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# Implications of Illicit Financial Flows on Africa's Democratic Governance

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*Abstract-* Illicit Financial Flows (IFFs) are a major challenge to Africa's democratic governance. They have a direct impact on a country's stability to raise, retain and mobilise its own resources to finance sustainable economic development. GFI (2017) finds that IFFs remain persistently high. The study finds that over the period between 2005 and 2014, IFFs on average accounted for between 14.1 percent and 24.0 percent of the total developing country trade, while outflows were estimated at 4.6 percent to 7.2 percent of total trade and inflows were between 9.5 percent and 16.8 percent. The problem with IFFs is that they are not only illicit but that their effect spreads far beyond their immediate area of occurrence. Millions of people are affected, economies are weakened, and development is stagnated, while a shady few accumulate wealth and influence. Financial flows are crucial for poor countries and have played an important role in most African countries that have made developmental progress. Since not all financial flows are good for development, the integration of poor countries into the global financial system poses opportunities as well as risks. IFFs usually facilitate most of these risks and have an overall negative impact on African countries.

*Keywords: illicit financial flows; financial outflows; democratic governance; trade misinvoicing.*

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# Implications of Illicit Financial Flows on Africa's Democratic Governance

Jeffrey Kurebwa

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## I. Introduction

The challenges of IFFs have been high on the international agenda for the last decade. There has been an increasing need to find workable solutions. IFFs have become one of the major challenges confronting the surge for structural transformation in Africa. They perpetuate Africa's economic dependence on other continents and also undermine the capacity of the African governments to articulate and implement a developmental state approach that prioritises capacity expanding, transformative and distributive economic and social development policies. Improving Africa's productive capacity requires increasing investment in infrastructure, promoting technology transfer and innovation for value addition, and boosting agricultural productivity, among other issues (UNECA and AUC, 2012). However, the quest for a developmental state in Africa has been significantly constrained by the financial structures of IFF. These structures undermine the potential for economic transformation in the continent through draining tax revenues and scarce foreign exchange resources, stifling growth and socio-economic development, and weakening governance. High and increasing IFFs from Africa impact on development through losses in tax revenue and the opportunity cost of savings and investment in various sectors of the African economy. These impacts are of particular policy significance due to the increasing importance of domestic resource mobilisation at a time when the role of official development assistance is declining (Kar, 2012).

The estimated volume of illicit flows has been staggering. It ranged between US$2 trillion and US$3.5 trillion in 2014. Illicit outflows from developing countries to the advanced world alone were estimated to be US$620 billion in 2014 in the most conservative calculation, while illicit inflows from the developed countries into the developing world totalled more than US$2.5 trillion. The total IFFs are estimated to have grown at an average annual rate of between 8.5 percent and 10.4 percent a year over the period 2005-2014. Outflows were estimated to have risen between 7.2 percent and 8.1 percent a year, while inflows rose at an even higher rate between 9.2 percent and 11.4 percent annually. By comparison, inflation in developed countries averaged only 1.4 percent a year over that ten-year period (GFI, 2017).

Over the last 50 years, Africa is estimated to have lost in excess of US$1 trillion in IFFs (Kar and Cartwright-Smith, 2010; Kar and Leblanc, 2013). This sum is roughly equivalent to all of the Official Development Assistance (ODA) received by Africa during the same timeframe. Currently Africa is estimated to be losing more than US$50 billion annually in IFFs. These estimates may however, fall short of reality because accurate data for all African countries does not exist given the nature and secrecy of such proceeds like bribery, trafficking, drugs, people and firearms. The amount lost annually by Africa through IFFs is therefore likely to exceed US$50 billion by a significant amount (Kar and Cartwright-Smith, 2010).

The massive flows of illicit capital in Africa represent diversions of resources from their most efficient social uses and have an adverse impact on domestic resource mobilisation and hamper sustainable economic growth. For example, in some countries illicit flows correspond to tax revenues lost (GFI, 2008). Such revenues will then not be available for use by

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governments in reducing inequality, eliminating poverty, and raising the quality of life for citizens. It is necessary to consider the source of illicit flows, and their role in any discussion of the sustainable economic development agenda. It is important to consider the volume of resources legally flowing into and out of developing countries and also the illicit flows associated with leakages of capital from the Balance of Payments (BOPs) and trade misinvoicing. Governments and international organisations must strengthen policy and increase cooperation to combat the scourge of IFFs (GFI, 2017).

