CURTAILING ILLICIT FINANCIAL FLOWS:
HUMAN RIGHTS OBLIGATIONS OF STATES AND NON-STATE ACTORS IN RESPECT OF ILLICIT FINANCIAL FLOWS

POLICY BRIEF

OCTOBER, 2021
State parties and national human rights institutions should include strategies to combat illicit financial flows in their National Action Plans under the UN Guiding Principles on Business and Human Rights (UNGPs).

State parties should include tax spillover impact assessments in its national action plans to assess the direct impact of their tax policy on another country’s tax base, tax policy and economic activity.

Non-state actors, including law firms, should include their financial schemes and those developed for their clients, in their human rights impact assessments to address tax compliance issues and associated mitigation strategies.

Non-state actors should fulfil their positive obligations regarding fiscal and transparency matters under Article 21 of the African Charter on Human and Peoples’ Rights (African Charter).

State parties should comply with the reporting guidelines under Article 21 of the African Charter and provide fiscal information to the African Commission on Human and Peoples’ Rights.

1. Introduction

This policy brief provides guidance on the use of tools derived from the UN Guiding Principles of Business and Human Rights (UNGPs) and the African Commission on Human and Peoples’ Rights (African Commission) to curtail illicit financial flows which includes tax avoidance from the African continent. The recommendations focus on three tools derived from the UNGPs namely the national action plan (NAP), tax-spillover assessment, due diligence and human rights impact assessments (HRIA); and two tools derived from the fiscal norms and standards established by the African Commission, namely fiscal and transparency obligations of non-state actors and fiscal reporting obligations of state parties.

2. The Three Pillars of the UNGPs

The UN Guiding Principles on Business and Human Rights are a set of guidelines for States and companies to prevent, address and remedy human rights abuses committed in business operations. The three pillars of the UNGPs are: 1) the state duty to protect people from human rights abuses; 2) the corporate responsibility to respect the human rights of people and to “do no harm”; and 3) the victim’s right to an effective remedy. Both states and corporations have a duty to ensure that effective remedies are available to victims of human rights abuses and that remedial action is taken to minimise harm and mitigate the negative impact that their conduct may have.

2.1 UNGPs and Taxation

Regarding illicit financial flows and taxation, states should strive for policy coherence between their fiscal policies and their human rights obligations at domestic and international level. Corporations, including tax advisors, lawyers and financial institutions need to be regulated to ensure that their aggressive tax minimisation strategies do not hinder the immediate and progressive realisation of human rights. The UNGPs are implemented and monitored through tools such as NAPs developed by states and due diligence and HRIAs undertaken by corporations.
2.2 UNGP Tool 1: National Action Plans (NAPs)

NAP entail policy strategies developed by a States to protect against adverse human rights impacts by business enterprises in conformity with the UNGPs. Through their NAPs, states articulate their strategic objectives and proposed plan of action to support the implementation of the UNGPs. Most countries that have already produced NAPs have not mentioned issues related to illicit financial flows and taxation. However, since it is of specific concern to Africa, Kenya and Uganda, the only two African countries that published their NAPs, set an example as they included sections on taxation, revenue, transparency and corruption.

Kenya, in its NAP, undertook to:
- Review current trade and investment promotion agreements and bring them into compliance with the Constitution and international human rights standards to ensure that they are not used to facilitate illicit financial flows and tax evasion by businesses.
- Use due diligence processes and HRIAs, should be conducted regarding their financial actions;
- Integrate and act upon its findings, tracking responses and communicating any findings.
- Look at all other clauses in their DTAs such as those that deal with permanent establishment and consider whether adjustments are needed.
- Explore measures which could be introduced to simplify the administration of transfer pricing.
- Re-negotiate DTAs without a proper anti-abuse clause.

Unfortunately, Kenya, with its newly established international financial centre (IFC) in Nairobi, did not examine how its tax and fiscal policy, and how the IFC, might negatively affect the tax base of other African states. Further, given that the IFC may potentially facilitate illicit financial flows through tax evasion, money laundering and other harmful tax practices, its establishment may potentially derail progress on the implementation of the NAP, specifically on stemming illicit financial flows.

