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Illicit financial flows: ending another pandemic

Summary

Illicit financial flows (IFFs) undermine the rule of law, stifle trade, worsen macroeconomic conditions, diminish fiscal space and exacerbate the risks and vulnerabilities arising from increased debt and inequality. IFFs are a major source of resource leakage that undermines domestic resource mobilization efforts. They weaken tax systems and deprive economies from resources that could have otherwise been made available to finance national development plans and socioeconomic responses, achieve progress on the Sustainable Development Goals (SDGs), and fulfil climate commitments under the Paris Agreement.

IFFs continue to evolve and proliferate through new conduits and technologies, leading to trillions of untaxed private wealth, phantom investments, and lost tax revenues. In the Arab region, while trade-based IFFs exacerbate inequalities, erode public revenues and hinder regional integration, tax competition and profit shifting by multinational corporations reduce corporate tax revenues and are incentivized by regional instability, conflict and crime. This, in turn, biases official data and hampers the development of consistent economic and social policies to meet Arab countries’ growth and development goals.

The present document provides a synopsis of the global and regional challenges to root out IFFs, and highlights the impact and magnitude of tax-based IFFs, foreign direct investment (FDI), and trade-based IFFs, including those arising from trade misinvoicing, tax base erosion, and other tax abuses that constitute significant revenue leakages in the Arab region. The report concludes with important policy interventions that need to be considered to enhance international and domestic transparency commitments, strengthen norms to combat IFFs, respond to emerging risks and improve enforcement capacity and the integrity of financial systems in the Arab region.

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Introduction

1. One of the marked lessons drawn from the Millennium Development era is that development requires systemic responses to the enablers and disablers of growth and development. The 2030 Agenda for Sustainable Development was hence disposed to tackle the factors that both advance and regress sustainable development. In congruence, the Addis Ababa Action Agenda highlighted actions to reduce the leakages that continue to undermine domestic resource mobilization efforts, including a commitment aimed at “substantially reducing illicit financial flows by 2030”. The Sustainable Development Goals (SDGs), notably SDG 16.4, further emphasized the commitment to combat illicit financial flows (IFFs) which undermine the rule of law, stifle trade, worsen macroeconomic conditions, deteriorate perception-based governance and corruption standings, and impair the capacity to enact fiscal policies aimed at achieving sustainable development and meeting human rights obligations.

2. The High-Level Panel on International Financial Accountability, Transparency and Integrity put forward 14 systemic recommendations to reform the global financial architecture. The Financing for Development in the Era of COVID-19 and Beyond initiative contemplated 40 short and medium-term policy options that set forth the means to root out IFFs by improving tax compliance and curbing trade misinvoicing practices and their perpetual leakage of resources that could have been harnessed to support COVID-19 recovery and finance the 2030 Agenda and climate action as called for in the Paris Agreement.

3. Notwithstanding all these efforts, IFFs continue to proliferate and mutate in terms of conduits and enablers. Their cross-border modes of transfer are making use of new technologies (such as crypto-assets) under increased conditions of capital mobility that underpin global interconnectivity in trade, finance, transport and communications. These factors facilitate IFFs as much as they provide the means to combat them. Yet, IFFs remain purposefully stealth, concealing the identities of their perpetrators and the activities that generate them. They have every motive to promote instability, and their impacts are felt in the real economy, whereby they undercut fiscal, trade, financial and governance systems. Additionally, their cross-border transgressions expose systemic gaps in the multilateral system of governance.

I. Scale, scope and conduits of IFFs

4. In terms of magnitude, the figures are striking, and they reveal the extent of damages inflicted upon the global economy. Nearly $8.6 trillion of untaxed private wealth is held in haven countries and low-tax jurisdictions (8 per cent of global gross domestic product (GDP));[1] $15 trillion in phantom investments are channeled through empty shell companies;[2] and $500–$600 billion in corporate income tax revenues are lost annually to tax abuse,[3] equal to a quarter of the annual SDG financing gap in developing countries.[4] These estimates vary widely among studies because of financial secrecy, insufficient data, and the absence of a clear definition of “tax havens” and of the fine line between tax evasion and avoidance.

5. An estimated $2 trillion is lost each year due to bribery (roughly 2.3 per cent of global GDP),[5] but the figure conceals the far greater social and economic costs of corruption. Illicit financial outflows are increasing nearly twice as fast as global GDP. The Organisation of Economic Co-operation and Development (OECD)

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[1] Gabriel Zucman, The hidden wealth of nations: the scourge of tax havens, University of Chicago Press, 2015. (Estimate based on 2016).

