LOSING OUT ON THE LION'S SHARE

A primer on illicit financial flows, tax and wage evasion in South Africa

AIDC was formed in 1996 in response to the democratic transition in South Africa and the new opportunities and challenges it brought those seeking greater social justice within the democracy. Over the years AIDC has played a leading role in various civil society responses to ongoing inequality. It has established itself as a leading source of research and information on themes of poverty, trade, and globalisation as well as playing a central role in various regional and international networks and forums. AIDC has contributed to strengthening South African civil society by building leadership and analytical capacity and facilitating networking though a series of conferences, trainings, and leadership schools for trade unionists, women and youth.

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GLOSSARY:

- **Austerity:** a programme of state budget cuts, usually implemented in order to repay debt or achieve a budget surplus.
- **BEPS:** Base Erosion Profit Shifting. Profit shifting that results in tax revenue losses.
- **Budget Deficit:** when state expenditure exceeds tax revenue. Opposite of a surplus.
- **Budget Surplus:** when a state's tax revenue exceeds its expenditure. Opposite of a deficit.
- **Capital Flight:** an exodus of foreign money from a country.
- **Debt Service Costs:** the cost of interest and other debt-related repayments.
- **Extractives:** economic activity based around extracting natural resources from the earth, such as minerals, gas, or oil.
- **FIC:** Financial Intelligence Centre. South Africa's financial crime tracking centre.
- **Fiscal:** to do with the fiscus – the "public purse"; the taxes the government has available to spend.
- **Neoliberal:** economic thought that favours free trade, market-based solutions and a smaller state.
- **Profit Shifting:** the movement of profits from one subsidiary company to another in order to avoid taxes or other obligations.
- **SARS:** South African Revenue Service. Our country's tax authority.
- **Trade Misinvoicing:** the intentional over- or under-pricing of exports or imports in order to launder money or evade taxes.
- **Transfer Mispricing:** over- or under-pricing of transactions within the same corporate group in order to evade taxes in countries like South Africa.
- **TNC:** Transnational Corporation. A corporate group controlling subsidiaries in multiple nations.

FIGURES AND TABLES:

- **Fig. 1.** Share of South African mineral production and capacity held by three largest companies. (2019)
- **Fig. 2.** Lonmin Ownership Chain (at time of *Bermuda Connection* report)
- **Fig. 3.** Samancor Ownership Chain in Descending Order of Ownership
- **Table 1.1** South African company tax rates, 1980-2001.
- **Table 2.1.** Estimates of trade-related IFFs from South Africa.

Contents

1 Introduction — 02
- Overview: Why Read This Primer? 03
- What are IFFs and BEPS? 04
- Defining IFFs: Illegal or Illegitimate? 05

2 The South African Economic Context — 06
- The Emergence of the Minerals-Energy Complex 07
- Capital Flight and Post-Apartheid Economic Policy 08
- Globalisation: A Disaster for South Africa 09
- Decade of Growth 10
- The Age of Austerity 10

3 IFFs and BEPS in South Africa — 12
- General Estimates and Trade Misinvoicing 13
- Challenges of Trade-Related Estimates 14
- Profit Shifting Beyond Trade Misinvoicing 16
- Case Study I: Lonmin and Marikana 18
- Case Study II: Samancor 21

4 The Impacts of IFFs — 24
- Lost Taxes 25
- The Disaster of Austerity 25
- Wage Evasion 26
- The Permanent Loss of Natural Resources 27

5 What is Being Done? — 28
- State Efforts 29
- Who is Responsible for Tackling IFFs and BEPS? 30
- Recent Improvements 31

6 Combatting Profit Shifting — 32
- The Need for a Paradigm Shift 33
- What Should a Paradigm Shift Include? 34
- What Can Labour, Communities, and Civil Society Do to Combat Profit Shifting? 36

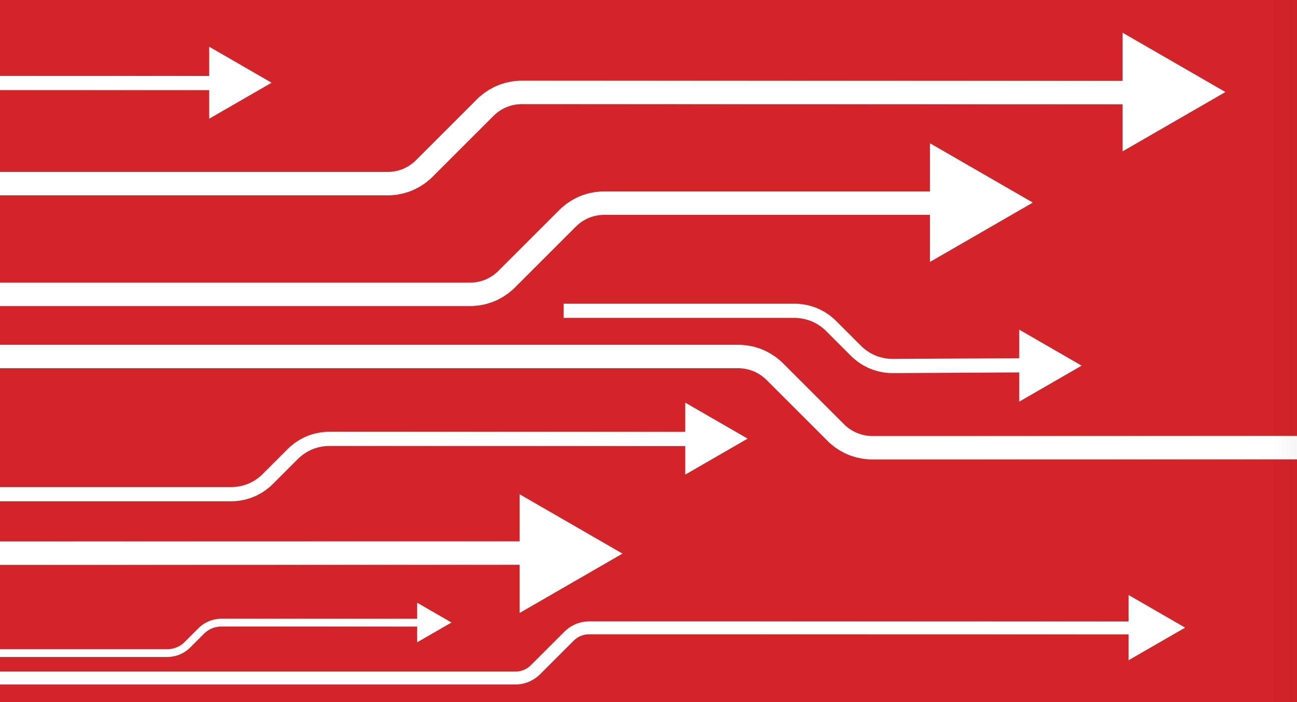
Notes — 38

Bibliography — 40

CHAPTER 1

Introduction

South Africa is a nation approaching breaking point. Despite vast mineral wealth, modern infrastructure, and other economic advantages, the country faces a crisis of economic injustice. The post-Apartheid government's reliance on a neoliberal development path has failed to transform the nation's economic structure. It has resulted in extreme inequality, massive unemployment, low wages, and stagnant economic growth.



The problem is that this wealth doesn't tend to stick around for long. South Africa suffers from massive outflows of wealth in the form of cross-border capital flight.

This includes corporate tax evasion and avoidance, trade fraud, repayments of foreign debt, and chaotic flows from stock market speculation.

Why read this primer?

The COVID-19 pandemic has underscored the fact that this kind of economic injustice is a matter of life and death. During the first year of the pandemic:

- Corporate monopolies (especially in mining) continued to grow their profits despite a recession. Meanwhile wages barely increased by a record low of 1%[1];
- The middle and upper classes continued to work from home, but general unemployment soared to 42.6%[2];
- The wealthy were able to confine themselves to spacious suburbs and modern private hospitals. Meanwhile the virus held extra danger for the poor and unemployed facing crowded informal settlements, as well as underfunded public healthcare and transit systems.[3]

It is clear that the nation's economic trajectory has to change. Unions, community and student organisations have started to push back against the post-Apartheid state's lack of economic transformation and development. However, despite mounting pressure, the government claims that its hands are tied. In its 2020 and 2021 budgets, the state has maintained that the nation's expenses are too great for its limited income, and that the resulting debt burden has now become an issue that cannot be ignored. In response, it has adopted a policy of austerity, despite a clear need for fiscal relief.

Despite these conditions, profits continue to be made in South Africa. The nation is still a hub of transnational corporate economic activity, especially in the mining and financial sectors. Despite the pandemic, 2020 ended with a record-breaking national trade surplus[4], and the mining sector in particular saw a 38% increase in revenue, more than doubling its payouts to shareholders.[5]

These cross-border flows deprive the state of vital tax revenue. They contribute to the declining labour share of income[6], and enable corporations to avoid their responsibilities to local communities while sending send the lion's share of profits overseas. They also enable corruption in both the public and private sector: the notorious Gupta family was famously implicated in money laundering through trade misinvoicing.[7]

In this primer, we will look at these outflows. We pull together research on their size and origin, and how they contribute to economic injustice in South Africa. Through this we hope to show how tackling capital flight - and illicit financial flows in particular - can be an alternative to austerity in this time of crisis.

Chapter Breakdown

Chapter 2:

Describes the South African economic context. It focuses on those features specifically relevant to illicit financial flows and the present fiscal crisis.

Chapter 3:

Illustrates both the scope and nature of illicit financial flows in South Africa. It deals both with how common they are, and how they occur.

Chapter 4:

Summarises the impacts of illicit financial flows. It links them to the austerity and inequality we see today.

Chapter 5:

Describes how the state is trying to deal with these issues.

Chapter 6:

Concludes with recommendations for how the struggle can be taken forward.

Hidden outflows linking "tax evasion, base erosion and profit shifting (BEPS), corruption, asset forfeiture, transnational crime, money laundering and terror financing"[12] are referred to as illicit financial flows.

What Are Illicit Financial Flows and BEPS?

One of the most fundamental features of today's global economy is the freedom and mobility enjoyed by finance and large transnational corporations (TNCs). While citizens face growing restrictions on travel and immigration, capital flows freely from London to Johannesburg to Rio de Janeiro. Some TNCs hold more wealth and influence than entire nations, operating webs of subsidiary companies across the globe with little outside oversight or regulation.

These massive cross-border flows of resources and money have huge impacts on countries whose economies are all in some way or another reliant on this global system of flows. For many countries, "common sense" economic policy has involved trying to build an open economic policy to keep as many as possible of these flows coming in, and as few going out. If resources and capital were to start leaving a country on a large scale (capital flight), then this was understood as the reaction of rational investors towards a country's political decisions or economic environment.[8]

However, research and public scandals (such as the Panama Papers) have started to show us that massive sums of money and resources are leaving developing countries under the radar. Much of these are linked to corporate tax evasion or corruption rather than supposedly innocent "market forces". For example, TNCs have been found to abuse their size, power, and wealth in order to secretly shift their profits across borders so as to pay as little as possible in taxes or wages. This is a phenomenon known as Base Erosion Profit Shifting (BEPS). Moreover, these outflows are often enabled by policies designed to *attract* investment and trade. These hidden outflows linking "tax evasion, base erosion and profit shifting (BEPS), corruption, asset forfeiture, transnational crime, money laundering and terror financing"[9] are referred to as illicit financial flows (IFFs).

