

# **Understanding Trade Mispricing in South Africa**

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# Presentation Outline

- **Overview: Understanding the Linkages between Illicit Financial Flows, the Illicit Economy, Trade Mispricing and Abusive Transfer Pricing**
- **Trade Mispricing**
- **Conclusions**

# **OVERVIEW: Understanding the Linkages between Illicit Financial Flows, the Illicit Economy, Trade Mispricing and Abusive Transfer Pricing**



# Overview of the Problem: A Global Problem

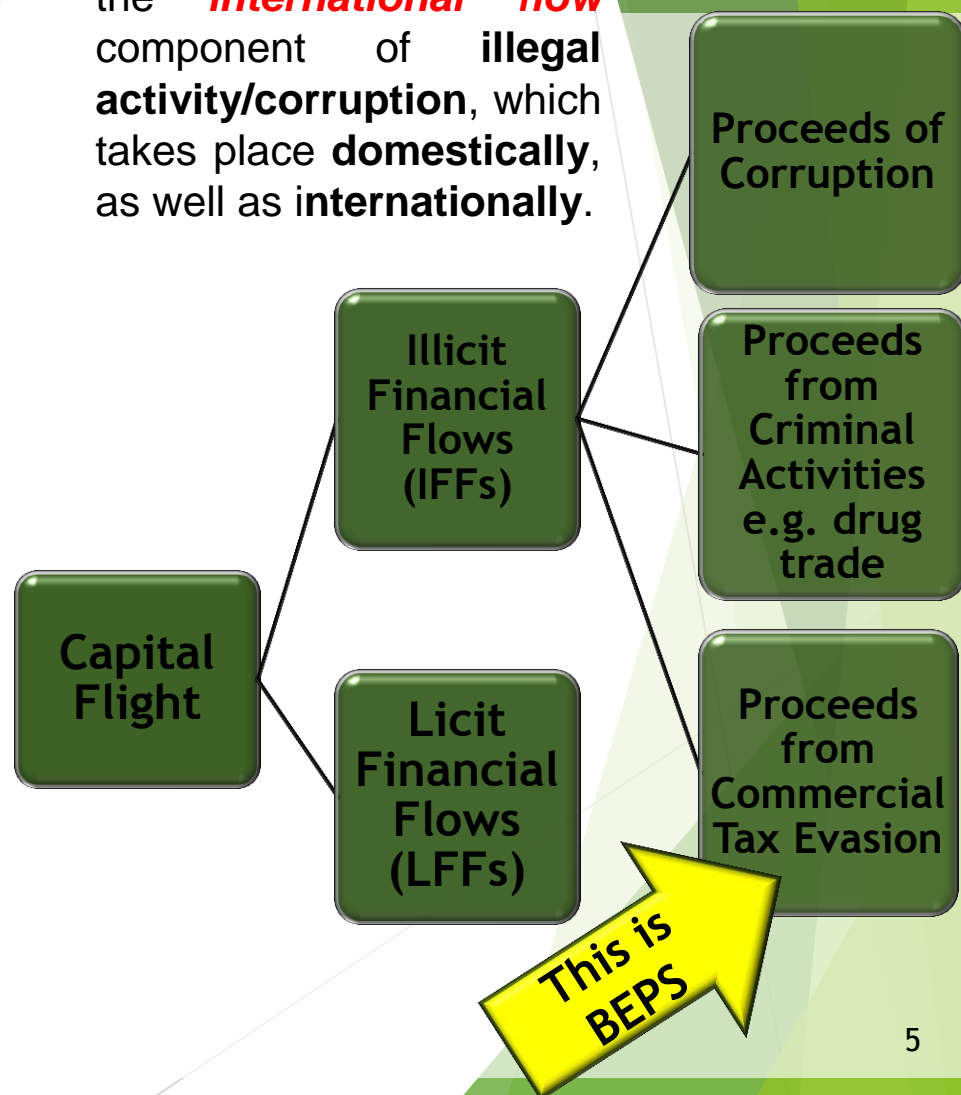
- **Organised crime, the illicit economy and Illicit Financial Flows (IFFs) affect democracies and the functioning of financial and trade markets in an economy and across the globe.**
- **Illicit traders generate vast amounts of cash that need to be laundered by morphing cash into instruments** that enable the movement of the funds into global electronic financial systems.
- **Money laundering, tax evasion, secrecy jurisdictions and IFFs are seen as developmental obstacles.**
- **Globally the annual average flow of IFFs is in excess of \$1 trillion (2007-09). Global IFFs have grown at an annual rate of 8%; doubling between 2001-10.**
- **Africa's share is ±6%, or \$60 billion annually (or \$450 billion over a 9 year period). South Africa's share of the total African proportion of IFFs for the period is 13%.**
- **Trade mispricing occurs in countries dominated by extractive industries – like South Africa**
- **Main components of IFFs (globally) are:**
  - **60% is in the form of commercial transactions, involving multinational enterprises, including tax evasion through transfer and trade mispricing;**
  - **35% is through criminal activities, such as trade in drugs, and smuggling of weapons and people; and**
  - **5% is corruption and the theft of public funds.**