IFFs are of great concern given the inadequate growth, high levels of poverty, resource needs and the changing global landscape of official development assistance. Although African countries have been growing at a rate of 5 percent annually since 2000, this rate is considered encouraging but inadequate. Poverty remains a serious concern in Africa in absolute and relative terms. The number of people living on less than US$1 a day in Africa is estimated to have increased from 290 million in 1990 to 414 million in 2010 (United Nations, 2013). This is because population growth outweighs the number of people rising out of poverty. Moreover, GDP per African was around US$2000 in 2013, which is around one-fifth of the level worldwide (IMF, 2014). Poverty in Africa is also multidimensional, in the sense of limited access to education, health care, housing, portable water and sanitation. The situation puts the loss of more than US$50 billion a year in IFFs in better perspective.

## II. Defining Illicit Financial Flows

There is no clear consensus on a single definition of IFFs, since the word illicit can be understood to mean both illegal and legal, but legally or morally contentious and otherwise not fully legitimate (Fontana and Hearson, 2012). There are many reasons why finance flows out of African countries illicitly, usually in contravention of national or international rules. There are a variety of definitions of IFFs in the literature. Epstein (2005) defines IFFs as "capital taken abroad in a hidden form, perhaps because it is illegal, or perhaps because it goes against social norms, or perhaps because it might be vulnerable to economic or political threat". Other scholars have also summarised IFFs as money illegally earned, transferred or used (Reuter, 2012; Barker, 2005 and Kar, 2011). These flows of money are in violation of laws of their countries of origin, or during their movement or use, and are therefore considered illicit. This study emphasises the issue of illegality of such outflows across countries. A legal act in one country does not nullify the intent and purpose of such outflows of hiding money even if it was legitimately earned. The term 'illicit' is also a fair description of activities that while not strictly illegal in all cases, go against established rules and norms, including avoiding legal obligations to pay tax (Cobham, 2014).

The term IFF underpins a different manifestation of the state-market relationship to that characterising the conventional work on capital flight. Khan and Blankenburg (2012) refer to IFFs as the portfolio choice. These follow standard mainstream neoclassical models of utility and profit maximisation while capital flight is explained as a portfolio diversification response by rational economic agents to higher foreign returns relative to domestic returns on assets. The emphasis on criminal, corrupt, and commercial activities of IFFs underlines a policy response that encourages a more active role for the State and that highlights the need for a better regulatory environment through enforcement of national and global standards of financial transparency and democratic accountability (Haken, 2011).

According to the OECD (2013), IFFs are cross-border capital transactions either concealing illegal activities or facilitating them. It argues that 'There are various definitions of illicit financial flows, but essentially they are generated by methods, practices and crimes aiming to transfer financial capital out of a country in contravention of national or international laws. In practice illicit financial flows range from something as simple as a private individual transfer into private accounts abroad without having paid taxes, to highly complex schemes involving criminal networks that set up multi-layered multi-jurisdictional structures to hide ownership." (OECD, 2013).

The World Bank appears to give a broader definition than the one suggested by the OECD. The organisation explains the phenomenon of illicit financial flows as financial flows that have a direct or indirect negative impact on (long-term) economic growth in the country of origin (depending on the particular national development situation). This definition underscores the outcome of a particular activity. The breach of the law is not required to classify a particular action as illicit. Instead, the activity is categorised as illicit if it hampers economic growth (Blankenburg and Khan, 2008).

GFI (2013) defined illicit financial outflows as 'all unrecorded private financial outflows involving capital that is illegally earned, transferred or utilised, generally used by residents to accumulate foreign assets in contravention of applicable capital controls and regulatory frameworks'. The basic assumption in this definition is that the transfers in question take place via unregistered channels because their background or purpose is illegal. Similar to the definition proposed by the OECD, the GFI requires that a particular activity is illegal. The OECD and the GFI both limit the definition of IFFs to illegal actions. Those financial flows that are against the spirit of law or are just not criminalised in a particular country but as such are perceived as unacceptable are not covered (OECD, 2013).



