model significantly constrain the source country’s rights.”
- Estimated loss in tax revenue compared to a standard “akin to source taxation” (IMF 2014, p. 20) is much greater for developing countries – indicative spillovers about twice as large for non-OECD countries compared to OECD countries.
BEPS Action Plan
Versus Developing Countries

• No consideration of source versus residence taxation

• **Outcome:**
  • Some innovations, such as country-by-country reporting
  • RETENTION OF SEPARATE ENTITY PRINCIPLE (arms length principle, OECD transfer pricing guidelines)
  • No significant progress on digital economy
  • No consideration of developing country issues: extractive industries, technical services
Developing Country Situation

• BEPS implementation
  o Implement OECD standards not theirs
  o “Inclusive Framework”: Participation in implementation and discussions on unfinished business

• Developing countries have their own approaches to transfer pricing, etc. not recognized by OECD
  o Brazil “fixed margin” method, Argentina “Sixth Method"
  o Objective tax havens standards
Developing country “viewpoint”

• Avoid double taxation treaties with OECD countries
  o No evidence increases foreign investment
  o Loss of taxing rights

• Prohibit and enforce trade misinvoicing

• Reject separate entity principle for related firms

• Manage tax competition (esp. regional)
  o Do not give tax incentives on profits and restrict to apply to local costs
  o Agree on minimum global effective tax rate . . .
Developing country “viewpoint”

- Practice source taxation methods
  - Alternative standards for permanent establishment
  - Taxation of technical services
  - Profit-split methods

- Apply developing country tax haven standards/approaches
  - Include NY, Miami, London, Amsterdam. . .

- Intensify South–South tax cooperation
  - AMATM (ATAF Mutual Assistance in Tax Matters)
  - Mutual assistance in collection of tax debts
  - Exchange of information
Thank you

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Will private sector invest in long-term projects or only on other financial assets?

Source: Bain & Company
The G20-BEPS ‘Action Plans’

1. Addressing the Tax Challenges of the Digital Economy
2. Addressing the Effects of Hybrid Mismatch Arrangements
3. Designing Effective Controlled Foreign Corporation (CFC) Rules
4. Limiting Base Erosion involving Interest Deductions and Other Financial Payments
6. Preventing the Granting of Treaty Benefits in Inappropriate Circumstances
7. Preventing the Artificial Avoidance of Permanent Establishment Status
8–10. Aligning Transfer Pricing with Value Creation: Intangibles, Risks and Capital, High-Risk Transactions
11. Measuring and Monitoring BEPS
12. Mandatory Disclosure Rules
14. Making Dispute Resolution Mechanisms More Effective
15. Developing a Multilateral Instrument to Modify Bilateral Tax Treaties
Developing Country Situation

• Political, physical, budgetary, and bureaucratic hurdles to exchange of information
• Source country interests: technical services and permanent establishment
• Reducing tax competition and “harmful tax practices”
Developing Country Difficulties

• Avoidance of tax on capital gains on natural resource enterprises through transfer of realization in low tax jurisdictions

• Interest cost deductability (double non-taxation)

• “Treaty shopping” – treaty tax networks (the Netherlands)

• Transfer pricing standards, not solveable through capacity building
Outline

• International
  o Policy
    ▪ Space
Session 4

Domestic Resource Mobilization – Implications of Illicit Financial Flows

Financing for Development Office
Economic Development & Integration Division
CONFERENCE ON FINANCING SUSTAINABLE DEVELOPMENT: CURBING ILICIT FINANCIAL FLOWS

By Bhumika Muchhala
Independent Consultant on Global Economic Governance, Sustainable Development and the Right to Development
(Currently consultant to the Right to Development office, Office of the High Commissioner for Human Rights, OHCHR)
Session 4: Domestic Resource Mobilization and Implications of Illicit Financial Flows

- Three frameworks key to illicit financial flows:
  1. The Right to Development:
     - *1986 UN Declaration on the Right to Development*
  2. 2030 Agenda on Sustainable Development
  3. Financing for Development

- **Right to Development:** (a) inalienable human right; (b) creating international and national conditions for development; (c) States have the primary responsibility for the creation of national and international conditions favourable to the realization of the right to development; (c) duty of States to cooperate with each other based on sovereign equalit
Domestic Resource Mobilization as an expanded policy discourse

- **Domestic resource mobilization** has become a global policy norm through SDG Target 17.1 and the particular SDG discourse and framework.

- A misnomer: not simply a function of domestic policy but rather a consequence of the international policy environment.

- History: Primarily domestic tax policy reform in IMF macroeconomic surveillance and loan conditions.

- Institutionalized and expanded by the key actors in global governance: primary means of financing development.

- Mission creep?
3 ways illicit financial flows constrain domestic resource mobilization to achieve the SDGs and the Right to Development

1. Constrains **public financial resources** that can be used for development needs: $7.8 trillion from developing world between 20004-2013 (GFI) & 6-13% of GDP (UN WIDER)

2. Nett transfer of financial resources from developing to developed countries: further exacerbates **inequalities** between countries (SDG 10)

3. Provision of **public services**, particularly health and education
Health and education

❖ Between 2001-2011: 39 African countries experienced tax evasion amounting to approximately 97.7 percent of national healthcare spending

❖ And 12 Latin American countries lost tax revenue equivalent to approximately 138.5% of national healthcare spending

❖ Between 2008-2012: 31 developing countries experienced illicit financial flows of sums greater than annual health budgets.

❖ And in 35 developing countries, illicit financial flows surpassed education spending.
Public service provision and gender inequality

- Taxation is arguably the most sustainable and predictable source of national revenue for the provision of public goods and social services.

- Key tool for reducing economic inequality, gender inequality and fulfilling economic and social rights.

- Lack of financing for public services and regressive taxation both fuel gender inequality: unpaid care work, informal sector work and unfulfilled right to education and health.

- Public services links gender inequality in SDG 5 to health in SDG 3, education in SDG 4, decent work and employment creation in SDG 8.

- Article 8 of DRTD: Women’s role in development.
Global Tax Competition

- Global tax regime – in which illicit financial flows are contextualized – enables systematic low or absentee corporate taxation through global tax competition.

- World Bank’s Doing Business Indicators: contradictions as to the role of low taxes and tax holidays/exemptions on attracting FDI.

- Not a significant barrier but still promoted as the key mechanism by which to boost foreign investment

- Widens the economic and competitive gap between foreign and domestic businesses when the same perks are not available to domestic enterprise: yet another way inequality is widened.
Role of the UN in global tax cooperation

❖ Intergovernmental tax body under the auspices of the UN:

(a) Universal membership of all countries;

(b) One-nation, one-vote decision-making process of the General Assembly;

(c) Inclusive of external stakeholders: free, active and meaningful participation of all enhances efficacy of the UN system as a whole; and,

(d) Attune global tax cooperation to the needs of developing countries.
Recommendations for a way forward

- Highlighting four ways forward:

1. Human Rights Impact Assessments (HRIAs)
2. Tax capacity building for LDCs: in line with Rio Principle 7 on common but differentiated responsibilities
3. Gender-sensitive tax policies
4. International cooperation (voice, representation, inclusive participation and democratic decision-making)