# What are IFFs: Definition

## Defining Illicit Financial Flows

- Dev Kar, lead economist at **Global Financial Integrity (GFI)**, defines IFF or illicit money as “money that is illegally earned, transferred, or utilised. Somewhere at its origin, movement, or use, the money broke laws and hence it is considered illicit.”
- **United Nations Development Programme (UNDP)**, definition: “include, but are not limited to, cross-border transfers of the proceeds of tax evasion, corruption, trade in contraband goods, and criminal activities such as drug trafficking and counterfeiting.”
- In **extractive sectors**, these flows mostly originate from **corruption, illegal resource exploitation and tax evasion (including smuggling and transfer mispricing)**.

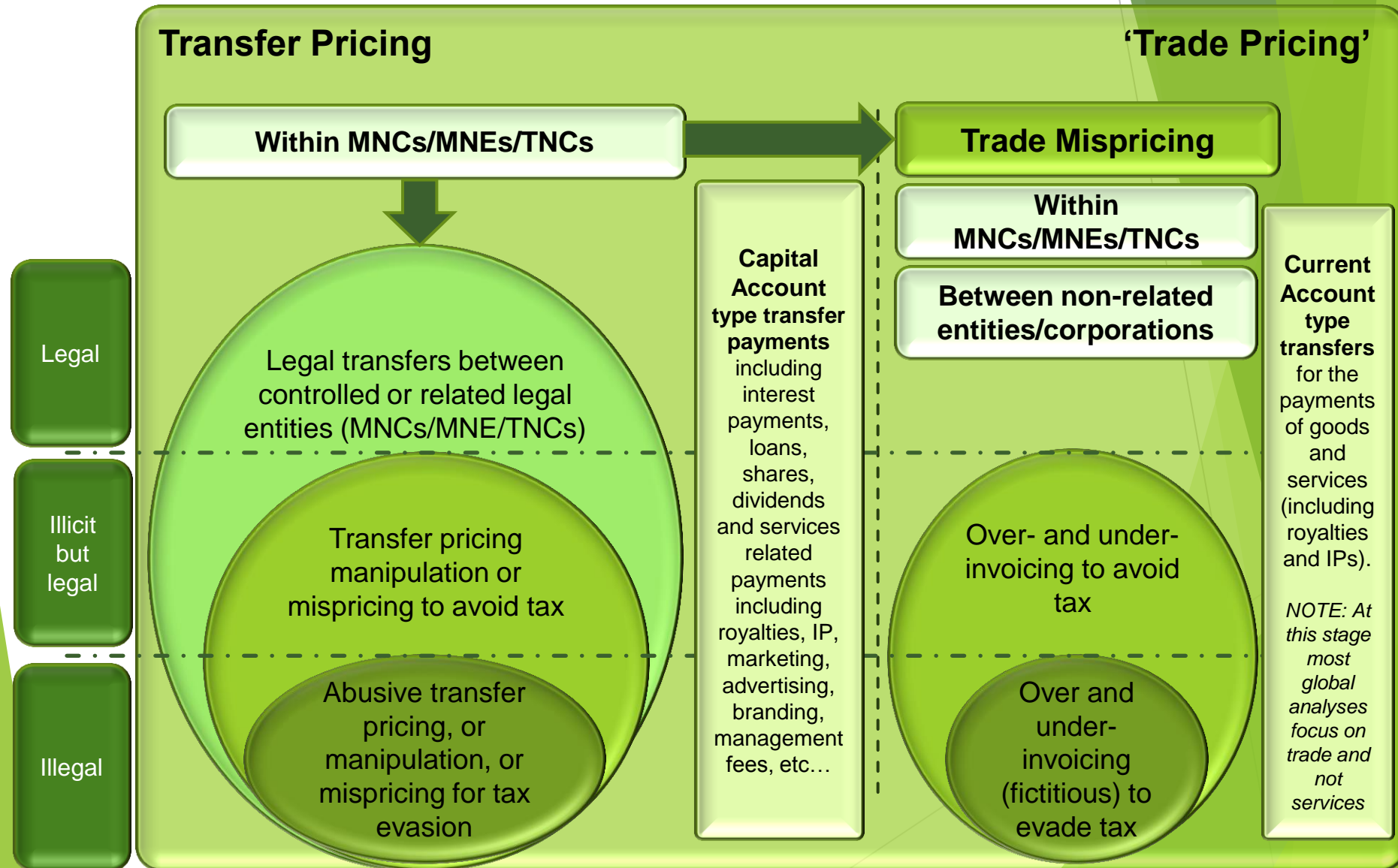
- IFFs are understood as the **international flow** component of **illegal activity/corruption**, which takes place **domestically**, as well as **internationally**.