Uganda’s NAP noted stakeholders’ concerns that tax exemptions were not provided transparently and that they were granted only to large or foreign companies. Further, these practices resulted in unfair competition between those who receive tax exemptions and those who do not. And, that these tax exemptions, if unchecked, ultimately caused the state to lose much needed revenue for the realisation of socio-economic human rights. Regrettably, the NAP did not include any tangible plans to address the problem.

Sweden’s NAP included a requirement that its state-owned investment companies ensure that it does not contribute to tax evasion, money laundering or terrorist financing. While each of these countries have taken some steps toward developing a tangible plan to combat illicit financial flows, none of them go far enough. Over and above that, all countries need to include these issues in their NAPs and ensure that they are fully implemented.

Recommendation:
NAPs should include steps to combat tax avoidance, evasion and illicit financial flows both in the process leading to its development and in the substance of the document.

Tangible strategies need to be discussed with all stakeholders involved to ensure that NAPs are strategically sound and viable including adopting a public register of ultimate beneficial owners and adopting public country by country reporting of multinational companies.

To achieve results, the NAPs should be fully implemented. Further, countries should ensure that both financial and human resources are adequately provided and NAPs should also include tax spillover assessments as discussed below.

2.3 UNGP Tool 2: Tax Spillover Assessments – A proposed new section of the NAP

Tax competition among state parties facilitates various forms of illicit financial flows, tax evasion and tax avoidance. Tax spillover effects are the direct impact of one country’s tax policy on another country’s tax base, tax policy and economic activity. Most tax treaties between one developed state and another developed state, broadly speaking, are balanced in that there is a comparable level of cross-border activity both ways. However, tax treaties between developed states and developing states, and in Africa, between least developed states and state parties with more advanced economies, especially with tax havens, are broadly speaking imbalanced. The structural imbalance created by the asymmetrical double tax agreements (DTAs) needs to be addressed as they facilitate illicit financial flows and are particularly damaging to developing countries, especially in Africa. Consequently, a tax spillover assessment will help countries redress the imbalances and form a strong basis for re-negotiation of treaties.

Recommendation:
States should therefore:
- Determine whether their DTAs reduce their capacity to levy withholding taxes in a disproportionate way. And, whether the benefit of the reduced withholding tax (in terms of additional foreign investments) is in fact sufficient to compensate for the loss of tax revenues, in view of the fact that withholding taxes provide an avenue for developing countries to tax given how much money they lose via intangibles like intellectual property rights;
- Look at other clauses in their DTAs such as those that deal with permanent establishment and consider whether adjustments are needed;
- Consider whether new clauses are necessary to deal with current challenges such as “Fees for Technical Services” to ensure fairness and potential new tax resources;
- Examine whether the DTA provides for a fair allocation of capital gains tax rights;
- Explore measures which could be introduced to simplify the administration of transfer pricing; and
- Re-negotiate DTAs without a proper anti-abuse clause.

2.4 UNGP Tool 3: Due diligence and human rights impact assessments (HRIAs)

Under the UNGPs, corporations have a duty to “do no harm” and are expected to “know and show” that they are not violating human rights. They have a responsibility to take steps to avoid infringing upon all individual and peoples’ rights. Due diligence helps corporations answer the question, “How does a business know that it is doing no harm?” The due diligence reports and HRIAs help corporations to identify, prioritize, and address human rights risks and opportunities at a corporate, country, site, or product level. Corporations should not only look at its own operations, but also those created by any business relationships. Corporations, including law firms, tax advisors, auditors and accountants, should avert all human rights risks, including financial schemes that facilitate illicit financial flows.