[2] Jannick Damgaard, Thomas Elkjaer, and Niels Johannesen, What is real and what is not in the global FDI network?, IMF Working Paper WP/17/274, 2019. (Estimate based on 2017).

[3] Ernesto Crivelli, Ruud de Mooij, and Michael Keen, Base erosion, profit shifting and developing countries, IMF Working Paper WP/15/118, 2016; Alex Cobham, and Petr Janský, Global distribution of revenue loss from corporate tax avoidance: re-estimation and country results, Journal of International Development, 30(2), 206–232, 2018. (Estimates based on 1980–2013 period).

[4] Djeneba Doumbia, and Morten Lykke Lauridsen, Closing the SDG Financing Gap, 2019.

[5] This estimate for 2015 is an extrapolation by Daniel Kaufmann based on his earlier estimate of $1.1 trillion. Daniel Kaufmann, Myths and realities of governance and corruption, 2005.

estimates the negative impacts of IFFs, stating that for every $1 granted to developing countries in the form of official development assistance (ODA), $3 is lost from these countries in the form of IFFs.[6] Unauthorized leaks, including the Panama papers, the Bahama briefs and the FinCen files, uncovered trillions of dollars in suspected IFFs moving through the international banking system.

6. Estimates of corporate tax abuse suggest that multinational corporations are not paying their fair share of taxes where economic activity has been created, and have shifted between $600 million and $1.38 billion in annual profits to low-tax jurisdictions, depriving public coffers around the world of $90–$280 billion in annual tax revenues.[7] The indirect losses, however, are much larger and remain unaccounted for, especially as IFFs have aggravated the financial vulnerabilities that contributed to the historic build-up of public debt stocks. As such, IFFs emerge as a major overlooked factor that distorts public spending decisions feeding the cycle of deficits and debt.

7. Seven years after the adoption of the 2030 Agenda and the Addis Ababa Action Agenda, there still isn't a multilaterally agreed definition of IFFs or an agreement over the best methodology to estimate them. Several methods have been employed to estimate different IFF components, but they do not provide a clear picture of their entire scope and scale. Institutional stakeholders resort to different methodologies and select different elements of IFFs, thereby frustrating the attempt to provide comparable global and regional assessments across time and space. Data sources pose another constraint as they are generally not tested for completeness or consistency. Under these conditions, measuring and tracking progress in combatting IFFs becomes an arduous task.

8. The conduits of IFFs have been in a constant state of mutation, outpacing detection. Traditionally, IFFs have been compartmentalized and associated with corruption, crime, terrorism, taxation trade, and illegal markets. These demarcations, however, remain elusive as several conduits of IFFs are used to perpetuate any mix or configuration of illicit finance. In determining the policy actions needed to address these conduits, it is necessary to distinguish between tax and trade-based IFFs, which directly diminish national revenues, and IFFs that undermine transparency and financial integrity (such as money laundering, concealment of proceeds of corruption, fraud and financial crime), which divert resources meant for investment in sustainable development.

9. To this end, the United Nations Office on Drug and Crime (UNODC) and the United Nations Conference on Trade and Development (UNCTAD) advanced a conceptual framework for the statistical measurement of illicit financial flows, which identifies IFFs as "financial flows that are illicit in origin, transfer or use, that reflect an exchange of value and that cross country borders". The effective application of the framework remains contingent, however, on recognizing how regional contexts interact with the systemic factors (legal, fiscal, tax, cultural, security, political, governance and macroeconomic) that continue to drive IFFs until this very day.

10. More granular assessments based on the conceptual framework are needed to identify potential gaps and target policy efforts. It is worth noting that illicit activities are often intertwined, such as when bribery or corruption is linked to extractive industries and trade mispricing. While it may be statistically challenging to estimate or trace how IFFs are transferred and used, especially when several hybrid modes facilitate their cross-border transfer, it is equally challenging to separate tax evasion (illegal) from aggressive tax avoidance (legal) as there is no agreed threshold to determine the point at which lawful tax planning becomes "aggressive", and hence harmful.

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[6] Economic and Social Commission for Western Asia (ESCWA), Conference on financing sustainable development: curbing illicit financial flows, 2018.