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The above definitions represent a major departure from the dominant notion of capital flight. Capital flight is understood as the movement of funds abroad in order to secure better returns, usually in response to an unfavourable business environment in the country of origin (Kant, 2002). Capital flight may be legal or illegal. However, IFFs present new conceptual conjecture that departs from capital flight both conceptually and in policy terms. The term IFFs reflects a more narrow definition that focuses unrecorded capital flows that derive from criminal, corrupt (bribery and theft by government officials) and commercial activities (Barker, 2005). The focus on hidden resources and their potential impact on development place the issue of capital flight firmly in the broader realm of international political economy which emphasises the role of governance at both origins as well as at the destinations. This stand in sharp contrast to the conventional models of capital flight, which tend to place the burden on developing countries rather than understanding the shared responsibility between developed and developing countries.

Income from illegal activities transferred across borders is considered as the first group of IFFs (Baker, 2005). The original sources of these IFFs can be both illegal (drug trafficking) and legal (legitimately generated funds can be transferred in an illicit way to another country for the purpose of reducing tax obligations in the country of origin). This group includes illegal activities such as money laundering, drug and human trafficking, smuggling, illegal trade with weapons, counterfeiting, corruption, bribery, customs fraud, or terrorist financing. These illegal activities may be practiced by individuals, corporations, governments or other entities. Cross-border financial flows associated with any of these illegal activities are considered IFFs (Ostfeld, 2013).

The GFI in its 2017 report established that IFFs from Africa are large and increasing. This finding is valid and is evident across the three main categories of IFFs: commercial, criminal, and corrupt activities. Empirical researches focusing mainly on the merchandise trade sector, found that IFFs from Africa had increased from about US$20 billion in 2001 to US$60 billion in 2010. The same conclusions were reached from a review of other related work undertaken by Global Financial Integrity (GFI), the African Development Bank (ADB), the United Nations Development Programme (UNDP) and several Civil Society Organisations (CSOs). Using a different methodology, GFI puts the trend growth of IFFs from Africa over 2002–2011 at 20.2 percent a year. Even those who question the methodologies used to estimate the outflows tend to agree that the problem of IFFs is serious and demands urgent action (GFI, 2017).

Existing work on IFFs has mainly examined discrepancies in recorded capital flows or discrepancies in recorded trade flows. In taking one of these approaches, researchers have worked on the basis of gross figures or netted out illicit inflows into Africa. The motives of the researchers determined which approach was taken. The researchers intent on showing the direct economic effects of IFFs preferred to use the net approach, while others preferred to work on gross outflows because other researchers argued that there is no such thing as 'net crime' (Kar and Freitas, 2012).

The occurrence of IFFs is first and foremost a governance problem, since good citizenship is the foundation of good government. In as much as IFFs are driven by the desire to hide wealth and to evade taxes, perpetrators clearly do not respect the obligations of citizenship. It is well established in the literature that there is greater government accountability when the bulk of public sector resources derive from taxpayers, who almost always demand to know how their tax monies are being used (Barker, 2005). It is also a governance problem in the sense of weak institutions and inadequate regulatory environments. IFFs accordingly contribute to undermining state capacity. To achieve their purposes, the people and corporations behind IFFs often compromise state officials and institutions. If left unchecked, these activities lead to entrenched impunity and the institutionalisation of corruption (Manton and Daniel, 2012).

Given the well-known dependence of several African countries on significant amounts of ODA, the loss of resources through IFFs can only serve to deepen reliance on donors. Such dependence is apparent not only in terms of funds to support the social sector and state institutions, but also in terms of development ideas. It is an established fact that despite assertions of ownership, development policy very often reflects the perspectives of creditors or donors. Thus, when strapped for resources, African countries can often find themselves at the receiving end of externally imposed ideas that might not really be in their own perceived interests (Kant, 2002).

Another governance dimension of IFFs relates to the unequal burden of citizenship imposed on other sectors of society, both in terms of tax fairness and 'free-riding'. When large companies, particularly Multi National Corporations (MNCs), engage in base erosion and profit-shifting activities, the bulk of the tax burden as a result falls on small and medium-scale enterprises and individual taxpayers (GFI, 2008). This runs counter to the idea of progressive taxation, in which those who earn more income contribute a larger percentage of tax revenues. Just as pernicious to governance is the 'free-riding' that results when entities evade or avoid taxes where they undertake substantial economic activities and yet benefit from the physical and social infrastructure, most of which is still provided by the public sector in Africa (GFI, 2013).



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The development consequences of IFFs are quite severe. When monies are illicitly transferred out of African countries, their economies do not benefit from the multiplier effects of the domestic use of such resources, whether for consumption or investment. Such lost opportunities impact negatively on growth and ultimately on job creation in Africa. Similarly, when profits are illicitly transferred out of African countries, reinvestment and the concomitant expansion by companies are not taking place in Africa (Kant, 2002).