In this primer, our concern is with the general problems of capital flight, hidden profits, missing tax revenue, and economic injustice in South Africa.

Defining IFFs: Illegal or Illegitimate?

The debate around the definition of IFFs is politically important. Many initiatives from the past few years have tended to adopt the 'broad' definition referenced above, This includes acts like corporate tax avoidance alongside money laundering and terror financing. However, there has been a push to narrow down where the emphasis of IFF-related efforts should fall.

Some seek to separate the illegal aspects of IFFs, such as money laundering and terror financing, from the legal but illicit aspects, such as corporate tax avoidance. These efforts have sought to focus the fight on the more outright criminal aspects of the issue. As one researcher in this camp argues, "we should not allow our enthusiasm for the cause of international tax policy reform to get swept up into a narrative which bundles together a large swathe of international investment, finance and professional services as being 'by definition' on the same side as drug cartels, kleptocrats and money launderers."[10]

However, tax justice organisations have rightfully resisted this reframing on criminality. They argue that "tax justice and the curtailment of illicit flows are deeply interlinked, and core to the progressive realisation of human rights."[11] The main concern should not be about illegality, as the interests of capital exert a huge amount of influence on both domestic and international economic law. Instead, we should be concerned primarily with their illicit nature; the fact that they are not only legally dubious, but also socially or ethically unacceptable.

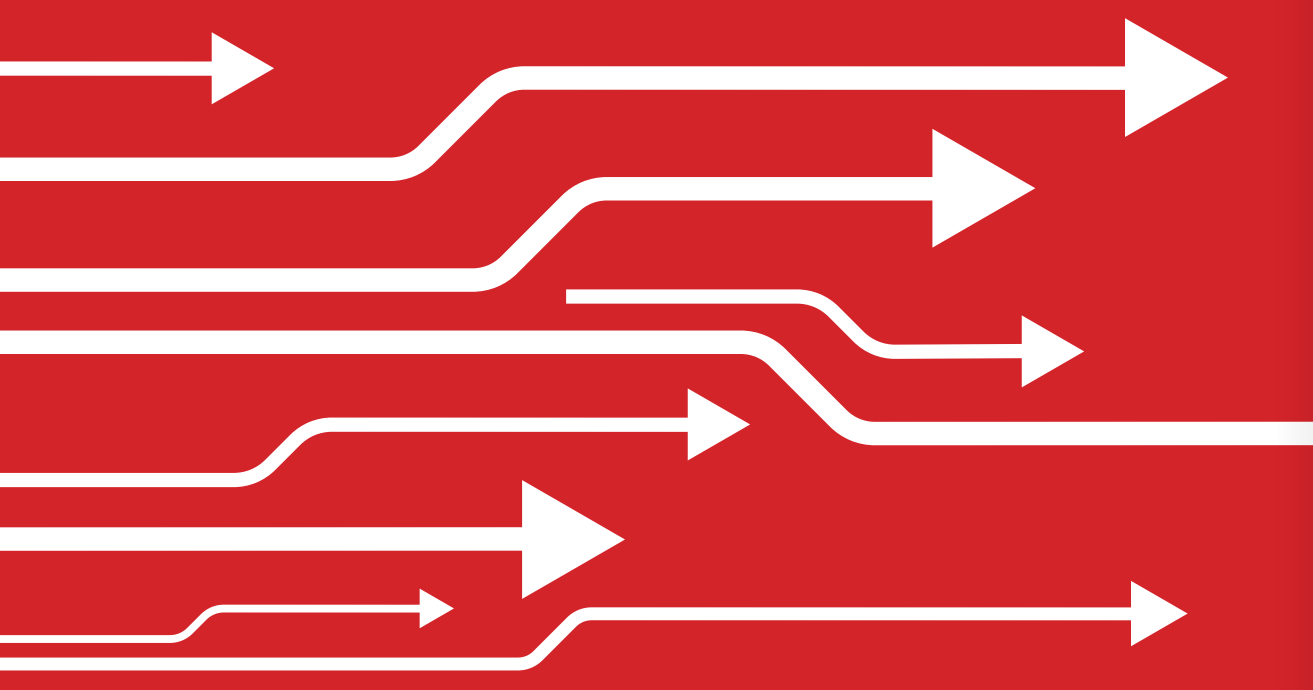
This is as much a tactical argument as it is a technical one. The fight against illicit financial flows has only just started to gain traction through the backing of heavyweights such as the OECD and the United Nations. The international reach and power of these organisations are key to dismantling the systemic outflow of corporate profits, but only so long as corporate tax abuse remains emphasised as an important component of IFFs.

In this primer, our concern is with the general problems of capital flight, hidden profits, missing tax revenue, and economic injustice in South Africa. As a result, our use of "illicit financial flows" refers first and foremost to instances of corruption, fraud, and profit shifting practices by TNCs operating within the South African economy. These are practices which are "illicit" because they result in tax and wage evasion, and they contribute to the broader problem of capital flight.

CHAPTER 2

The South African Economic Context

Cross-border corporate profit shifting and IFFs are not random criminal acts. These issues are tied up with the economic development of South Africa; an economic history that has created fertile ground for profit shifting to take root. This same development path has also made the country particularly vulnerable to the impact of these acts.



There are three pieces of context crucial to understanding the place and impacts of IFFs in South Africa:

1:

The first is the country's reliance on an extractivist, export-led, minerals-based economic core. Globally, IFFs tend to be concentrated around the minerals sector, and South Africa is no stranger to this.

2:

The second is the country's post-Apartheid shift to a neoliberal and "open" economic development strategy, with the removal of multiple controls on the cross-border movement of capital and profits. This has created an enabling environment in which complex IFFs, especially tax avoidance schemes, can flourish.

3:

Thirdly, we must look at the country's present fiscal crisis. This has both been worsened by and contributed to illicit financial flows.

The Emergence of the Minerals-Energy Complex

Ever since the discovery of gold and diamonds in the late 19th century, South Africa's economic development has been deeply influenced by a close alliance between the large mining houses, which were at first largely owned by wealthy British capitalists, and the colonial state. By the time political power was ceded to the Afrikaner minority in the 1920s, these mining houses had already undergone a process of consolidation and monopolisation. This left a handful of large companies like De Beers and Anglo-American in control of the majority of the nation's natural resources.

Throughout the 20th century, these large corporations in the mining sector, as well as those in related industries like chemicals and ore refining, were the centres of wealth accumulation. They generated massive profits as a result of both direct state support, and a system of oppression based on racial categories that ensured a steady supply of cheap labour. In exchange, the state appropriated some of these profits and used them to finance and develop a domestic Afrikaner capitalist class. Meanwhile a large portion of this wealth was also used to ensure a comfortable life for the white middle class that kept this state in power.

This close relationship between the state and private interests - especially in the mining sector - has been referred to as the "minerals-energy complex". It played a defining role in shaping South Africa's economic development.[13] The resulting economic structure was a skewed one: domestic capital was directed largely to mineral exports, production of mining equipment, and luxury consumer goods for the white minority.[14] The persistent regime of low wages for the majority (leading to low domestic demand), combined with sanctions and low profitability, eventually led to a crisis of overaccumulation in the 1970s. There were no sufficiently profitable places to invest capital. As a result, South Africa experienced a fall in domestic investment in the final decades of Apartheid.[15]

This extraction-focused development path also had profound implications for the social structure of the country. The early colonial state implemented a number of policies intended to create a workforce for the nation's rapidly expanding mining industry. These crucially included a "hut tax" on rural homesteads that forced rural men to go seeking work in the nation's extractivist heartlands. Women were left

behind to carry on the work of social reproductive labour, while mineworkers provided the only source of income. In this context, the low wages and poor working conditions of mineworkers impact doubly on women.[16] This system of internal migrant labour still persists in some form today.

By the time the twilight years of Apartheid arrived in the 1980s, the capital and profits of this minerals-energy complex were still mostly confined to South Africa, as a result of capital controls and economic sanctions. However, the final years of Apartheid brought with them serious political and economic turmoil. Profits fell, and the close relationship between the minerals-energy complex and the Apartheid state was endangered. The large corporations dominating the South African economy sought ways to get their capital out of the country; to reconfigure the flows of wealth in order to restore their profitability.

Aided by a highly developed financial sector, capital flight became more common among the big conglomerates during this late-Apartheid period. Exploitation of the General Export Incentive Scheme by means of export misinvoicing was especially prevalent.[17] It has been estimated that this capital flight during the final 13 years of Apartheid (1980 - 1993) totalled around 6.6% of the country's GDP every year.[18]

Capital Flight and Post-Apartheid Economic Policy

After Apartheid, a period of economic liberalisation followed. Disregarding its left-wing Alliance partners, the economic strategy of the government became directed towards integration with the global economy and encouragement of a larger private sector. They hoped that this would not only result in economic efficiency, but also in explosive growth, as liberalisation could "unleash a 'democratic dividend' in the form of pent-up demand for private investment in the country."[19]

Practically, this meant that an attractive environment for Foreign Direct Investment had to be created. As a "necessary" sacrifice, the government locked horns with unions on wage growth and reduced corporate income taxes for the sake of maintaining a profitable investment environment. Corporate income taxes dropped from a high of 50% in the mid 1980s, to the present 28% and a future proposed low of 27% in 2022.[20] Table 1.1 below illustrates this dramatic shift in corporate taxation.

Table 1.1: South African company tax rates, 1980-2001.. SARB (2015). Supplement to the South African Reserve Bank Quarterly Bulletin: tax chronology of South Africa (1979 - 2015)

Year of assessment ending during the period:	Rate of normal tax on taxable income	Surcharge	Transitional levy	UPT (Per cent)
01/04/1980 — 31/08/1981	40	5	–	33 ⅓
01/04/1981 — 31/08/1982	40	5	–	33 ⅓
01/04/1982 — 31/08/1983	42	10	–	33 ⅓
01/04/1983 — 31/08/1984	42	–	–	33 ⅓
01/04/1984 — 31/08/1985	50	–	–	33 ⅓
01/04/1985 — 31/08/1986	50	–	–	33 ⅓
01/04/1986 — 31/08/1987	50	–	–	33 ⅓
01/04/1987 — 31/08/1988	50	–	–	33 ⅓
01/04/1988 — 31/08/1989	50	–	–	33 ⅓
01/04/1989 — 31/08/1990	50	–	–	33 ⅓
01/04/1990 — 31/08/1991	50	–	–	–
01/04/1991 — 31/08/1992	48	–	–	–
01/04/1992 — 31/08/1993	48	–	–	–
01/04/1993 — 31/08/1994	40	–	–	–
01/04/1994 — 31/08/1995	35	–	5	–
01/04/1995 — 31/08/1996	35	–	–	–
01/04/1996 — 31/08/1997	35	–	–	–
01/04/1997 — 31/08/1998	35	–	–	–
01/04/1998 — 31/08/1999	35	–	–	–
01/04/1999 — 31/08/2000	30	–	–	–
01/04/2000 — 31/08/2001	30	–	–	–

At this time, the state proceeded with efforts to connect the economy to global financial flows by reversing the Apartheid-era restrictions on capital mobility.