[7] Kimberly Clausing, The effect of profit shifting on the corporate tax base in the United States and beyond, National Tax Journal 69(4): 905–34, 2016; Thomas R. Tørsløv, Ludvig S.Wier, and Gabriel Zucman, The missing profits of nations. National Bureau of Economic Research Working Paper 24071, 2018; Petr Janský, and Miroslav Palanský, Estimating the scale of profit shifting and tax revenue losses related to foreign direct investment, International Tax and Public Finance 26(5): 1048–1103, 2019; Alex Cobham, and Petr Janský, Global distribution of revenue loss from corporate tax avoidance: re-estimation and country results, Journal of International Development 30(2): 206–32, 2018.

11. The lingering divide between statistical and legal concepts and definitions needs to be bridged. While statistical definitions serve the intent of measuring IFFs, the absence of a regional or multilateral legal description of what constitutes IFFs holds severe consequences, not least in relation to asset recovery and prioritizing the policies, instruments and regulations needed to root them out from intra and inter-regional settings.

II. IFFs in the Arab region

A. Trade-based IFFs

12. Trade misinvoicing is a key conduit of IFFs in the Arab region. IFFs associated with trade misinvoicing pose severe structural, socioeconomic, governance and security complications for Arab economies. Misinvoicing is driven by country/regional idiosyncrasies and provokes "beggar-thy-neighbor" dispositions. As trade fraud exacerbates inequalities, trade-based money laundering erodes public revenues and indirectly undermines efforts to forge regional integration.

13. In his 2022 report on "International coordination and cooperation to combat illicit financial flows" (A/77/304), the United Nations Secretary-General acknowledged the first regional assessment of IFFs in the Arab region conducted by ESCWA in 2018. According to the assessment, Arab economies fall prey to at least $60.3 billion–$77.5 billion per year in damages due to IFFs associated with four trade-related money laundering (import under- and over-invoicing and exports under- and over-invoicing) and illegal markets. Misinvoicing appears more pervasive in non-resource-rich economies and in the non-oil product categories. It also permeates both Arab preferential and non-preferential trade.

14. Regional instability remains a daily source of IFFs, which constitute a direct or indirect implication of occupation, terrorism, corruption, transnational crime or militant activity. Proxy wars, sectarian conflicts, and terrorist networks have provided ample incentives for IFFs. For instance, militant groups have exploited correspondent banking relations to launder billions in drug money through the sale of second-hand and used car parts.[8] Illicit gold trade has been subject to misinvoicing when converted into crypto assets in some of the Arab region's gold souks, leaving no trace in the world's formal financial system.[9]

15. Contraband purchases have flourished due to the crisis in the Syrian Arab Republic, where only four of the 72 crossing points along the 260 km border with Lebanon are official.[10] The dire humanitarian situation in the Syrian Arab Republic has prompted new trade routes for smuggled commodities, including foodstuffs, electrical appliances, natural gas, and petrol. The Islamic State of Iraq and the Levant (ISIL/Da'esh), believed to be one of the world's richest terrorist organizations, has generally funded itself through illicit trade and the illicit sale of "blood antiquities". There are also reports of illicit or undeclared trade in oil by ISIL through various routes, including Türkiye, the Syrian Arab Republic, and Iraqi Kurdistan.[11]

16. The stalled Middle East Peace Process provides other incentives for IFFs. Natural resources and agricultural products from Israeli settlements in the West Bank, including East Jerusalem, and the Syrian Golan Heights are mislabeled by Israeli operators, who issue Israeli certificates of origin for products originating in the Occupied Palestinian Territory in contravention of the terms of the Oslo Accords and the 1994 Paris Protocol. UNCTAD reports that Israeli exploitation of Palestinian natural resources, including oil and natural gas, imposed considerable costs amounting to $47 billion between 2000–2017 in lost public revenues leaked to Israel.[12]

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[8] ESCWA, Illicit Financial Flows in the Arab Region, 2018.

[9] International Monetary Fund, The Terror-Crime Nexus, 2017.

[10] ESCWA, Illicit financial flows in the Arab region, 2018.

[11] David Sheppard, John Reed and Anjli Raval, Israel turns to Kurds for three-quarters of its oil supplies, Financial Times, 2015.

[12] UNCTAD, $48 billion is the estimated revenue loss by Palestine from 2000-2017 due to occupation, 2019.

B. Tax-based IFFs

17. Over the past four decades, international tax competition ushered a race to the bottom, bringing visible declines to corporate tax rates in Arab countries. In turn, multinational corporations (MNCs) resorted to tax planning strategies to exploit mismatches in tax treaties (treaty shopping) and escape tax liability by shifting their profits away from the jurisdictions where the activities creating these profits are taking place. In the era of mass digitalization, these practices and tax abuses have been amplified as new business models allowed MNCs to generate income without maintaining a physical presence where the real economic activity is taking place.