# Key Definitions

Term	Definition
Illicit Financial Flows	Money that is illegally earned, transferred, or utilised. Somewhere at its origin, movement, or use, the money broke laws and hence it is considered illicit.”
Transfer Pricing (LEGAL)	Transfer pricing is the setting of the price for goods and services sold between <b>controlled (or related) legal entities within an enterprise</b> . For example, if a subsidiary company sells goods to a parent company, the cost of those goods is the transfer price.
Abusive Transfer Pricing (or Transfer Mispricing)	<p>Transfer mispricing is a form of a more general phenomenon known as trade mispricing (which is the trade between unrelated or apparently unrelated parties) within multinationals/same group of companies across national boundaries.</p> <p><b>FORM OF TAX EVASION</b></p> <ul style="list-style-type: none"> <li><i>Transfer (mis)pricing utilises legitimate accounting mechanisms to facilitate the transfer of revenues, profits or investment returns (or fictitious management and overhead costs), to secrecy destinations, through complex smurfing arrangements between subsidiaries and their holding companies.</i></li> </ul>
Trade Mispricing (Trade Pricing Manipulation or Fraudulent Transfer pricing)	<p>It refers to trade between <i>unrelated parties</i> at prices meant to manipulate markets or to deceive tax authorities. It includes the deliberate over-invoicing of imports and the under-invoicing export usually for the purpose of tax evasion.</p> <p><b>FORM OF TAX EVASION</b></p>