At this time, the state proceeded with efforts to connect the economy to global financial flows by reversing the Apartheid-era restrictions on capital mobility. Between 1993 and 1998, capital was given increasing amounts of freedom as several important measures were introduced. According to the then-governor of the South African Reserve Bank, Chris Stals, in a 1998 Sydney speech, these included:[21]

- The removal of all exchange controls on current account transactions.
- Allowing non-residents to "introduce funds for any purpose into South Africa, to repatriate such funds and to transfer out of the country currency and capital gains earned on their investments without restriction."[22]
- Enabling resident companies to make direct investments in foreign subsidiaries through transfers or direct loans.
- Relaxing of numerous smaller restrictions, including allowing banks to authorise various transfers without reference to the Reserve Bank
- A restructuring and liberalisation of the financial sector and JSE to allow for "almost explosive increases in volumes."[23]

Globalisation: A Disaster for South Africa

The unintended consequences of this began in the reaction of South African capital. Rather than investing domestically, South African corporations took advantage of their newfound capital mobility to seek greater profits in costly - and often disastrous[24] - overseas ventures. Some of the largest, like Anglo-American and De Beers, relocated their headquarters to London. Key drivers behind the globalisation of South African corporates were, as Seeraj Mohamed writes, their "evasive action"[25] in response to South Africa's uncertain political future, as well as their pent-up desire to partake in the "increased efforts to control global markets and value chains"[26]. This was a cornerstone of profit maximisation in the new globalised world of the late 1990s.

When foreign investment arrived, it was generally FDI directed to the old MEC industries, where they could produce products for export. Or, more commonly, it took the form of short-term investments (known as hot money flows) in the financial sector. In 2017, investment in the mining and financial sectors together accounted for 66.2% of all FDI.[27] A key point of failure for post-Apartheid economic policy is the fact that the anticipated influx of foreign capital was quickly

A key point of failure for post-Apartheid economic policy is the fact that the anticipated influx of foreign capital was quickly matched by unexpected outflows - both domestic and foreign.

matched by unexpected outflows - both domestic and foreign. The net level of foreign investment has remained low as a result of persistent capital outflows. These are largely related to interest and dividends paid out from hot money investments, and profit shifting or illicit financial flows from the extractives sector. These outflows have only grown stronger in the past two decades.[28]

Decade of Growth

When the governing African National Congress embarked on the post-Apartheid economic strategy outlined above, it also gave up on its promises of rapid, state-led economic redistribution and reindustrialisation meant to undo the economic legacy left by Apartheid. Instead, transformation was intended to come about *through* growth, without the need for redistribution or a massive public sector. In time, it was hoped that the growing wealth of the private sector would "trickle down" to the rest of South Africa. However, without reindustrialisation or other inward-focused development, the possible base of growth remained narrow: much as in Apartheid, the core drivers of the economy remained the minerals and financial sectors.

Nonetheless, in the decade between 2002 and 2012, global economic winds blew in South Africa's favour. A massive global boom in commodity prices allowed South Africa's narrow base of growth to propel it forward, bringing economic growth, capital inflows, and strong tax revenues for the state.[29] While still falling short of economic transformation, this period allowed the state to expand its size, growing its spending on public services and infrastructure in particular. Between 2001 and 2011, state spending per person grew by an average of 7% per year.[30]

The Age of Austerity

This good fortune was an opportunity to make good on the promises of the 1990s and build a sustainable and equal economy - one not reliant on export-focused extractivism. In reality, the state chose to stick to their guns, using the 2000s boom as an opportunity to *lower* taxes instead, despite conventional economic wisdom suggesting otherwise.[31] At the height of the boom, a political choice was therefore made against the possibility of a sustainable welfare state.

The commodity boom ended in the early 2010s and along with it came falls in growth, exports, tax revenues, and foreign investment.[32] The South African state was left with larger-than-ever commitments to public expenditure without the economic foundation to back it up - a house built on sand. The state attempted to increase taxes, but it was already too late: From 2008, the state's finances have remained in the red, maintaining a budget deficit of between 4% - 5% of GDP, and substantially growing its debt burden while having little in the way of either growth or redistribution to show for it.

At the same time, the factional conflict within the ANC grew more intense, leading to then-president Thabo Mbeki losing the race for party presidency to Jacob Zuma in 2008. Any initial optimism for the Zuma presidency's more expansionary state-led economic approach quickly faded, however, as allegations of corruption began to surface. By the end of the decade, numerous scandals and reports had revealed the extent of "state capture"; the name given to the phenomenon of corruption at the highest levels of government. State capture added on to the growing fiscal crisis by crippling institutions such as the South African Revenue Service in order to allow for the looting of state funds by well-connected actors, and more specifically in order to enable cross border illicit financial flows to remain undetected.[33]

In the face of this fiscal crisis, the state has adopted a policy of austerity. This has resulted in plans for massive cuts to the public sector in the next two years, including a 7.2% cut to healthcare spending per user,[34] a 27% cut to job creation schemes,[35] and a more than R300bn cut to the public sector wage bill over the next two years. In real terms, this means hiring freezes which leave essential public sector posts empty. It means effective pay cuts for those who have been at the frontline of the COVID-19 pandemic, such as nurses and teachers. As the state is the biggest employer and spender in the South African economy, these cuts will worsen the unemployment and economic recession South Africa is currently facing.[36]

CHAPTER 3

Illicit Financial Flows and Profit Shifting in South Africa

How much wealth does South Africa lose to IFFs and BEPS? There is no one method we can use in order to get a simple answer. Instead, we can try and stitch together a picture of the problem, using everything from international government trade statistics to case studies of individual corporations' financial statements.

The Big Picture: General Estimates and Trade Misinvoicing

The scale of IFFs in and out of South Africa is, by all accounts, massive. According to Global Financial Integrity (GFI), South Africa has the 7th highest average IFFs of any developing country.[37] The 2016 Report of the High Level Panel on Illicit Financial Flows from Africa estimated that around 4% of the nation's GDP is lost to IFFs every year. The 2017 Global Financial Integrity (GFI) report on IFFs gave an upper estimate of around 7-8%.[38] Taking these as our lower and upper estimates, and accounting for current GDP and currency conversion rates...

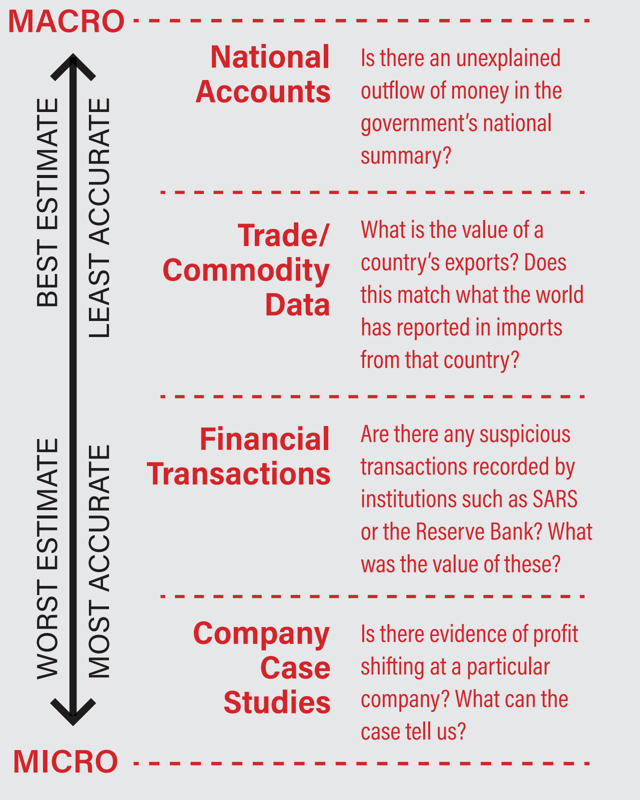
we can estimate that South Africa loses between R200bn and R400bn per year to IFFs.

South Africa's large extractives sector is a key source of IFFs. South African mining is export-based, which by its nature opens up a variety of channels for IFFs. Most notably, the export trade allows for trade misinvoicing to take place between trading partners who wish to avoid export/import duties, or to claim export subsidies, or to engage in trade-based money laundering schemes. For example, Ndikumana et al. have found that, between 2010 and 2018, South Africa declared $17.8bn in diamond exports, while its trading partners declared $51bn in diamond imports.[39]

Between 2000 and 2014, export misinvoicing in silver, platinum, iron, and gold was estimated at $90.5bn.[40] When measured against an estimated total export misinvoicing of $385.1bn over the same period, this means that these minerals alone accounted for 23.5% of all trade misinvoicing from South Africa between 2000 and 2014.[41] It is also worth noting that this sample group excludes diamonds, chrome, manganese and coal, all of which together constitute 43% of South Africa's mineral exports[42]. This means that the true proportion of IFFs constituted by extractives is undoubtedly much higher. Further estimates of IFFs linked to trade misinvoicing in South Africa may be found in Table 2.1.

How IFFs can be detected and measured:

There is no way to pin down exactly how much countries lose to IFFs and BEPS. Methods which look at the big picture are not very accurate, but they are good estimates because are easily available and they give us a sense of scale for the problem in general. On the other hand, methods which look at small-scale evidence are very accurate but difficult to generalise and very hard to access.



Source	For Years	Estimate
Capital Flight From SA: A Case Study, Ndikumana, Naido, Aboobaker (2020)	1998 - 2017	$146bn (net outflow)
Illicit Financial Flows from Developing Countries: 2005-2014, Global Financial Integrity Report (2017)	2006 - 2014	$136.7bn (gross)
Trade-Related Illicit Financial Flows in 135 Developing Countries: 2008-2017, Global Financial Integrity (2020)	2017	$22bn (gross)
Illicit Financial Flows: Estimating trade mispricing and trade-based money laundering for five African countries, Nicolaou-Manias, Wu (2016)	2015	$67bn (gross)

Table 2.1: Estimates of trade-related IFFs from South Africa.

Challenges of Trade-Related Estimates

These general estimates are valuable, but they only give us one part of the bigger picture - and tell us little about the true extent of profit shifting in South Africa's private sector. These estimates rely on trade data provided from "official" sources, such as the IMF's Direction of Trade Statistics, the United Nations Comtrade Database, and reports from national governments. In order to find evidence of IFFs, researchers look for mismatches in this data, for example by comparing the declared value of imports versus exports. This methodology means that they are primarily indications of trade-related outflows, such as money laundering.

These approaches are useful in that they furnish us with an "order of magnitude" for the problem. Estimates like the "4% - 8% of GDP lost to IFFs" give an indication of the scale of the problem and, by extension, confirm that it is worth paying attention to. Moreover, they are politically useful in that they dispel the notion that profit shifting is a problem of a few "bad apples". This puts pressure on the state to take action.