18. As a repercussion, corporate income tax rates in the Arab region declined from 35 to 21 per cent over the period 1980–2020. Nonetheless, corporate income tax levels in the region do not necessarily translate into proportional effective tax rates or yield commensurate corporate tax revenues. This is driven by an anomaly of tax leakages, symptomatic of tax base erosion and profit shifting, tax arbitrage, low tax enforcement, and foreign direct investment (FDI) reversals of untaxed passive income. This is also explained by the generous tax exemptions and other fiscal and tax incentives awarded to MNCs. In a cursory assessment, ESCWA found that the foregone revenues to tax incentives amounted, on average, to nearly 60 per cent of the potential corporate tax revenues of the Arab region in 2019/2020.

19. Broadly speaking, MNCs contribute, on average, about 23 per cent of total corporate tax revenues in developing countries.[13] In the Arab region, this share can be as high as 28 per cent for the United Arab Emirates and as low as 13 per cent in the case of Egypt (excluding the 56 per cent share of State-owned enterprises in corporate tax revenues).[14] Between 2017 and 2019, MNCs generated nearly $640 billion (5 per cent of their global profits) from the Arab region, exceeding the region's share of global GDP. In contrast, MNCs with foreign ownership operating in the region paid 15 per cent of their profits in taxes over the same period as opposed to 38 per cent in Latin America and the Caribbean. This implies that the region is well below its potential in terms of taxing MNCs.

20. In fact, according to ESCWA, Arab middle-income countries suffered an estimated $8.6 billion in annual tax revenue losses owing to corporate tax abuse.[15] This is equivalent to 16 per cent of the entire expenditures of the Arab region on health and nearly 11 per cent of its education budgets in 2017.[16] In fact, the region witnessed significant tax leakages over the past decade, in line with several investigative reports on corporate tax evasion. For example, according to the Jordanian Government, tax evasion costs the treasury between $100 million and $200 million a year.[17] In Lebanon, annual corporate income tax evasion is on the order of $400 million to $450 million.[18] Oxfam estimates that Morocco loses $2.5 billion annually due to tax evasion,[19] while in Tunisia, it is estimated at $540 million per year.[20]

21. Overall, the Arab region endures almost 5 times the losses that it inflicts on other jurisdictions due to corporate tax abuse. On aggregate, the average effective tax rates of Arab countries have been declining as much as corporate income tax rates, reaching 8 per cent in 2020 (compared to an average of 22.5 per cent in

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[13] UNCTAD, World Investment Report 2015, 2015.

[14] International Monetary Fund (IMF) Middle East and Central Asia Department, Arab Republic of Egypt - Selected Issues, 2018.

[15] Annual estimated revenue losses due to declining corporate income tax (CIT) rates between 1980 and 2020. ESCWA, Survey of Economic and Social Developments in the Arab region, 2021-2022.

[16] The combined health expenditure of the Arab region amounted to $74 billion in 2017. However, Saudi Arabia alone accounted for nearly 40 per cent of this figure. As such, health expenditures in the region (excluding Saudi Arabia) amounted to $46 billion in 2017, based on figures from the Arab Monetary Fund.

[17] Organized Crime and Corruption Reporting Project (OCCRP), Cash-strapped Jordan targets premium tax evaders, 2020.

[18] Blominvest Bank, Tax evasion in Lebanon: how much of a burden?, 2017.

[19] Naoufel Darif, Evasion fiscal: le Maroc bien paré pour quitter la liste grise debut janvier, La Vie éco, 2020.

[20] African Manager, Tunisie: L'évasion fiscale esitimée a 1,5 milliard de dinar par an, selon un expert !, 2019.

OECD countries).[21] Estimates by ESCWA suggest that Arab countries with average effective tax rates lower than 15 per cent accrue on average half of their potential corporate income tax revenues from MNCs.

C. Phantom foreign direct investments

22. Not all FDIs hold positive spillovers and positive externalities. They can also function as a conduit for IFFs, including round tripping of capital, tax evasion, tax avoidance and money laundering. This is particularly evident when official statistics report a magnitude of investments that hardly reflect productive assets employed in recipient countries.

23. The Arab region is susceptible to FDI-related IFFs. These include round-tripping, which is the process in which capital is routed through a third country to gain tax benefits or regulatory advantages, and is recycled back to its country of origin as FDI to minimize tax liability and possibly exploit other incentives or exemptions awarded to MNCs' foreign income or earnings. Round-tripping undermines the ability to attract genuine and productive FDI and is often unassociated with job creation or technology transfer. Another FDI-related IFF is phantom investments, which are closely connected to tax evasion and tax avoidance. The presence of tax havens and financial hubs and the significant disparities in tax treatment among Arab countries also increase regional vulnerability to FDI-based IFFs.