# Inter-relationships between Transfer Pricing, Transfer Mispricing and Trade Mispricing: Overview





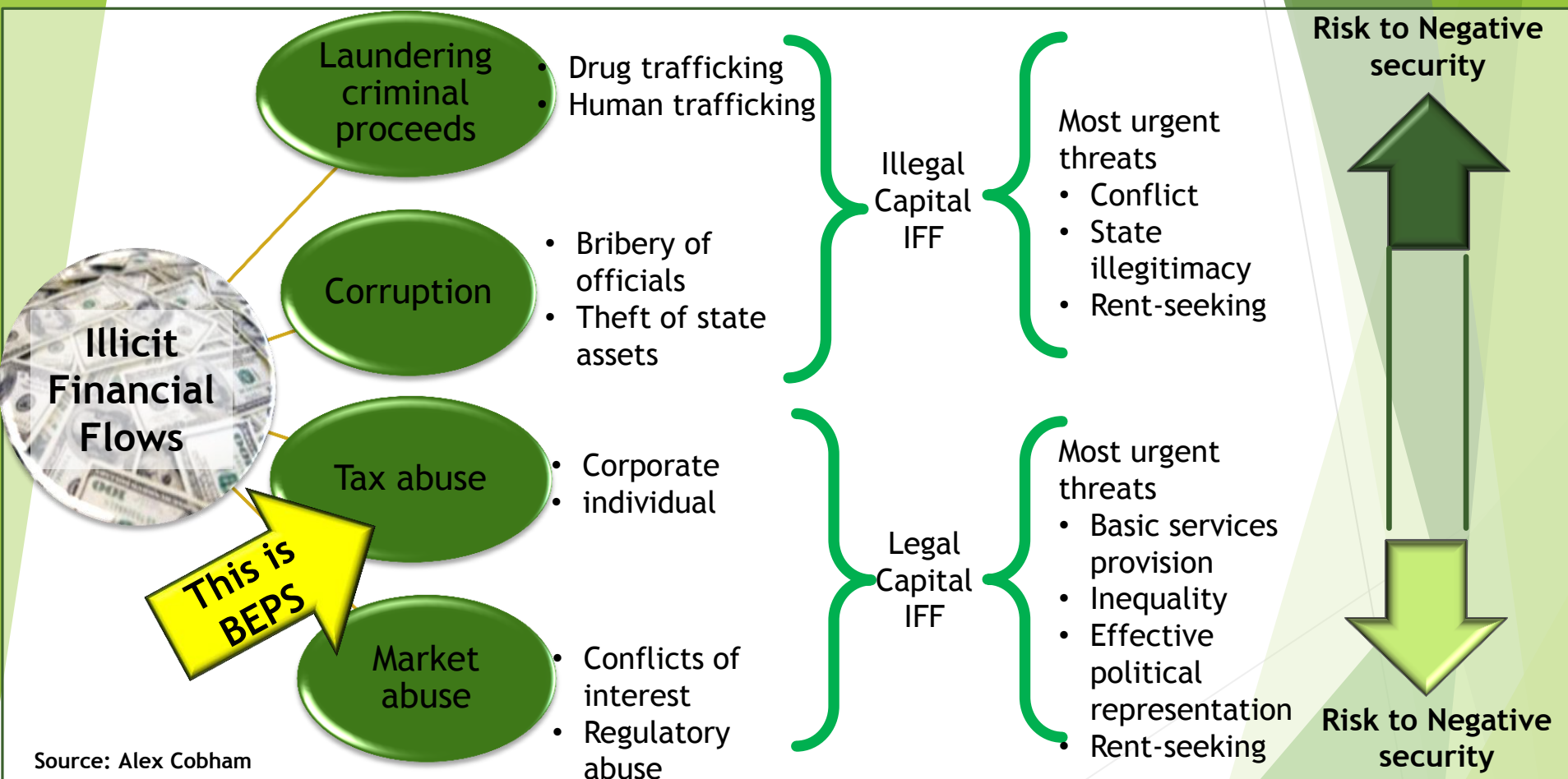
# Enablers and Drivers

- IFFs are driven by a number of “push” and “pull” factors.
- The most obvious push factor is a desire to **hide illicit wealth**, i.e. to hide the proceeds away from the public eye and law enforcement agencies; conceal the ways and means by which illicit wealth is created and that make it difficult to trace the associated money flow.
- The following push and pull factors **enable** IFFs:
  - Poor governance, corruption, weak enforcement and regulatory institutions and structures;
  - Double taxation agreements (DTAs);
  - Tax incentives especially if abused or used in conjunction with tax holidays (by exploiting the rules relating to the change of ownership that results in base erosion of a country’s wealth and asset base); and
  - The existence of financial secrecy jurisdictions and/or tax havens.
- NOTE: *Financial secrecy jurisdictions* have elaborate frameworks aimed at attracting financial resources regardless of their origin (or manner generated, i.e. legally or illegally). *Tax havens* on the other hand exploit the differences in tax rates across jurisdictions.
- NOTE: these are the same factors driving BEPS