However, these approaches are not unproblematic. For one, they rely on often incomplete "official" data to measure a fundamentally clandestine activity. This inherently results in a significant degree of inaccuracy. In some cases this may be relatively harmless, such as when legitimate statistical errors result in small errors on the nation's balance of payments, which then get counted as IFFs in some approaches. However, in other cases this inaccuracy may end up creating red herrings. For example, a 2016 United Nations Conference on Trade and Development (UNCTAD) study claimed that trade misinvoicing in South Africa's gold exports amounted to $78.2bn from 2002-2014.[43] Going by this figure, it would seem as if gold exports were the epicentre of the IFF problem in South Africa. The Chamber of Mines commissioned research into this claim, which found that UNCTAD had confused quirks in South African gold export classifications with trade misinvoicing. It concluded that, once corrected, "the trade discrepancy in gold exports... shrinks from the initially alleged USD 78.2 billion to USD 19.5 billion."[44]

More important is the fact that most of these estimates are reliant on data reflecting the trade of commodities between two separate entities. This excludes some significant channels of profit shifting from consideration in these estimates.

In reality, trade within the same entity (generally a transnational corporation) accounts for over a third of all global trade.[45] This is called "intra-group" trade, and a large chunk of transfers within corporate groups are payments for services - not just goods. TNCs commonly adjust the prices of these internal sales so as to minimise their profits claimed in high-tax jurisdictions, and maximise their profits in low-tax jurisdictions. This is a practice known as transfer mispricing. Moreover, TNCs enjoy the ability to shift their debt around between their subsidiary companies. This allows them to reduce the tax obligation on subsidiaries in high-tax areas by loading onto them the interest-bearing loans of subsidiaries (or headquarters) in low-tax areas.

Profit Shifting Beyond Trade Misinvoicing

There is no easy way to come up with a large-scale estimate for the kinds of intra-group profit shifting practices which are excluded by those general trade-related estimates.

The official mechanisms that do exist for identifying transfer mispricing within intra-group transfers are only relevant to individual cases. For example, South Africa has adopted a variant of the OECD's "arm's length principle". This states that an intra-group "transfer price should be the same as if the two companies involved were indeed two independents, not part of the same corporate structure."[46] Tax authorities need to flag individual transactions and conduct a lengthy investigation, the results of which are not made public.

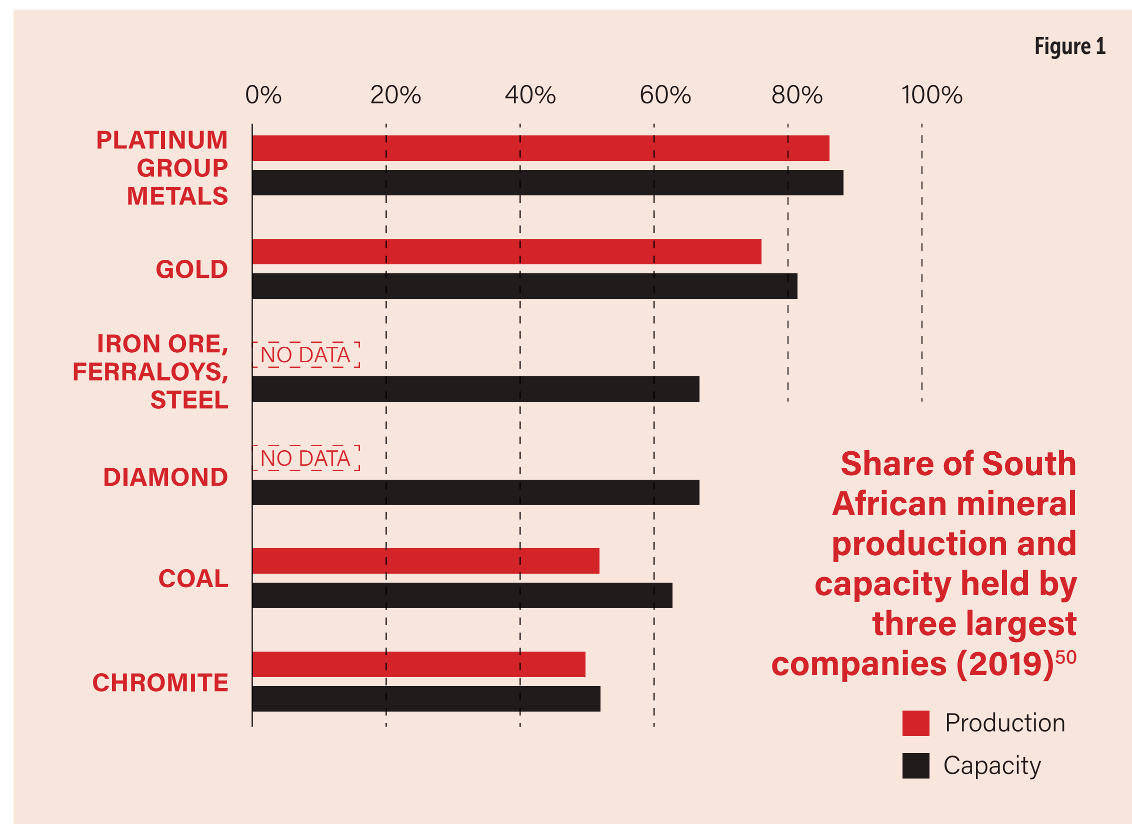
Even these individual "arm's length" investigations are only practically possible in cases where physical goods have been exchanged (commodity mispricing). It is very difficult to determine what an "arm's length" price would be for intangibles, such as management services or the use of trademarks which are not sold on the open market. But it is also difficult to determine whether these services were actually rendered, and if so, whether the substance or quality thereof was worth the price.

We therefore need to infer the scale of the problem. Here we are guided by two main factors:

- **The conditions for profit shifting:** to what extent is the South African economy dominated by corporations with the ability to engage in cross-border profit shifting?
- **The likelihood of profit shifting:** what do we know about the behaviour or culture of cross-border corporations in South Africa with regards to profit shifting?

On the first point, the South African economy is particularly vulnerable as it is a hub of transnational corporate activity. Foreign-owned companies account for only 2000 out of the 1.2 million companies in South Africa. But those 2000 companies make up more than 30% of all the sales made in the country.[47]

This is especially the case in the mining sector. As Figure 1 below illustrates, the top three mining companies *alone* account for well over 50% of all domestic mineral productive capacity. These corporations generally have subsidiaries in South Africa that do the mining and subsidiaries abroad that sell the mined and processed goods. This is true even for many ostensibly "South African" companies. They tend to fall under the umbrella of transnational corporate ownership, or they may be headquartered here but are in fact themselves transnationals.



Fertile ground for profit shifting:

In South Africa, we see a combination of three factors which create high-risk conditions for profit shifting:

- The economic dominance of large transnational corporations,
- A large extractives sector focused on export, and
- Relatively open economic policy, combined with institutions weakened by state capture

> Large foreign-owned firms have a massive presence in the South African economy, and around 20% of these firms are owned by a parent company operating out of a tax haven.[77]

These three factors, summarised on the left, make for particularly fertile ground for profit shifting. This is especially so once we take into account the political reality of a government desperate for FDI and therefore cautious about any action that might be perceived as creating an unattractive investment environment for these companies.

In terms of assessing the *likelihood* of profit shifting under these conditions, a number of indicators are available. Researchers have compared South African companies owned by a "parent" in a tax haven with companies which are not. They found that the "tax haven" companies tend to be 34% less profitable than the "non-tax haven" companies with parents based elsewhere, despite having the same level of economic activity.[49] When it comes to the largest 10% of firms, this figure rises to 80%. The implication of this is that the "tax haven" companies have somehow exported their profit to the tax haven, where it is not taxed.

As mentioned above, large foreign-owned firms have a massive presence in the South African economy, and around 20% of these firms are owned by a parent company operating out of a tax haven.[50] The only conclusion that can be drawn from this is that profit shifting is common among large corporations operating within South Africa.

A more circumstantial clue is the oft-quoted 2020 PwC report on economic crime, which places South Africa in third place for the prevalence of corporate corruption. It noted that "South African companies have seen a notable upsurge (from 15% in 2016 to 34% in 2020) in instances of senior management perpetrating fraud".[51] This last claim is particularly concerning when we take into account the fact that "South African companies" in the extractives sector are generally subsidiaries of transnational corporations. It is their senior management who would have the closest relationship with their controlling companies and therefore be most likely to comply with instructions for setting up profit shifting arrangements.

Beyond this, we can also look at evidence in the form of concrete case studies. We rely on micro-level data such as financial transaction statements, ownership chains, and corporate balance sheets in order to examine profit shifting at specific mining companies in South Africa. In the next section, we look at two case studies of profit shifting practices, drawing from research conducted largely by the Alternative Information & Development Centre.

Case Study I: Lonmin and Marikana

On August 10th 2012, around 3000 miners began a wildcat strike at the Marikana platinum mine owned by British multinational, Lonmin. Driven by their growing frustration with complacent unions, low wages and inequality in the face of the massive profits extracted by Lonmin, the miners organised around their demand for a living wage of R12 500.[52] This demand was dismissed as unaffordable by Lonmin, and so the strike continued.

Aside from wage demands, another source of tension fuelling the Marikana strike could be found in Lonmin's failed promises to build houses in the workers' communities. In order to receive a mining license, the South African state stipulates that mining companies need to present and adhere to a "Social Labour Plan" (SLP). This outlines the developmental commitments the mining companies have to the nearby communities.[53] While mining companies may often preach the rhetoric of "giving back to the communities" in creating these plans, they are more often than not left unfulfilled. Lonmin was no exception: these commitments, including the construction of houses and sanitation for nearby communities, were halted because, according to the company, they did not possess sufficient funds to carry them out.[54]

Both Lonmin and government officials - including current president Cyril Ramaphosa - soon urged police to break the strike. And so, on August 16th, a special police unit trapped a group of protesting miners and opened fire. 34 miners were killed in the deadliest act of police brutality since the Apartheid-era Sharpeville Massacre.

The Marikana Commission of Inquiry was quickly established to investigate the massacre. It included research into the roles played by Lonmin. As part of this, a researcher from the AIDC was assigned to investigate and report on the affordability of the workers' demands (specifically the R12 500 wage) for Lonmin. Drawing from experience in a previous investigation of profit shifting, the researcher requested the annual financial statements (AFS) of Lonmin's subsidiaries from the Commission. He then began an investigation that culminated in *The Bermuda Connection*[55]; a report indicating extensive profit shifting practices at Lonmin from 1999 to 2012.

Ownership and Structure at Lonmin

It is necessary to note here that, unlike Samancor, the investigation into Lonmin did not have the benefit of a whistleblower who could outline the company's structure and functioning. So the investigation into Lonmin had to construct its own outline - a complicated task given the company's own contradictory statements about its internal structure. Lonmin (and the Marikana mine) was also acquired by Sibanye-Stillwater in 2019, and therefore the relevance of the following information might be called into question. However, it is necessary to understand Lonmin's structure as outlined at the time of investigation in order to understand the key points.