Further, illicit financial outflows from Africa end in developed countries. Countries that are destinations for these outflows also have a role in preventing them and in helping Africa to repatriate illicit funds and prosecute perpetrators. Thus, even though these financial outflows present a problem to Africans, united global action is necessary to end them. Such united global action requires that agreement be reached on the steps to be taken to expedite the repatriation of the illicitly exported capital. This must include ensuring that the financial institutions that receive this capital do not benefit by being allowed to continue to house it during periods when it might be frozen, pending the completion of the agreed due processes prior to repatriation (Cobhan, 2012).

*a) The World Bank Residual and Trade Misinvoicing Models*

There are two main channels through which illicit capital, unrecorded in official statistics can leave a country. The Wold Bank Residual Model captures the first channel through which illicit capital leaves a country through its external accounts. The second type of illicit flows, generated through mispricing of trade transactions is captured by the Trade Misinvoicing model which uses International Monetary Fund (IMF) Direction of Trade Statistics (GFI, 2008). The World Bank Residual Model compares a country's source of funds with its recorded use of funds. The country's inflow of capital includes increases in net external indebtedness of the public sector and the net inflow of Foreign Direct Investment (FDI). The net external indebtedness is derived by calculating the change in the stock of external debt which was obtained from the World Bank's Global Development Finance database. Use of funds includes financing the current account deficit and additions to central bank reserves. Both these data series along with data on FDI were obtained from the IMF Balance of Payments database. According to the model, whenever a country's source of funds exceeds its recorded use of funds, the residual comprises illicit capital outflows. The trade misinvoicing model can also yield estimates that are negative, suggesting illicit inflows through export over invoicing and import under invoicing (GFI, 2008).

Estimates of IFFs can be based on the Gross Excluding Reversal (GER) method and the Traditional Net Method (TNM). In the TNM, gross capital outflows are reduced by gross capital inflows to derive a net position. The net positions are then added to the World Bank Residual Model estimates. In contrast under the GER method, only estimates of export under-invoicing and import over-invoicing are included in the illicit flows analysis, while inward illicit flows (export over-invoicing and import under-invoicing) are ignored. The rationale for the GER method is as follows:

i. The netting of illicit inflows from outflows is not realistic in countries with a history of governance issues, political instability, and lack of prudent economic policies. As structural characteristics that derive IFFs are unlikely to swing back and forth, the GER method limits inward illicit flows to clear cases where flight capital returns following genuine and sustained economic reform. Since legitimate traders do not often use the trade misinvoicing mechanism to bring money into the country, the GER method is preferred rather than the TNM.
ii. The traditional method equates all 'wrong signs as genuine reversals of illicit capital. This flies in the face of macro-economic reality. For instance, if substantial and sustained inflows of illicit capital (above recorded capital inflows) were in fact true then central bankers in developing countries should have been complaining of the impact on inflation as well as the tendency of such inflows to appreciate the real effective exchange rate. Instead inflation is mainly driven by well known factors affecting the monetary base while the domestic currencies of most developing countries have depreciated over time against most convertible currencies like the US dollar. Macro economic theory holds that in general a reversal of capital flight is only likely to occur when economic reforms and agents are convinced that the government has implemented lasting economic reforms and there are improvements in governance and or political stability.
iii. The netting of inflows from outflows implies that a country somehow gains from illicit inflows which therefore need to be set off against what the country loses through illicit outflows. Illicit inflows captured by these models are also unrecorded and hence the government cannot tax them or use them for productive purposes.

Trade misinvoicing has long been recognised as a major conduit for IFFs. By overpricing imports and under pricing exports on customs documents, residents can illegally transfer money abroad. To estimate trade misinvoicing, a developing country's exports to the world are compared to what the world reports as having imported from that country, after adjusting for insurance



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and freight. Additionally, a country's imports from the world are compared to what the world reports as having exported to that country. Discrepancies in partner country trade data, after adjusting for insurance and freight indicate misinvoicing. However, this method only captures illicit transfer of funds abroad through customs re-invoicing and the IMF Direction of Trade Statistics cannot capture mispricing that is conducted on the same customs invoice (Manton and Daniel, 2012).