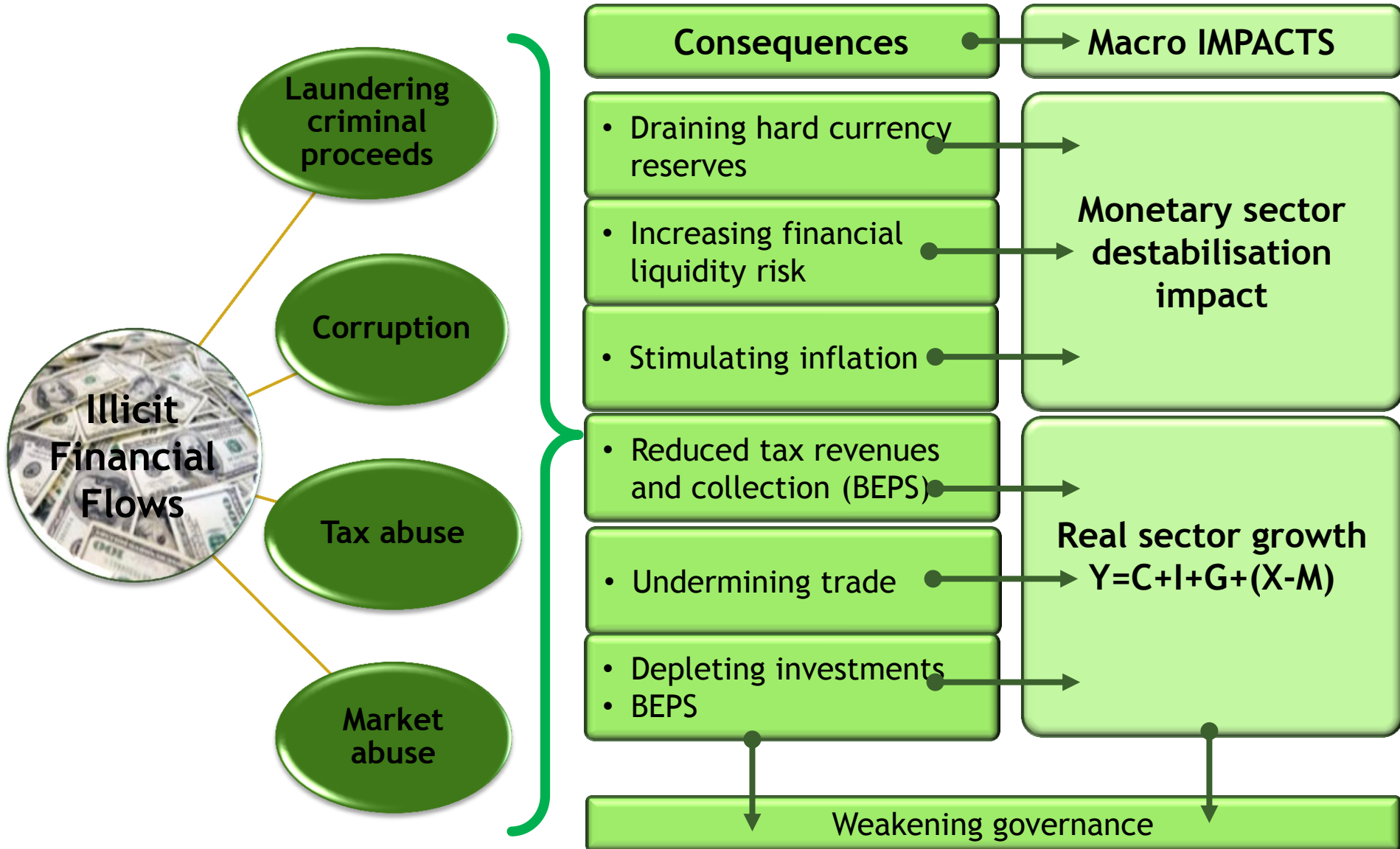


# The Impact of IFFs on the South African Economy

- IFFs are an important part of the policy coherence agenda in **international development**, featuring prominently in the G20, G8, OECD, NEPAD, UNCAC, UNECA, etc...