Lonmin PLC (Lonmin), based in London, constitutes the headquarters of the multinational mining house. This head office also has a direct branch in South Africa named Lonmin Management Services (LMS).[56]

Lonmin SA (LSA UK) is Lonmin's main holding company for its actual mine-owning subsidiaries in South Africa. Of specific interest here are the subsidiaries named Eastern Platinum Ltd, and Western Platinum Ltd, the latter of which owns the Marikana mine.

Finally, Western Metal Sales Ltd (WMS) refers to a subsidiary of Lonmin based in Bermuda - a known tax haven. According to Lonmin, WMS was responsible for selling the PGMs extracted by LSA's subsidiaries in exchange for a sales commission. This arrangement will be interrogated below.

LONMIN OWNERSHIP CHAIN

Fig. 2: Lonmin Ownership Chain (at time of *Bermuda Connection* report)

Lonmin Insurance Ltd. (LIL) [Bermua (Guernsey from 2013)]

LONMIN PLC [UK]

Lonmin Management Systems, LMS [Lonmin PLC's SA Branch]

LSA (UK) Ltd

AfriOre Limited [B.V.I]

EASTERN PLATINUM Ltd [SA] [Incwala Resources owns 18% 2012]

WESTERN PLATINUM Ltd [SA] [Incwala Resources owns 18% 2012]

MESSINA Ltd. [SA]

Akanani (Pty) Ltd. [SA] [Incwala Resources owns 24% 2012]

MESSINA PLATINUM MINES Ltd. [SA] [Incwala Resources owns 18% 2012]

Sales Commissions and Marketing Fees

A major red flag revealed in the investigation of WPL's annual financial statements was the fact that the company was paying substantial sales commission fees to the Bermuda based Western Metal Sales Ltd. Lonmin stated that between 1999 and 2006, over 2% of WPL's income went to WMS in exchange for the marketing of its products. According to Lonmin, this arrangement was terminated in 2006/7 - but "Sales Commissions paid to Western Metal Sales"[57] continued to appear on WPL's AFS until 2012. Between these years of reported and actual termination, R1.228bn continued to flow from South Africa to Bermuda.[58]

A similar red flag was an arrangement between Lonmin Management Services (LMS) - the direct South African branch of the London-based head office - and LSA's subsidiaries. In its financial statements, WPL was found to be paying more than 2% of its revenue to LMS as "management fees".[59] In turn, LMS paid similar "management fees" to the head office in London - totalling R429mn between 2007 and 2010.[60] In addition, after the termination of the WMS arrangement, LMS proceeded to receive a similar sales commission. Between the commissions to WMS/LMS and the management fees of LMS, WPL had been paying an average of between R200m and R300m per year for these services from 2002 - 2012.[61]

Profit Shifting and Substance

Of course, the above is not evidence on its own of profit shifting. Sales commissions and service fees sent abroad are commonplace for multinationals in the mining sector.

Nonetheless, transactions made within the umbrella of the same multinational should always be subject to scrutiny. Transfer mispricing presents a simple yet nearly undetectable avenue through which profits can disappear in high-tax jurisdictions and reappear in low-tax jurisdictions.

In the absence of direct evidence it is therefore the question of substance that must be central: were these transactions priced in line with their substance, the actual quality and extent of the services delivered?

The issue of substance posed difficulties for the Lonmin investigation. The annual financial statements of Bermuda-based WMS were not available for the investigation; the recording of these payments was unconventional; and the company's statements continually presented contradictory explanations regarding these arrangements. Nonetheless, the investigation outlined some key pieces of evidence that point to a high likelihood that these arrangements were primarily for the sake of profit shifting.

For one, there is no real evidence that WMS existed as a functional company with actual staff and workplaces. WMS has no presence outside of Lonmin's internal accounts, and its address was found to be the same as Appleby Services, a law firm specialising in offshore business with branches in tax havens all over the world. Appleby was notoriously implicated in the Panama Papers as an enabler of profit shifting, specifically in its willingness to set up so-called "shell companies".[62]

There was also no evidence that WMS actually did any marketing work. During a period in which Lonmin paid Impala Platinum for marketing, "Impala was paid a sizeable commission for selling Lonmin's metals, but WMSL's commission stays put at the same rate, namely at 2% of WPL's total revenue, indicating that the character of the latter is a routine transfer, not an agreement

between two independent business parties."[63] In a statement at odds with the "official story" at the time, Lonmin also admitted that "Lonmin's metal is sold by Lonmin's operating subsidiary [in South Africa] (WPL) directly to third parties at prices which are market prices".[64]

By contrast, LMS was an actual firm with staff and operating expenses. However, the question of substance enters when one considers the price of the services paid by WPL to LMS. According to the accounts, WPL paid LMS R1.742bn for marketing and management from 2009-2012. But R1.029bn was also paid by the whole Lonmin Group to external providers for rendering the same services during the same period.[65]

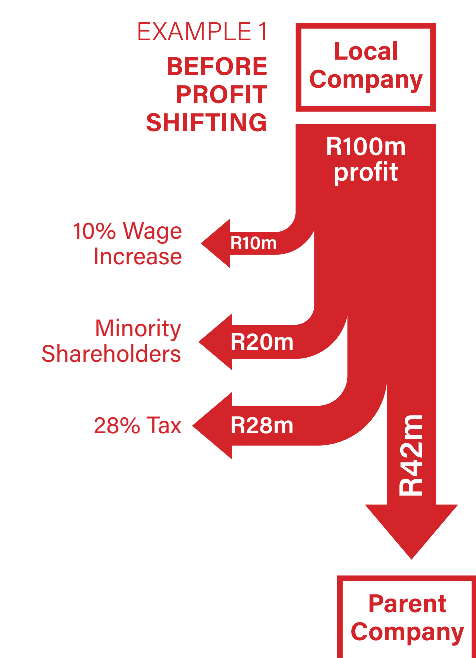
Further evidence for artificial price inflation is found in the fact that, in 2011, "LMS's employees cost the company R70-million versus a management fee income of R194-million."[66]

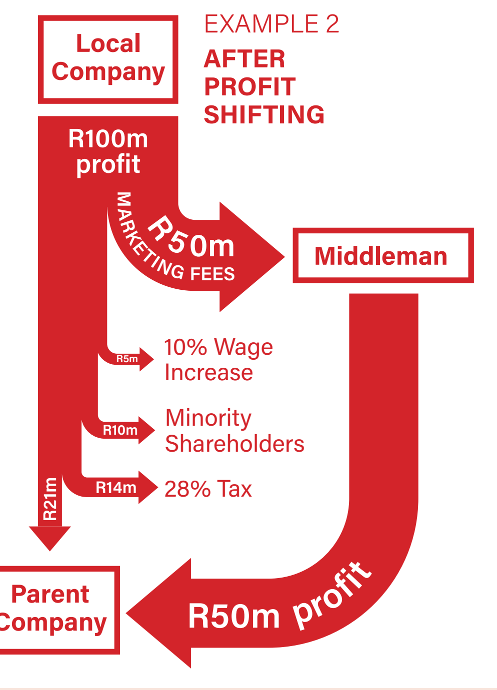
It is especially likely that service mispricing via LMS functioned as a method of profit shifting for Lonmin, considering the fact that LMS in turn paid huge "management fees" to Lonmin PLC. At a 20-37% share of LMS' already large income, these fees are well out of the bounds of a fair business transaction.[67] In reality, Lonmin's chains of fees and commissions were most likely intended to shift the profits of mining subsidiaries like WPL from South Africa to the head offices in the UK.

Figure 3

Subsidiaries, Communities and Workers

Aside from serving as an example of how profit shifting occurs, the Marikana case is a clear example of the impact profit shifting practices have on workers and communities. Profit shifting can make subsidiaries artificially unprofitable. This is used to annul the claims workers and communities have on them - even if they would otherwise have been able to afford them. In the findings of the *Bermuda Connection* report, the author concludes that "collapsing the Bermuda arrangement and cutting back on fees to LMS to a reasonable amount would have allowed the Lonmin subsidiaries – the actual employers of Lonmin's workers – to meet the 2012 rock drill operators' demands for a basic wage of R12 500 after tax, even after allocating 28% of resources to meet their SLP commitments."[78] It is for this reason that we argue that the scope of these issues must be widened beyond the erosion of the tax base to include wage evasion as a critical dimension of profit shifting.





Owners Share: R42m / R71m

Profit Shifting is Wage Evasion

Case Study II: Samancor Chrome

Samancor Chrome is the largest integrated producer of ferrochrome and the second largest chrome mining company in the world. Its two ore mines and six smelting plants - spread throughout the extractive heartland provinces of North-West, Mpumalanga and Limpopo - produce up to 2.4 million tons of ferrochrome per year.[68]

In October of 2019, the Association of Mineworkers and Construction Union (AMCU) filed court papers against Samancor. AMCU, acting on the testimony of a whistleblower as well as research conducted by the Alternative Information & Development Centre, has accused the directors of Samancor of systematically, since 2006, shifting around R28bn in profits out of the country to the detriment of more than 5000 Samancor workers, minority shareholders, community members and the general public.

The Samancor case presents some complexities which require unpacking.

Firstly, the channels by which profits were shifted are diverse. They involved both transfer mispricing and trade misinvoicing, as well as long ownership chains consisting of similarly named companies, and enablers and accomplices from both within and outside Samancor's umbrella of ownership.

Secondly, the beneficiaries are equally diverse, ranging from lower-level directors to board members of Samancor's parent company. With regard to the latter, the Samancor case is somewhat different from a "textbook" case of profit shifting. The intention was not always to increase the share of profits taken home by a parent corporation. It was rather to directly enrich individuals both at the subsidiary and the parent company.

Finally, the Samancor case was made possible through the testimony and evidence provided by an ex-director, now-whistleblower. This gives us an internal perspective not only of the motives of profit shifting, but also of its potential channels which may otherwise be invisible.