24. Capital round-tripping erodes the tax base, distorts the investment climate, creates artificial investment "bubbles", and inflates investment figures. It may be associated with instability and vulnerability of the financial system, as sudden outflows can disrupt the economy and lead to financial crises and volatility in exchange rates and asset prices, and can undermine governance and transparency, ultimately impeding economic development.

25. Tax havens play a significant role in facilitating IFFs associated with FDI. These jurisdictions offer low or zero tax rates, financial secrecy, and lax regulatory frameworks, attracting MNCs and individuals seeking to evade taxes or hide their profits and wealth. The regulatory frameworks of tax havens enable the artificial shifting of profits, the establishment of shell companies, and the use of complex ownership structures that make it challenging to trace the origin of funds. These elements complicate the identification of true beneficial owners of assets held in tax havens, impeding efforts to effectively combat IFFs.

26. Empirical evidence shows how the concentration of holding and intra-group finance activities in favourable tax environments can lead to FDI positions that are entirely unrelated to the size of the local economy.[22] In other words, an increase in FDI to a country could reflect that real economic ties with partner countries are deepening, but could also imply that MNCs are adding more layers of corporate shells to their ownership chains to minimize their tax liability.

27. According to the International Monetary Fund (IMF), phantom FDI into empty shell companies with no real activities and no links to the local economy are growing steadily at an average annual rate of 1.25 per cent, and account for around 40 per cent of global FDI, 2 per cent of which is directed towards the Arab region and 26 per cent leaves Arab countries to be repatriated or concealed in tax havens,[23] hindering the genuine benefits that FDI can bring in terms of technology transfer, employment generation, and economic growth.

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[21] ESCWA calculations based on OECD statistics on forward looking effective tax rates available in 2020.

[22] Jannick Damgaard, Thomas Elkjaer, and Niels Johannesen, What is real and what is not in the global FDI network?, IMF Working Paper WP/17/274, 2019.

[23] Estimates on data from 2009 to 2017. Jannick Damgaard, Thomas Elkjaer, and Niels Johannesen, What is real and what is not in the global FDI network?, IMF Working Paper WP/17/274, 2019.

28. According to ESCWA empirical estimates of FDI-based IFFs:[24]

- Inward FDI flows along both intensive and extensive margins[25] are negatively correlated with the taxing rights of Arab countries over inward investment, in particular, tax treaty fields related to permanent establishment.[26] This suggests that a substantial portion of FDI into Arab countries is directed towards jurisdictions with lower bargaining power in terms of taxation, which inherently offer a favourable environment for capital to transit without necessarily implying a proportional tax liability (see section II.B).
- Outward FDI flows along intensive and extensive margins are positively correlated with the Corporate Tax Haven index[27] of destination countries. This suggests that capital leaving the Arab region is often directed to jurisdictions that offer a wide scope for tax and financial abuse and high secrecy, which points towards profit shifting, tax arbitrage, and corporate tax evasion/avoidance schemes of companies operating in Arab countries that try to minimize their tax liability.

Special Economic Zones: opportunities and challenges

Special economic zones (SEZs) play a significant role in shaping investment patterns in Arab countries. The Arab region has been witnessing a surge in SEZs and free trade zones during the past four decades, with estimates indicating that the region houses today more than 200 such zones.

Although the general motive behind SEZs is to induce growth in transformative FDI and to catalyse economic growth, industry deepening, diversification, and employment generation, SEZs and free trade zones in the Arab region exhibit unique differences in their rationale and typology. SEZs in Gulf Cooperation Council countries are established mainly to support structural diversification and reduce reliance on fossil fuel revenues. Meanwhile, free trade zones, such as the Jebel Ali Free Zone in the United Arab Emirates, have been key in generating income through transshipment and re-export activities. The recent announcement of Saudi Arabia to establish four new SEZs is not in isolation from these dynamics. Alternately, export processing zones, such as the qualifying industrial zones in Jordan and Egypt, have been established to exploit regional cumulation opportunities and benefit from trade preference when exporting qualifying industrial zone products to the United States of America and the European Union through the Agadir Agreement.