# Understanding the Linkages and Impacts



# Trade Mispricing



# Trade Mispricing Definition

- Trade mispricing is also known as transfer pricing manipulation or fraudulent transfer pricing.
- It refers to trade between unrelated parties at prices meant to **manipulate** markets or to deceive tax authorities. It includes the deliberate over-invoicing of imports and the under-invoicing export usually for the purpose of tax evasion.
- The traditional approach used to estimate trade mispricing is where a country's exports (imports) to the world are compared to world imports (exports) from that country to determine export or import under- and over-statement.
- Export under-invoicing and import over-invoicing reflect illicit outflows, while export-over-invoicing and import under-invoicing reflect illicit inflows.
- Traditionally, economists have netted out illicit inflows from outflows thereby understating the adverse impact of illicit flows on developing countries.
- **Tax evasion (ILLEGAL)** is mainly performed through trade mispricing/mis-invoicing, which includes trade between unrelated or apparently unrelated parties.

# Research Methodology

- Trade mis-invoicing is a commercial conduit for acquiring foreign assets (i.e. the illegal transfer of capital), by over-invoicing imports and under-invoicing exports.
- Researchers have analysed mis-invoicing by comparing partner country trade data after adjusting for the cost of insurance and freight.
- Country *A*'s exports to the Country *B* (valued free-on-board (f.o.b.)) are compared to what Country *B* reports as world imports from Country *A*, after adjusting for the cost of insurance and freight (c.i.f.). The same approach is used when analysing Country *A*'s imports from Country *B*.
- This is the IMF DOTS methodology:

$$K_{i,j} = [X_i] - M_j / \beta + [M_i / \beta] - X_j$$

- This equation seeks to capture mispricing on both the export (*X*) and import (*M*) side, assuming that illicit financial flows take place through both exports and imports, after adjusting for c.i.f. (represented by  $\beta$ )

# Data Sources

- South African imports and exports are obtained from the SARS website, official custodians of customs and excise.
- The matching or mirror country data is obtained from the International Trade Centre (ITC) and is secondary data. The ITC is a subsidiary organization of the [World Trade Organization](#) (WTO) and the [United Nations Conference on Trade and Development](#) (UNCTAD) and provides trade-related [technical assistance](#) and houses the UN's COMTRADE database of imports and exports at the 4-digit HS product level, reported by statistical authorities in more than 200 countries or territories, standardised by the UN Statistics Division.
- The period of analysis is from 2011 to 2013.

Variable	Source or Description
South African Exports	South African Revenue Service
Corresponding Partner Country Imports	International Trade Centre
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Corresponding Partner Country Exports	International Trade Centre
c.i.f./f.o.b. ratio	1.2

# Data Anomalies

- **Mapping:** Link standardised (or harmonised) national I-O tables to international bilateral trade matrices. There are anomalies with respect to differing classifications. (mapping)
- **Coverage** of data is not complete in all countries, hence we could only use a 3-year period (2010/11 – 2012/13).
- **Reporting:** Exporters and importers may report the same trade differently due to various factors e.g. (import cost, insurance and freight), timing and export Free on board, inclusion and exclusion of some commodities etc.
- **Calendar year:** A calendar year has been used and not the government financial year