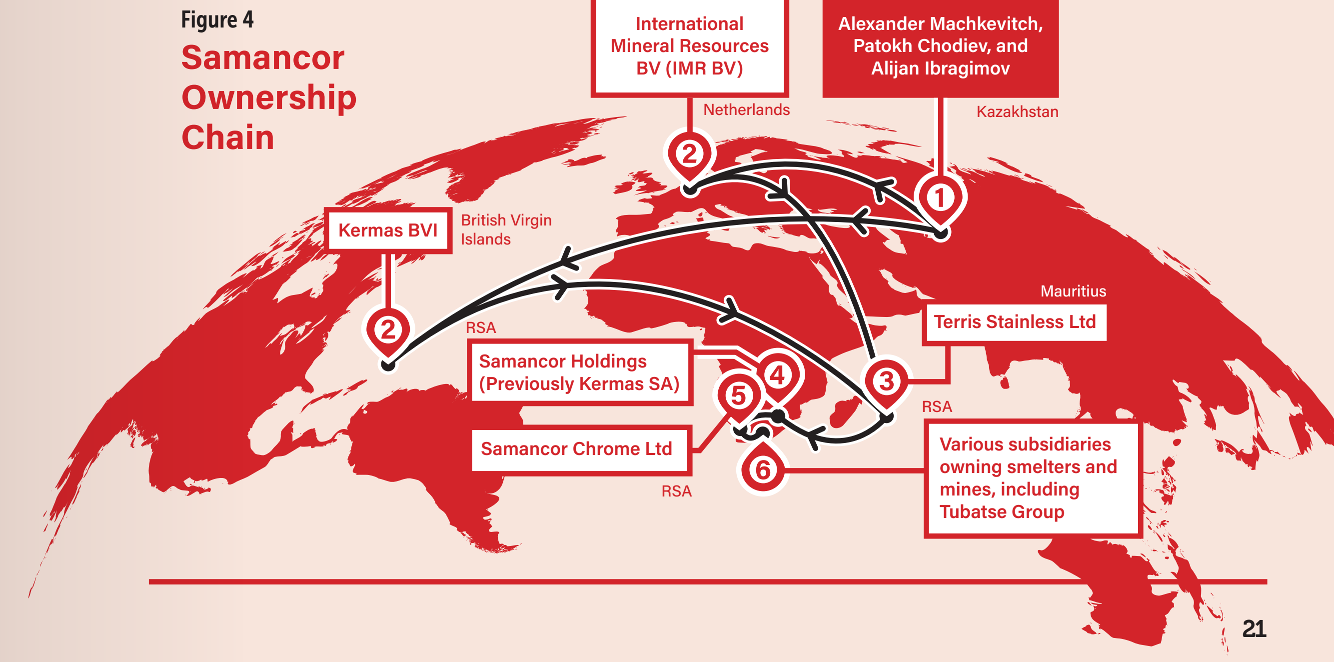
Ownership Structure at Samancor

In 1998, Samancor was bought out by transnationals BHP Billiton and Anglo American and subsequently delisted from the Johannesburg Stock Exchange. In June 2005, Samancor was acquired by Kermas SA, a purchase funded by its main shareholder, Kermas BVI - a company registered in the tax haven British Virgin Islands.[69] It is controlled by Dr Danko Koncar. Two other directors of Samancor also had a stake as minority shareholders: Juergen Schalamon who was the CEO of Samancor until 2018, and Branislav Lazovic, who left in 2010.

The purchase of Samancor by Kermas SA/BVI was in turn financed by means of a loan from International Mineral Resources BV (IMR BV). IMR BV is a Dutch-based company that traces its ownership to three Kazahkstani oligarchs: Alexander Machkevitch, Patokh Chodiev and Alijan Ibragimov.[70] By 2009, IMR had acquired control of Samancor through a series of mergers (including a merger with Kermas SA), purchases, and modifications to the Kermas loan. The details are illustrated in Figure 2 below:

Figure 4

Samancor Ownership Chain



The Malta Connection

According to the whistleblower testimony, Samancor's products have been marketed and sold by a company called Samchrome Malta since 2005. In exchange, Samchrome Malta took a 9% commission on all sales.[71] It is not unusual for companies like Samancor to rely on third parties for marketing and sales in this way. However, what is unusual is the size of the commission; the company used to market Samancor's chrome before 2005 took only up to 2.5% as commission. In addition, Samchrome Malta was entirely owned by Kermas until 2009. This fact was kept secret from Samancor's minority shareholders, who had no idea that the company was paying these massive fees to a company within the same group.

The country of Malta is a known tax haven, with a very low tax rate on corporate profits of 4%, compared with South Africa's 28%. This, combined with the exorbitant sales commission, meant that Samchrome became very profitable, reporting R520mn net profit in 2006 alone. To make matters worse, Samchrome's financial statements recorded zero expenses for wages or operating costs like telephone bills, and it also did not appear to rent or own any physical offices. In all likelihood, Samchrome Malta only ever existed as a name on paper, while the actual marketing must have been contracted to actual sales agents elsewhere. [72]

Although Samancor became less profitable as a result, allegedly shifting Samancor's would-be profits to Samchrome Malta meant that less taxes were paid overall, in turn allowing Kermas to sit in control of a larger share of total group revenue. The alleged mechanism used, of manipulating the price of a transaction between related entities so as to shift profits under the radar of tax authorities or minority shareholders, is a clear-cut case of transfer mispricing.

When IMR took over Samancor from Kermas in 2009, they became aware of the Malta connection and closed down Samchrome - only to open a *new* Samchrome, this time based in Dubai, where the corporate tax rate is 0%. The 9% sales commission arrangement allegedly continued beyond 2009 with this new Samchrome under the control of IMR.

The alleged mechanism used, of manipulating the price of a transaction between related entities so as to shift profits under the radar of tax authorities or minority shareholders, is a clear-cut case of transfer mispricing.

The Tubatse-Sinosteel Deal

In 2007, the Chinese parastatal Sinosteel purchased a 50% stake in the Tubatse Group - a set of affiliated Samancor subsidiaries.[73] This purchase was allegedly facilitated by Samancor directors as well as two board members from Kermas BVI. E-mails provided by the whistleblower suggest that they had been closely cooperating on what they termed "solutions for the Sinosteel transaction payment".[74]

The widely-reported price of this transaction was $230m, but ultimately Sinosteel paid $225m. However, instead of this $225m going to Samancor directly, Samancor's annual financial statements revealed that it had received only $100m - less than half of what it was owed.[75] What happened to the remainder?

The two implicated board members from Kermas BVI had allegedly arranged for Sinosteel to transfer the remaining $125m to a Nedbank account in London belonging to Kermas BVI. The success of this deal was confirmed by an email from Nedbank Capital announcing "that Nedbank London has received $125 million on the account for Kermas".[76]

Not only was Samancor allegedly robbed of the true value of its sale, but Kermas BVI had succeeded in transferring the capital of its subsidiary directly to a tax-free jurisdiction. This put it under their direct control and removed it from the claims of other potential beneficiaries. In particular, these included minority shareholders like the Ndizani Worker's Trust, which was intended to put the benefits from its 5.6% stake in Samancor towards the use of workers and their communities.

CHAPTER 4

What are the Impacts of IFFs and BEPS?

Our big picture view of IFFs and BEPS confirms that the scale of the issue is truly massive. However, what truly underscores the urgency of dealing with profit shifting is the fact that these outflows have serious and far reaching impacts on South African communities, workers, and the state.

In 2019 the Davis Tax Committee estimated tax losses from IFFs and BEPS at a minimum of R50bn per year[93], while SARS has estimated that "at least R100bn"[94] is lost to tax avoidance in general. Given what we know about the scale of profit shifting from South Africa, these are likely to be very conservative estimates.

Lost Taxes

When transnational corporations use these profit shifting mechanisms in order to make sure that their profits are booked in tax havens rather than in South Africa, it results in a massive loss to the country's tax income. In a 2018 report, SARS notes that it "has detected an evolution from businesses, especially transnational corporations, whereby they utilise domestic and international loopholes to evade and impermissibly avoid tax, take advantage of cross-border structuring and transfer pricing manipulations"[79]. In 2019 the Davis Tax Committee estimated tax losses from IFFs and BEPS at a minimum of R50bn per year[80], while SARS has estimated that "at least R100bn"[81] is lost to tax avoidance in general. Given what we know about the scale of profit shifting from South Africa, these are likely to be very conservative estimates.

In chapter 1 we showed how the state has responded to its growing deficit by adopting a policy of austerity. The Medium Term Expenditure Framework of October 2020 announced deep cuts in spending of up to R390bn for the next three years. These included cuts to various departmental budgets and a huge cut to the public sector wage bill, including both wage and hiring freezes. The 2021 budget has announced further cuts to health and basic education budgets in order to stabilise the deficit.[82] This austerity is therefore an indirect consequence of widespread profit shifting practices within the South African economy.

The Disaster of Austerity

Austerity has been known to result in both economic and social or human suffering. But the inequality, unemployment and need for public services in South Africa means that it will most likely have catastrophic effects. This is especially so in the wake of an economic crisis that has slashed economic spending and sent unemployment skyrocketing up to 43.1%.[83]

Under these conditions, austerity will also result in a further erosion of South Africa's already narrow tax base. A report from the World Inequality Database reveals that "the top 10 per cent own 86 percent of aggregate wealth and the top 0.1 per cent close to one third. The top 0.01 percent of the distribution (3,500 individuals) concentrate 15 percent of household net worth, more than the bottom 90 percent as a whole."[84] Cuts to government spending and the consequent economy-wide drop in employment and demand

will widen this gap, reducing state revenues further, and creating another economic trap.

Women are also particularly impacted by the erosion of the tax base due to IFFs and BEPS. As in any patriarchal society, South African women carry the burden of care work, such as childcare and domestic labour, and they face higher levels of unemployment.[85] As such, women are more reliant on public services and social grants, which are always areas cut by austerity policies. In addition, women are more heavily represented in the frontline public sector jobs (such as nurses and teachers) which are also targets of austerity.[86]

If the resources lost to IFFs and BEPS could be reclaimed, then they could provide a tax base from which to reverse austerity. They could provide urgently needed social relief through a basic income and increased investment in public services such as hospitals and schools. These resources could also be used to invest in a state-led reindustrialisation effort towards a low-carbon wage-led development path. This would include investment in public transit systems and a domestic manufacturing industry supporting the transition to renewable energy, for example.[87]

Wage Evasion

In recent work around IFFs and capital flight from organisations such as the United Nations, there is a tendency to describe the impacts of IFFs from the perspective of tax – their impact on "the ability of states to provide, to positively construct, secure conditions in which rapid human development can take place."[88] While true, this narrow perspective is also insufficient.

As the case studies in the primer have demonstrated, the mechanisms of corporate profit shifting practices tend to leave their subsidiaries artificially unprofitable by transferring this capital elsewhere. However, aside from tax evasion, this also functions to reduce a company's financial commitments towards its employees and the surrounding communities. For example, it makes it harder to argue that a TNC's mine-owning subsidiary ought to increase its workers' wages and improve working conditions, or that it must implement its legally required community development plans, if its South African subsidiary is showing little or no profit.

The mechanics of this are simple: let us take a TNC which has a subsidiary operating in South Africa, where the corporate tax rate is 28%. For a TNC to save R28mn in tax, it will have to shift R100mn out of the South African subsidiary. If the R100mn remained in the country, SARS could theoretically tax the full 28 percent, even if that is hardly ever the case given the much lower effective tax rate. Even with the 28% tax deduction, that would leave R72m in additional profit when wage bargaining processes begin. So shifting R100mn out of the South African subsidiary, removes at least R72mn from the negotiation table. This is especially visible in Case Study 1, where questions of affordability were central to an investigation of profit shifting at Lonmin, former owner of the Marikana mine. The popular story reduces IFFs to a problem of tax evasion. In fact it is often workers who lose the most from profit shifting practices; profit shifting is wage evasion.