The favourable tax treatment and flexible regulatory frameworks maintained in SEZs are not enough to create economy-wide jobs, upgrade skills, promote industrial deepening, and increase the productivity of the local private sector. An important development in global FDI trends has been the rise of “efficiency seeking” investors who are looking for productivity incentives – in terms of a skilled workforce, efficient logistics, and supportive infrastructure – rather than fiscal benefits, to offset their long supply chain costs.

Nevertheless, the proliferation of SEZs in the region has in many cases outpaced regulatory oversight, causing them to become channels and facilitators of IFFs, and defeating their purpose to serve as catalysts of economic growth and sustainable development. As the Financial Action Task Force (FATF) underlines, SEZs and free trade zones can in fact be connected to a variety of circumstances and conduits related to IFFs, including smuggling, value-added tax carousel fraud schemes, tax evasion and avoidance, shell companies, and trade-based money laundering.

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[24] Valentina Gullo and Pierluigi Montalbano, Financial transparency and anomalous portfolio investment flows: A gravity analysis, Journal of International Money and Finance, Volume 128, 2022.

[25] FDI intensive margin (proxied by stocks) represents decisions on investments’ magnitude. FDI extensive margin (proxied by flows) refers to the decision of investing or not (location of investments). Data on FDI stocks are from IMF’s Coordinated Direct Investment Survey. Flows are calculated as the annual variation in stocks.

[26] Permanent establishment refers to the threshold above which a foreign company’s presence in a country becomes taxable. Data on tax treaties are from the International Centre for Tax and Development (https://www.treaties.tax/en/).

[27] Corporate Tax Haven Index by the Tax Justice Network (https://cthi.taxjustice.net/en/).

Favourable tax treatments offered to investors in SEZs may be seen as yet another strong indicator of tax competition at work in the Arab region, which functions as a multiplier for tax-based IFFs and phantom FDI. Balancing the opportunities arising from SEZs for economic development with the mitigation of IFFs is crucial for Arab countries. While SEZs offer opportunities for investment, job creation and industrialization, they also pose risks of money laundering, tax evasion and smuggling. By effectively managing these risks, Arab countries can ensure sustainable development, preserve financial integrity, attract foreign investment, and enhance their international reputation. This requires implementing comprehensive regulatory frameworks, robust anti-money laundering measures, and effective supervision, and embarking on capacity-building initiatives. By striking this balance, Arab countries can create an environment that fosters economic growth while preventing illicit financial activities and controlling the related negative externalities.

Source: UNCTAD, World Investment Report 2019, Chapter IV: Special Economic Zones.

III. Towards an Arab roadmap to root-out IFFs

29. Following the High-Level International Conference on Financing Sustainable Development, organized in Beirut on 28–29 November 2018, several elements forming the premise for a regional Arab roadmap to curb IFFs were advanced. These elements reflect a broad consensus reached among international and regional decision-makers, practitioners and experts participating in the conferences, and take their cue from a wide-range of commitments to combat IFFs advanced across a range of multilateral conventions and international normative frameworks, despite the fact that they might not always be free of gaps, overlaps and fragmentation. New efforts to implement existing commitments, strengthen international and regional norms to close existing gaps, respond to evolving risks, improve enforcement capacity, and enhance the use of national and intra-regional institutions are needed to ensure coherence and coordination in combatting IFFs.

30. At the national level, rooting out IFFs ultimately depends on a concerted whole-of-Government approach to adapt national policies and regulations with international instruments and fill the systemic gaps exposed by IFFs, especially in terms of enhancing measurement and transparency across all levels by setting up centralized and harmonized registries for beneficial ownership of all legal entities and arrangements; enforcing automatic exchange of information; and disseminating consistent, updated and disaggregated country-by-country reporting of all MNC profits. There is also a need to address the tax challenges arising from digitalization of the economy, which has been associated with significant tax abuse and public revenue losses for developing countries, including many in the Arab region.

31. In terms of measurement, knowledge on the precise scale and nature of IFFs is lacking because of their essentially clandestine nature. Comparable and reliable statistics on IFFs can help shed light on the activities, sectors and channels most prone to illicit finance, and identify priorities for enforcement resources. Any efforts to eliminate IFFs would hence require reliable granular estimates of their volume, nature and direction to expose complex IFF schemes and new enablers, and to establish the most appropriate means and instruments to combat them at the national level.

32. In terms of transparency, the proper collection, retention and sharing of beneficial ownership information is essential to fight trade and tax-based money laundering and other financial crimes. IFF perpetrators conceal their activities/identities using opaque legal structures. Shell companies, for example, have no real economic activities, and their transactions are spread across multiple jurisdictions. Beneficial ownership transparency can pierce the veil of secrecy and curb IFFs. Since March 2022, the Financial Action Task Force (FATF) amended its recommendation, requiring public authorities to hold information on beneficial ownership of legal persons (e.g., companies, firms, partnerships) through a registry.