Recommendation:
Corporations, including law firms, should undertake due diligence processes including obtaining complete information to know their clients;
- Due diligence processes should include assessing actual and potential impacts, integrating and acting upon its findings, tracking responses and communicating any actions;
- Due diligence processes and HRIAs, should be conducted regarding their financial schemes and, in the case of law firms and financial advisors, schemes that are developed for their clients; and
- Tax compliance issues and associated mitigation strategies should be included in HRIAs.

As part of its promotional mandate, the African Commission has included the issue of illicit financial flows in its state reporting guidelines, requiring state parties to address questions regarding steps taken to curtail illicit financial flows in their respective periodic reports. In addition, the African Commission has posed questions on this issue during its examination of state reports. It has also issued statements regarding state parties that operate as tax havens and called upon them to review their policies and laws. The new guidelines address positive and negative obligations of corporations and of states to curtail illicit financial flows. Regrettably, these guidelines are limited to corporations that operate within the extractive industry sector.

3.1 Tool 1: Fiscal and transparency obligations of non-state actors

Fiscal transparency entails the comprehensive, clear, reliable, timely and relevant public reporting on the past, present, and future state of public finances. The African Commission went further than the UNGPs to state that non-state actors have more than just the responsibility to respect, but they also have both positive and negative obligations to “do no harm” including regarding fiscal issues and their financial schemes. Countries are obliged to implement legislation and policies that mandate the establishment or legal empowerment of existing institutions to monitor and ensure compliance with fiscal or other transparency. Such legislation should further ensure the application of human rights. The New Guidelines specifically define positive obligations for non-state actors, particularly when pertaining fiscal and transparency issues.

Recommendations:

Non-state actors should fulfil the obligations listed below:

- Disclose identities of owners, shareholders and local partners;
- Fully declare profits they make from their operations in the host country;
- Disclose financial terms of agreements relating to license fees, national and local taxes, custom duties, royalties and shares due to the government in terms of the contract and applicable laws of the country; and
- Adopt measures to comply with requirements against illicit financial flows.

3.2 African Commission Tool 2: Fiscal reporting obligations of state parties

State parties to the African Charter are required to include fiscal information in their respective periodic reports to the African Commission. To do this, they will need to establish mechanisms to gather this information. If state parties and corporations adhere to these systems, this in itself will be a major step towards greater accountability and transparency in fiscal policy and administration and consequently will help to curtail illicit financial flows. However, of the 12 state parties that presented their reports since the adoption of the New Guidelines in 2018, only Cameroon and Mauritius submitted some information on taxation, even though neither fully complied with all the items required under the new guidelines.

Recommendations:

State parties should comply with the new reporting guidelines and at least, provide the information below:

- Detailed information on any financial or tax related information such as tax expenditure, incentives and exemptions provided to companies in the extractive industries;
- Information on the steps taken to address illicit financial flows through amendments to national tax laws and policies, rules on related party transactions, company laws and policies, banking laws and policies and laws and policies governing the financial services sector;
- Information about the measures put in place to renegotiate agreements that limit the State's ability to collect adequate revenue from commercial activities within the extractives sector;
- Information on the legislative, administrative and judicial measures put in place to combat corruption in the extractive industries sector;
- Information on the extent to which the State is involved in joint ventures and the tax implications of such ventures.

4. Way forward

Only two African states have published NAPs. More African states should follow with even greater emphasis on plans to combat illicit financial flows and ensuring their full implementation. Few states of the global north have included fiscal, tax transparency and revenue related issues in their NAPs. African states, policy makers and stakeholders need to advocate more forcefully at an international level for these countries to do so.

If thorough tax spillover assessments were undertaken, either as part of the NAP process or on its own, it could help states to identify and then contain the negative impact of their tax policies and practices on other states.

The tools derived from the African Commission are limited to corporations in the extractive industry sector. Advocacy strategies ought to be developed to expand the focus of these guidelines to all sectors.

Sources

12. International Consortium of Investigative Journalists FinCEN Files
13. OHCHR "Guiding Principles on Business and Human Rights"
"We work to see a united, just and prosperous Africa, built on the rule of law and good governance."