Although our emphasis here is on the loss of wages and working conditions of largely male mineworkers, it must again be emphasised that South African women suffer these consequences in tandem. The legacy of the Apartheid-era labour system means that mineworkers are generally the sole breadwinners for families based either in mining towns or distant rural communities. Women in these communities are therefore left largely reliant on the income and health of mineworkers, while being left with the burden of care work themselves. A study on the women of Marikana demonstrated how "mine work is not something they interface with once a month through the wage-slips, or merely as economic or employment hubs: instead, it, drives, organises and orders their lives."[89] When mineworkers' wage negotiations fail, women are forced to provide with less. When mineworkers are injured due to poor working conditions, women have to take up the work of pre- and post-clinic healthcare.[90]

The Permanent Loss of Natural Resources

The most common way for the state or private sector to "sell" new mining ventures to communities and the media is to amplify their purported economic benefits. For example, the Amadiba community situated on the predominantly rural South-East coast, has been fighting against the approval of sand-mining rights on their land since 2007. Despite an unprecedented level of grassroots organisation and resistance against the proposed TNC-owned mine, both the state and the company involved have continued to push for local approval by touting the supposed "R500mn per annum" economic value of the project.[91]

However, as economist Patrick Bond points out, this kind of cost-benefit calculation has a key flaw: it fails to account for the wealth that the nation loses through the depletion of its non-renewable natural resources.[92] When this loss of natural capital is taken into account, the estimations of extractivist projects' economic value begin to look far less attractive. We cannot just count the extracted resources as income, without accounting for the loss of natural capital at the same time. As the "economic value" of a coal mine falls throughout its lifespan, the economic costs of the lost mined, processed and shipped coal continue to rack up. In addition, activities such as mining may degrade the land, making agriculture impossible without rehabilitation.

An implicit (albeit inadequate) recognition of this cost exists in South Africa's Mineral and Petroleum Resource Royalty (MPRR). The MPRR exacts a tax on the extraction and transfer of South African resources, based on the value of the mineral extracted. Putting aside the inadequate nature of the MPRR system, we can see that trade-related IFFs which occur through trade misinvoicing will also evade this mechanism, which is supposed to compensate for the permanent loss of natural capital.

The concrete impacts of this evasion could be captured under the umbrella of "tax losses", but this would underplay an important point: IFFs contribute substantially to the permanent loss of natural capital that is already largely unaccounted for. When mining projects are pushed on unwilling communities because of their "economic value", the likelihood of IFFs from the project need to be taken into account, in addition to the potential loss of natural capital.

CHAPTER 5

What Is Being Done?

Despite creating an enabling environment for IFFs and BEPS, the South African state does recognise that these outflows are a problem. However, its approach to the problem is a half-hearted one.

In addition, there is no purpose-built legislation aimed at tackling IFFs and BEPS. The different aspects of IFFs are defined within the ambit of ordinary tax, anti-corruption, and customs laws, which are often limited in scope or particularly vague.

State Efforts

The South African state has failed to adopt a comprehensive strategy that is capable of tackling IFFs and BEPS as a whole. Instead, various agencies are left to tackle whichever components of IFFs and BEPS may fall within their area of concern. For example, trade misinvoicing would generally fall under the South African Revenue Service's Customs division along with the police service. Meanwhile, IFFs related to fraud or corruption would fall to the National Prosecuting Authority or specialised departments within the police service.

In addition, there is no purpose-built legislation aimed at tackling IFFs and BEPS. The different aspects of IFFs are defined within the ambit of ordinary tax, anti-corruption, and customs laws, which are often limited in scope or particularly vague. For example, transfer mispricing is covered under Section 31 of the Income Tax Act, which stipulates the need for intra-group transactions to follow the "arm's length" principle. This principle states, as we saw before, that an intra-group "transfer price should be the same as if the two companies involved were indeed two independents, not part of the same corporate structure."[95] SARS needs to flag individual transactions and conduct a lengthy investigation in order to make a determination. At the end of this process, a civil case should be opened to force the relevant firm to pay the appropriate missing tax. Transfer mispricing is treated only as a tax dispute between SARS and the firm. It must be treated as a criminal offence against the state and other parties affected by profit shifting. It is also worth noting that this narrow legislation has not led to even a single successful case against a firm accused of profit shifting.

A series of parliamentary hearings in 2017 gave some insights into the major flaws of this decentralised approach. Discussions between state agencies concerned with some aspects of IFFs, including SARS, the South African Police Service and the Financial Intelligence Centre, devolved into arguments centring around the general lack of action and cooperation among themselves.[96] Information is passed from one agency to the other without action; inter-agency communication is ineffective; and most importantly, cases get referred to the police and left unprosecuted. As no single agency is granted the full range of powers necessary to identify problem cases, investigate them, *and* prosecute them, successful prosecution of IFFs is impossible without going through this dysfunctional web of agencies.

WHO IS RESPONSIBLE FOR TACKLING IFFS AND BEPS?

South African Revenue Service

- Recovers tax revenue lost to tax evasion, including tax fraud and transfer mispricing.
- Customs Division monitors and stops trade misinvoicing.

Financial Intelligence Center

- Monitors the financial system for abuse
- Responds to financial crime, such as money laundering and transfers related to terror financing or organized crime.
- Provides information to other agencies.

National Prosecuting Authority/ Hawks/South African Police Service

- Prosecutes IFFs where criminal elements are involved.
- Generally rely on other agencies to refer cases to them.

South African Reserve Bank

- Monitors foreign currency transactions for IFFs.
- Refers suspicious cases to the police and NPA.

Given these conditions, it is no surprise that state-led efforts against IFFs have been focused on what SARS itself has called "easy wins"[101]. These involve the outright illegal side of IFFs such as tobacco smuggling, drug-related proceeds, and the illegal cross-border movement of hard cash. The more complex side of IFFs with serious economic implications, such as profit shifting practices, are thus neglected.

Recent Improvements

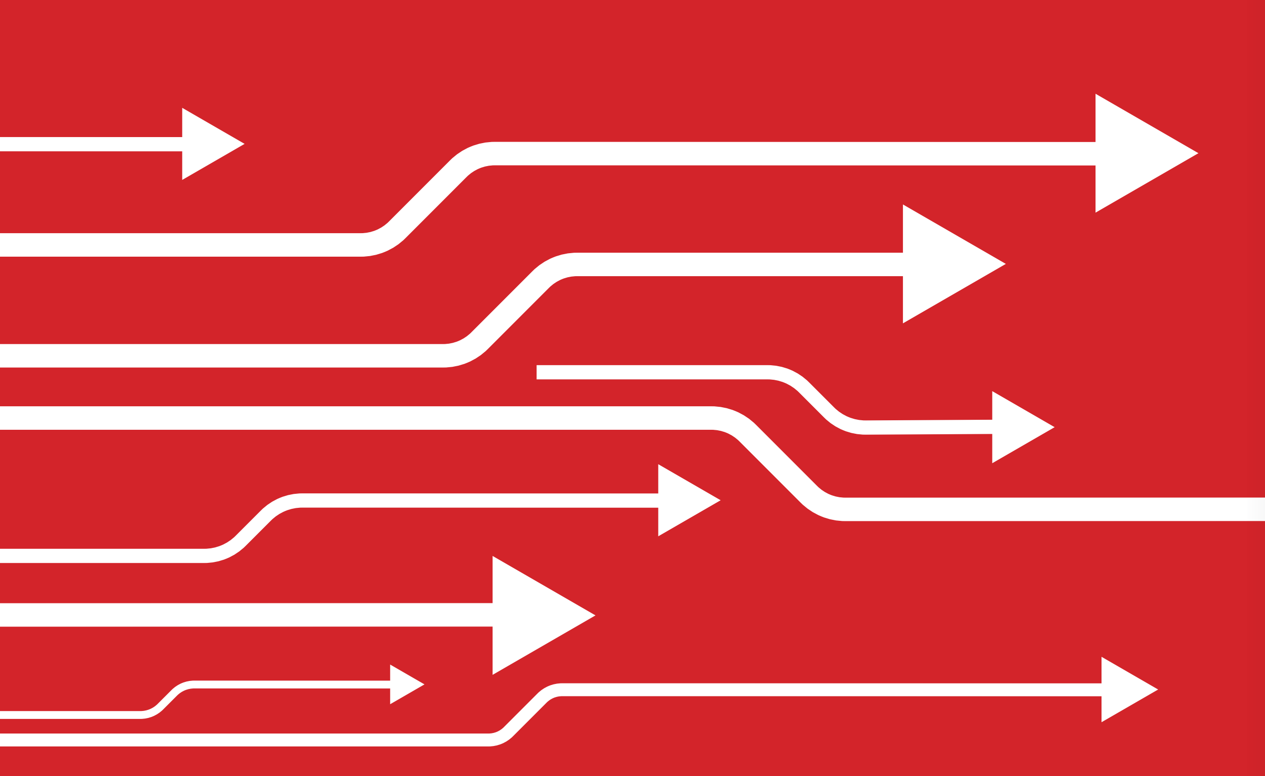
That said, the South African state has also not ignored the issue of IFFs and BEPS. The South African Revenue Service (SARS), prompted by a massive R300bn shortfall in revenue for 2020, has acknowledged the importance of these issues. The recently appointed commissioner, Edward Kieswetter, has made commitments towards tackling profit shifting, "broadening the base and improving compliance".[97] More recently, the finance minister, Tito Mboweni, also announced an additional R3bn funding for SARS over the medium term, noting their "renewed focus" on transfer pricing and the addition of machine learning technology.[98]

Inter-agency cooperation has also been somewhat improved following the 2017 hearings, with the FIC establishing an Inter-Agency Working Group on IFFs in 2018. This working group fosters inter-agency cooperation on selected cases of IFFs which satisfy a number of criteria, including a minimum financial threshold of R100mn.[99] The Group has succeeded in recovering R400m between 2018 and 2019 (last year of report).[100] However, the selected cases still tend to reflect the outright criminal side of IFFs, such as "cash and carry" operations and proceeds from rhino horn smuggling, to the relative neglect of the "capital IFFs" described in this primer.

CHAPTER

Combatting IFFs and BEPS

When we take into account the scale of IFFs and BEPS, their impact, and the inadequacy of the state's efforts to resolve them, it becomes clear that urgent and radical changes are needed.



The first and most meaningful reform a progresive government can make is to enact a paradigm shift; to consider IFFs and BEPS as serious interconnected issues arising from the country's economic structure. From this new perspective, it becomes clear that a coordinated and radical strategy is required in order to tackle IFFs and BEPS beyond "business as usual".

The Need for a Paradigm Shift

In the previous chapter, we outlined some progress the state has made in tackling IFFs. Unfortunately, there is little reason to be optimistic about these measures when the state continues to rely on the same fundamentally flawed decentralised approach that it relies on now. IFFs and BEPS are still approached as lists of related offences, the bad behaviour of "bad apples" best left to the "business as usual" workings of state agencies. Only the most serious cases are singled out for inter-agency attention.

What the state has failed to do is consider IFFs and BEPS as structural issues:

- which are caused by economic policies and structures, such as an extractives-based economy and a neoliberal export-led development path; and
- which are just as relevant to unemployment, environmental degradation, and inequality as other basic economic issues such as low growth.

The failure to recognise this big picture view has also distorted the state's approach to economic policy:

- The undeniable damage caused by large-scale mining has thus far been justified in terms of tax revenue, job creation, and inflows of investment. But would this assessment hold up when considering the scale and impacts of profit shifting within this sector?
- The state's narrow focus on IFFs as an issue for tax agencies neglects a great deal of pragmatic reforms which can be carried out in order to enable the media, civil society, labour, communities, and other groups outside of the state to contribute to the fight against IFFs and BEPS.