33. Trade misinvoicing is a type of IFF which involves transactions being manipulated for the purposes of evading tariffs or circumventing capital account rules or financial regulations, among others. Cross-border information exchange is more complicated when it comes to trade and customs data because of agreements to

maintain commercial confidentiality. For this purpose, some countries have proposed a multilateral automatic exchange of transaction-level trade data. A new generation of regulations, standards and norms is needed to improve compliance and oversight in international trade. Additionally, the trade-related aspects of electronic commerce should be reworked to ensure a level playing field for domestic and foreign suppliers of digital products and services. Proposed tax reforms related to the digitalized economy, such as taxation based on economic rather than physical presence, are particularly relevant to the regulation of the multilateral trading system over trade of digital content.

34. Budget transparency, credibility and procurement procedures have been identified as means to enhance transparency and curb IFFs. Mutual legal assistance and exchange of information over suspicious financial transactions is an important route to trace IFFs. Tax administrations generally have the right to demand such information from their taxpayers. However, ownership and origin of taxable assets and income can be easily concealed and hidden in the absence of proper international legal assistance and exchange of information mechanisms. By the end of 2022, and according to the Common Reporting Standard (CRS), information on over 111 million financial accounts was exchanged automatically, covering total assets of almost 11 trillion euros. Despite these figures, many developing Arab economies are not fully benefiting from the automatic exchange of information system. As at the end of 2022, there were no least developed countries that received information from requested developed jurisdictions. Measures should be developed to automatically provide information on a non-reciprocal basis to developing countries.

35. Country-by-country reporting (CbCR) is another means to enhance transparency and denotes a mechanism for multinational enterprises to disclose key financial and operational information on a country-specific basis. This information is shared with tax authorities to facilitate risk assessment, identify potential tax base erosion and profit shifting, and ensure compliance with transfer pricing rules to promote fairness and reduce the opportunities for tax avoidance and aggressive tax planning. Although The OECD-hosted Multilateral Competent Authority Agreement on the Exchange of CbCR facilitates the exchange of CbC reports, developing countries lag behind in the access to this information. Only 12 non-OECD/G20 developing countries or jurisdictions (and no least developed countries) currently receive CbC reports. Arab tax authorities may institute requirements for multinational enterprises operating locally to file such reports with the local tax administration. This would give them access to useful information on MNC profits for enforcement purposes. Requiring public transparency on CbC reports from all multinational enterprises above a relatively low threshold would be a more comprehensive solution that would level the playing field and support the efforts of all countries to combat IFFs.

36. Governments across the region have implemented several tax reforms in the recent past. However, further qualitative reforms are needed to make fiscal, tax and trade systems in the region fairer and progressive, and to make administrative procedures simpler and more transparent for better compliance. Several actions need to be taken to redesign tax brackets, consider wealth and property taxes and rationalize tax exemptions towards improving equity and efficiency in taxation. Equally, the Arab region ought to re-assess how extractive industries are taxed and consider ways to effectively tax capital gains and reduce overlapping deductibles or tax arbitrage.

37. In parallel, there is a need to rejuvenate -at the regional level- approaches and structures that have been established to clamp down on cross-border tax evasion, and to require legislative and policy reforms following the review of tax and investment treaties to re-establish taxing rights and permanent establishment requirements and re-define digital presence. Arab countries may also wish to consider launching an inter-governmental process to revamp the Arab Anti-Corruption Convention and the cooperation agreement on collecting taxes and fees and curbing tax evasion, especially in light of the changing structure/digitization of supply and value chains in the region. It would also be beneficial to assess the implications arising from the OECD/G20 Inclusive Framework on existing dispute settlement structures in the Arab region, including the Arab Investment Court.

38. There is a need to quantify tax expenditures and assess their impact on development targets: Tax exemptions and holidays need to be consistently applicable, quantifiable and made conditional on achieving defined development targets with the possibility of replacing them by direct transfers, to the extent admissible by multilateral and preferential arrangements (in order not to trigger countervailing measures or distort competition). Their impact and spillovers should be monitored and periodically evaluated.

39. Improving tax and customs administration, simplifying coding and regulation, and investing in digital technology to improve transparency in tax collection and reporting data[28] would be helpful to enhance compliance and increase potential tax revenues.