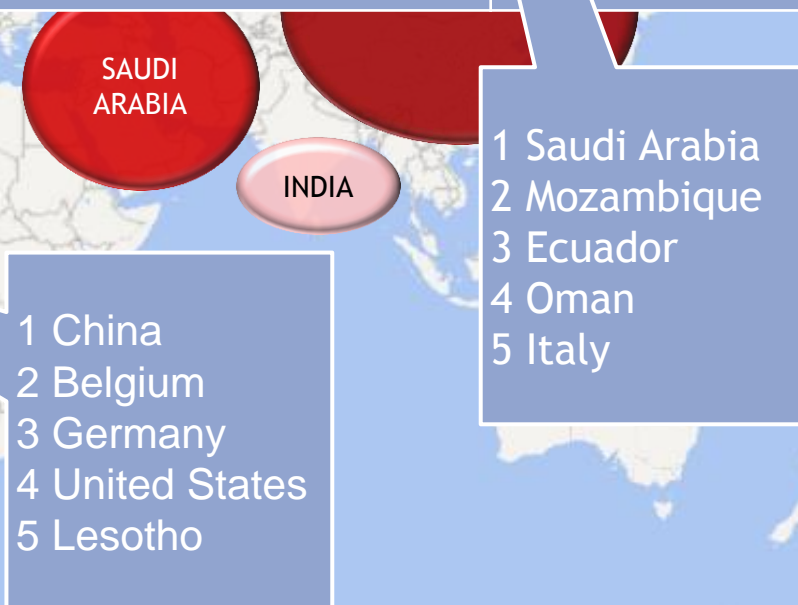


# Trade Mispricing by Country 2012 (Outflows)

Rank	Country
1	China
2	Saudi Arabia
3	United Kingdom
4	Hong Kong
5	India
6	Thailand
7	Germany
8	Italy
9	Turkey
10	Mozambique

Rank	Product Category Import Over-Invoicing	Sector
1	'27 Mineral fuels, oils and distillation products	Petroleum
2	'99 Commodities not specified elsewhere	Other
3	'84 Machinery, nuclear reactors and boilers	Machinery and Equipment
4	'85 Electrical, electronic equipment	Electrical Machinery
5	'28 Inorganic chemicals, precious metal compounds, isotopes	Inorganic chemicals

Rank	Product Category Export Under-invoicing	Sector
1	'99 Commodities not specified elsewhere	Other
2	'71 Pearls, Precious stones, metals and coins	Metals
3	'26 Ores, slag and ash	Iron and Steel
4	'27 Mineral fuels, oils and distillation products	Petroleum
5	'08 Edible fruit, nuts, peel of citrus fruit, melons	Food



# Trade Mispricing by Country 2012 (Inflows)

Rank	Country
1	Ghana
2	China
3	Germany
4	Netherlands
5	United Kingdom
6	Zimbabwe
7	Nigeria
8	United States
9	Mali
10	Botswana

Rank	Product Category Import Under-Invoicing	Sector
1	'71 Pearls, Precious stones, metals and coins	Mining
2	'87 Vehicles, other railway, tramway	Iron and Steel
3	'27 Mineral fuels, oils and distillation products	Petroleum
4	'84 Machinery, nuclear reactors, boilers	Machinery and Equipment
5	'85 Electrical, electronic equipment	Electrical Machinery

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- 
- 1 India  
2 Israel  
3 Netherlands  
4 Malaysia  
5 Mozambique

- 1 Ghana  
2 United Kingdom  
3 Mali  
4 Tanzania  
5 Lebanon

# Conclusions



# Conclusions

- **Trade Mispricing represents more than 65 percent of IFFs. Illicit trade represents more than 35 percent of IFFs. Thus IFFs are in fact a TRADE story.**
- **Curbing IFF means the following Acts can be used as levers:**
  - Companies Act
  - Credit extension Act
  - Promotion and Protection of Investment Bill
  - Competition Act
  - International Trade Act
  - IPAP
  - Income Tax Act
  - VAT and Corporate Tax
  - Customs and Excise
  - Mineral and Petroleum Royalties Act
- **Measures to address Transfer pricing, capital flight, IFFs, etc.. Need to distinguish between LEGAL, ILLICIT (but LEGAL) and ILLEGAL elements.**
- **Only the ILLEGAL elements are enforceable. Care needs to be taken not to render licit elements illegal which will become too onerous and costly to enforce and scare foreign investors, having the adverse desired effect.**

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- **.**