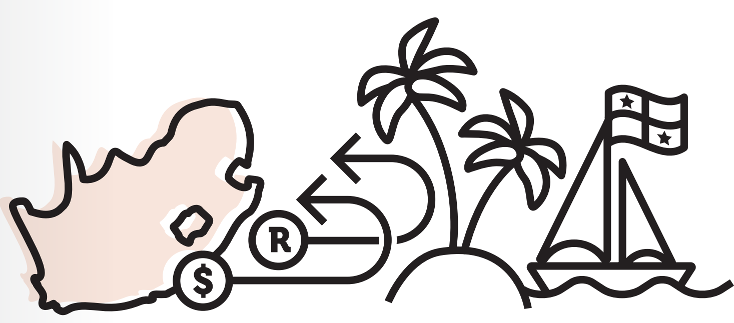
WHAT SHOULD A PARADIGM SHIFT INCLUDE?

Leveraging Macroeconomic Policy

Instead of thinking of IFFs and BEPS as resulting from the misbehaviour of a few "bad apples", the state must look at how its larger scale economic policy enables these flows and make changes where necessary. Examples include reversing the 1990s' relaxation of exchange and capital controls, or rethinking the need for tax incentives for extractive industries.

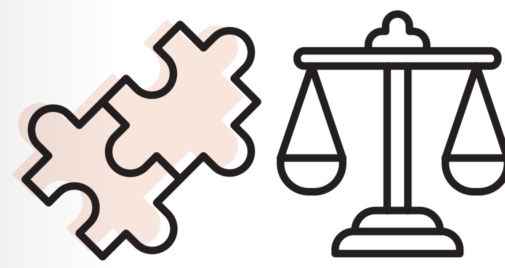
Rethinking Extractivism

Related to the above, IFFs and BEPS need to be accounted for when assessing the true economic costs and benefits of courting multinational extractive firms. The supposed economic benefits and investment value of mining projects will look far less appealing when we begin to account for the losses they will incur due to the loss of natural capital and the likelihood of profit shifting. Given both the harm caused by extractivism in South Africa on the one hand, and the scale of IFFs from this sector on the other, such a shift in understanding lends credence to calls for a move toward socially necessary mining, and away from the mindset of "investment at any cost".



Changing Priorities

As this primer has shown, profit shifting and similar business-related IFFs have serious and far-reaching impacts on society. The state needs to shift the focus of agencies from "easy wins" like tobacco smuggling, to BEPS. The driving force behind this shift has to be the recognition that profit shifting causes serious economic and social harms. It undermines the right to a decent life and prevents the state from embarking on a just development path.



Purpose-built Legislation

The state needs to institute a package of legislation specifically designed to tackle profit shifting practices. For instance, the current "General Anti-Avoidance Rule", the set of laws which define and prohibit tax-avoidance, is vague and ineffective. This could be replaced with a purpose-built legal framework that would help eliminate loopholes and uncertainty. This legislation could also enforce better inter-agency cooperation when it comes to IFFs, or otherwise create a new statutory body with the sole purpose of tracking, investigating, and prosecuting profit shifting.

Moving towards Transparency

A key struggle against IFFs is the fight for information. Without access to transaction data, organisational structures, financial statements, and so on, both state and non-state actors are unable to properly identify illicit financial flows and especially harmful profit shifting practices. There are a number of straightforward reforms which could be made here:

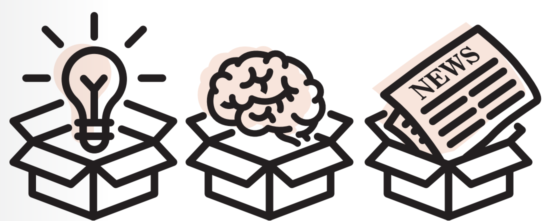
- The AIDC has proposed[102] a general amendment to the Companies Act that requires all **for-profit companies to submit their annual financial statements** to CIPC. No subsidiary of a multinational corporation or private company that has far-reaching social obligations (such as mining firms) should be exempt from this requirement.
- Further, we advocate for the creation of a **publicly accessible database** containing information that identifies **the beneficial owner** of all registered companies. This would be a vital step to help both the state and private investigators navigate the difficult terrain of corporate ownership.

BEYOND THE STATE: WHAT CAN LABOUR, COMMUNITIES, AND CIVIL SOCIETY DO TO COMBAT PROFIT SHIFTING?

IFFs are a complex and multifaceted issue that cannot be solved by any single institution or agent. The strengths of labour, communities, and civil society are as vital to driving this struggle forward as they are to checking other forms of corporate abuse. Below are some of the most important places at which interventions can be made:

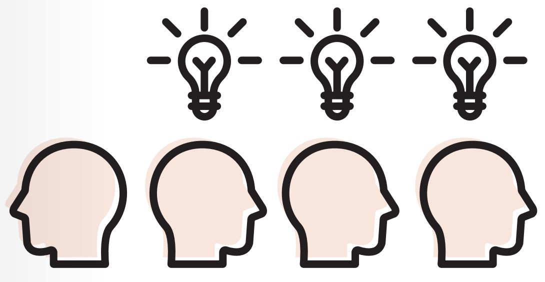
Pressuring the state for reform

While many well-meaning "development experts" may think that change will come simply through convincing states to take the problem seriously, the reality is that it is not always in the interests of public officials to do so. Within the complicated party politics of South Africa, competing interests within the state, corruption, and ideological conviction all work to undermine progressive reform. Labour, communities, and civil society will have to put consistent pressure on the state in order to pursue the demand for the "paradigm shift" advanced above.



Controlling the Narrative of IFFs

Momentum is growing around the fight against IFFs and BEPS. Beyond the South African government's increasing recognition of the problem, international initiatives such as the OECD's BEPS Action Plan and the UN FACTI Panel are beginning to pick up steam. However, these efforts threaten to be derailed by those whose interests lie with TNCs or the wealthy countries in which they are based. Progressive civil society needs to wield the intellectual and social capital at its disposal in order to ensure that these initiatives do not get watered down and become increasingly concessionary or convoluted. In doing so, civil society must consistently push for an understanding of IFFs that is broad, political, and fundamentally concerned with the well-being of workers and communities on the ground.



Building popular consciousness

IFFs and BEPS are often represented as an abstract "tax issue", something that takes place beyond the reach of everyday life. As this primer has shown, profit shifting has very concrete and severe consequences for the lives of everyday people. Education, advocacy, and campaigning has to take place in order to build a public understanding that invites action rather than deters it. Profit shifting is an issue that cuts across campaigns for social and economic justice. So activists, reporters, researchers, and unionists should be capacitated and encouraged to incorporate IFFs in their understanding and action.

Combatting profit shifting from the inside

Unions and community organisations have the advantage of being collectively organised at the coalface of TNCs' activities, with the potential to see when they are being short-changed. Unions can demand to see the financial statements of subsidiaries during wage negotiations and, once sufficiently capacitated, identify instances of profit shifting. This is unprecedented but, as the Samancor and Lonmin cases demonstrate, holds immense potential. This can constitute a form of "bottom-up" resistance against profit shifting through investigation, prosecution, and industrial action on a company-by-company, subsidiary-by-subsidiary level.

Civil society must consistently push for an understanding of IFFs that is broad, political, and fundamentally concerned with the well-being of workers and communities on the ground.

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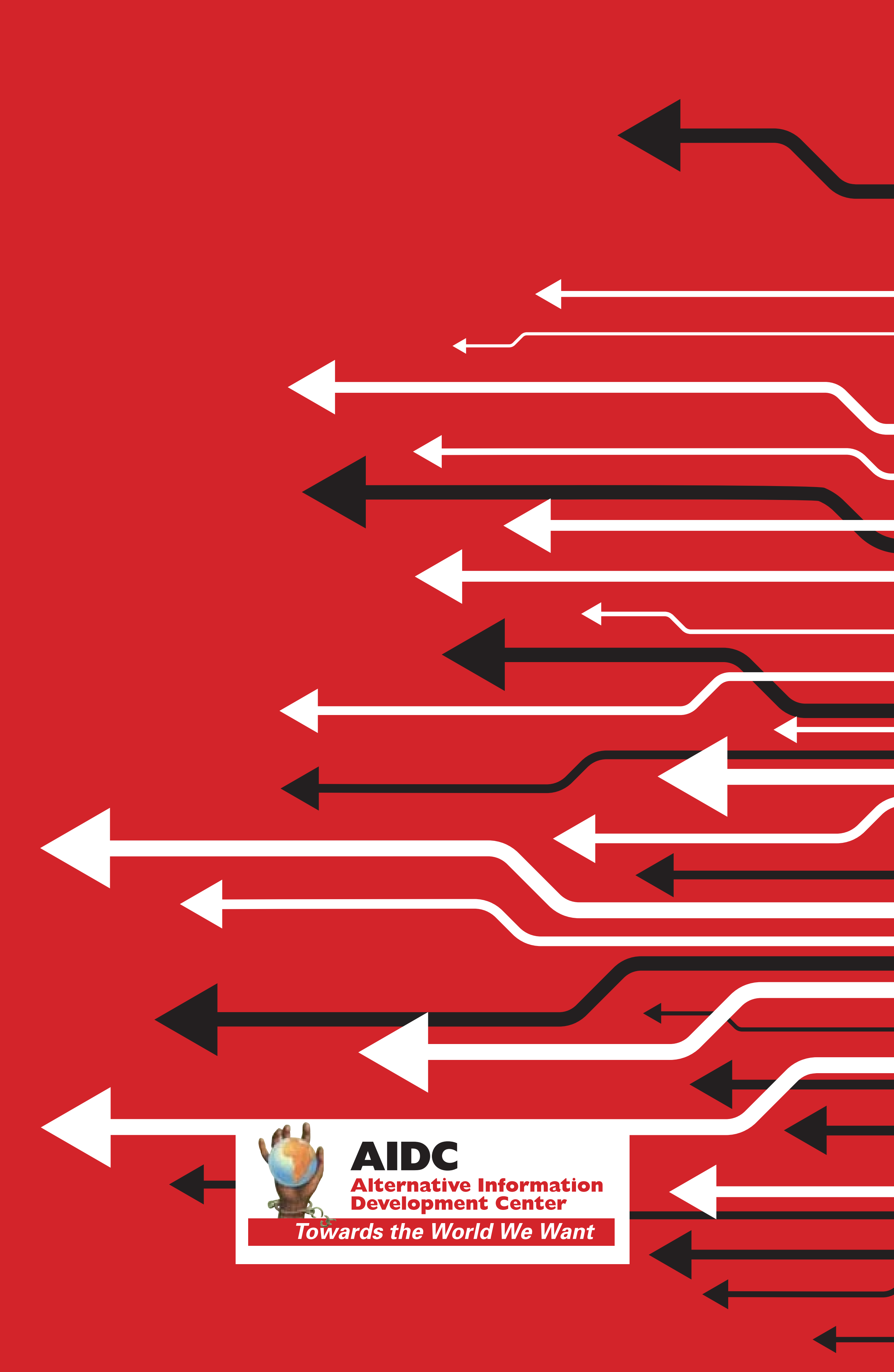
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