40. Multiple plurilateral and unilateral instruments have prompted less than ideal outcomes in terms of combatting IFFs and have raised questions about inclusivity, scope and enforcement of measures, including the premise for black-listing tax jurisdictions. The fragmentation of the current global and regional set-up - with each instrument tackling in silos a particular aspect or conduit of IFFs – is not able to holistically address all conduits and enablers of IFFs. Such fragmentation provides fertile ground for IFFs to propagate and exploit the cracks between these instruments. A Universal Periodic Review (UPR) of Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) should be contemplated to link the United Nations Convention Against Corruption (UNCAC) peer reviews with FATF mutual evaluations, removing overlaps and capitalizing on synergies arising from these two currently distinct processes. In tandem, and as advanced by the United Nations Common Agenda, there is an urgent need to establish a joint structure, with membership centred around the United Nations, to strengthen international cooperation and overcome the fragmentation of current approaches to tackle IFFs.

41. It is equally important to match advancements in digital technologies with responsive and responsible regulation. Urgent action is needed in three domains that fall behind in terms of multilateral and regional action, namely (a) taxation, where multinational corporations shift significant amounts of profit away from jurisdictions where they were generated; (b) trade, where illegal markets and trade misinvoicing are rarely detected and challenged, especially as the Arab region forges ahead with deeper forms of integration through the Arab Customs Union; and (c) environmental crimes, that are inconsistently investigated and prosecuted.

42. Particular attention should be paid to how multinational entities shift profits and on how these schemes are enabled by different types of financial institutions and designated non-financial businesses and professions. There is also a need to gather information to support the advancement of a global legal framework and platform for asset recovery that goes beyond the proceeds of corruption and helps address the barriers to the effective execution of requests for mutual legal assistance.

43. It is also important to invest in the human and physical capabilities of Arab Financial Intelligence Units (FIUs) by providing them with adequate resources, technology and training to analyse and disseminate financial intelligence. Fostering collaboration between FIUs and law enforcement agencies is essential to facilitate the prompt investigation and prosecution of perpetrators and enablers of IFFs. Additionally, fostering institutional, regional and international cooperation is essential to track cross-border flows, identify illicit networks, and facilitate joint investigations and prosecutions.

44. Arab countries should leverage on the opportunities arising from the establishment of SEZs while mitigating the contingent IFF-related risks. It is important to strengthen regulatory oversight by implementing robust AML/CTF within free trade zones. This entails enforcing reporting requirements for suspicious

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[28] Examples of such ways to improve tax data collection by tax authorities through "electronic transaction reporting" include the use of an electronic file, the "Standard Audit File for Tax (SAF-T) format developed by the OECD Forum on Tax Administration", where tax data is filled and transferred to "tax authorities in a standardized electronic format" and the obligation of businesses to use "electronic cash registers" so that cash transactions between businesses can be monitored and recorded, with the possibility of recording transactions even in "(near) real time" as well. (OECD (2020), Consumption Tax Trends 2020: VAT/GST and Excise Rates, Trends and Policy Issues, 2020; Natasha Sarin and Lawrence H. Summers, Understanding the revenue potential of tax compliance investment, National Bureau of Economic Research Working Paper Series, 2020).

transactions and enhancing customs oversight to prevent trade-based IFFs. Improved due diligence procedures for businesses operating in SEZs, including the verification and record-keeping of beneficial owners' information, can contribute to preventing illicit activities, as well as promoting transparency and comprehensive reporting of financial transactions within SEZs. Conducting specific risk assessments for SEZs can help identify vulnerabilities and design targeted measures to address IFFs. Lastly, enhancing collaboration between the public and private sectors is crucial to facilitating the exchange of information, sharing best practices, and leveraging technological solutions to control and curb IFFs in SEZs.

45. Reformed financial, tax and trade systems are critical to responding to the realities of growing cross-border flows in an increasingly digitalized economy, while also addressing existing shortcomings in fair and effective taxation to combat tax and non-tax-based IFFs. However, the current OECD-led Global Anti-Base Erosion (GloBE) proposals to reform the global tax architecture stand in pale contrast to the Arab region's diverse needs. Arab countries may wish to consider advocating for:

(a) Lower thresholds to establish in-scope MNCs and open registries for beneficial ownership and country-by-country reporting of MNC profits;

(b) Lower country nexus for market jurisdictions;

(c) Lower profitability ratios to determine MNCs' routine profits;

(d) Higher reallocation percentage of residual profits, and the protection of established regional tax dispute mechanisms and of countries' "right to regulate" the delivery of automated digital services.