## III. The Normative and Legal Arguments of IFFS

The normative and legal arguments have been advanced to define financial flows as illicit. The normative interpretation argues that financial flows are illicit because they hinder development and are regarded as illegitimate from the perspective of an existing consensus about the social good (Blankenburg and Khan, 2012). The legal argument focuses on IFFs as money that is 'earned, transferred or used' in contravention to a country's existing laws (Kar and Freitas, 2012).

Barker (2005) classified illicit money into three main forms, namely:

i. The proceeds of theft, bribery and other forms of corruption by government officials;
ii. The proceeds of criminal activities including drug trading, racketeering, counterfeiting, contraband, and terrorist financing; and
iii. The proceeds of tax evasion and laundered commercial transactions.

Barker (2005) estimates that laundered commercial money through multinational companies constitute the largest component of IFFs, followed by proceeds from criminal activities, and lastly corruption. However, the proceeds of components of IFFs are so intricately connected that makes it virtually impossible to disentangle them into concrete unified units. The cross border nature of IFFs highlights the critical need for a better crosscutting analysis of IFFs as a phenomenon.

The UNODC World Drug Report (2012) estimates that drug trafficking generates between 20-25 percent of all income derived from organised crime and approximately half of the income from transnational organised crime. The trend in illicit drug market seems to be stable and changes in flows can mainly be observed below the surface. This indicates that the illicit drug market is resilient and illicit drug suppliers and users are quick to adapt to preventative measures (UNODC, 2012). Tracking the flows of illicit funds generated by drug trafficking and organised crime and analysing the magnitude and the extent to which these funds are laundered through the world's financial systems remain daunting. A 2009 study by UNODC on 'Transnational Trafficking in West Africa' noted that much of the best information on contraband flows through the region comes from data sources outside the region.

UNODC (2011) estimated that about US$1.6 trillion (equivalent to about 2.7 percent of global GDP) was available for money laundering activities across the globe. The largest income for transnational organised crime seems to come from illicit drugs, accounting for a fifth of all crime proceeds. It is estimated that the illicit flow of goods, guns, people and natural resources is approximately US$650 billion. Illicit drug trafficking and counterfeiting are the two largest components of these criminal activities. The market for illicit drug trade is estimated to be worth US$320 billion (50 percent) while the market for counterfeiting comprises US$250 billion (39 percent) and other sources such a human trafficking and illicit oil trade comprise 5 percent and 2 percent of the total respectively (Haken, 2011).

## IV. Actors in Illicit Financial Flows

There are different actors in the policy sphere of IFFs. These actors have different stakes, with some of them implicated as perpetrators while others are actively engaged in combating IFFs (Haken, 2012). These actors have also different capacities with regard to responding to the policy and regulatory requirements of IFFs and have different levels of information at their disposal. It is important to understand the respective roles, motives and incentives of these different actors, as well as the complex interrelationships between them. These actors include governments within and outside Africa, the private sector, CSOs, criminal networks and global actors such as international financial institutions. The actors are looked at in detail below (Kar, 2010).

*a) African Governments*

African governments have a political interest in IFFs because these flows impact their national development aspirations and encroach on state structures. Governments therefore have law enforcement and regulatory agencies whose duties include preventing IFFs. Among these agencies are the police, financial intelligence units, and anticorruption agencies, customs, and revenue services whose purpose are thwarted or hindered by IFFs (Barker, 2005). Most African governments have a strong interest in stemming IFFs, including through obtaining the cooperation, compliance, and commitment of other actors. They seek to stop IFFs in order to maximise tax revenues, keep investible resources within their countries, prevent state capture and impede criminal and corruption activities. Most African governments lack specialised agencies to deal with IFFs. They also lack various capacities in law and finance to tackle IFFs effectively, with unbalanced institutional capabilities in some countries. For example several African countries



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have set up anticorruption agencies. Policy on IFFs is generally set by one more central government departments which may also play a coordinating role in the implementation of law (GFI, 2008).

*b) The Private Sector*

The private sector in Africa consists of large companies, small and medium-scale enterprises and the informal sector. The large companies are engaged in all economic sectors such as agriculture, mining, manufacturing and services. These include multinational corporations, international banks, international legal and accounting firms that operate in several African countries. In terms of the financial flows involved, it is the large companies that engage IFFs through abusive transfer pricing, trade misinvoicing, misinvoicing of services and intangibles and use of unequal contracts (Moore, 2012). They exploit the lack of information and capacity limitations of government agencies to engage in base erosion and profit shifting activities. Given their scale, IFFs will at some point pass through banks and the financial system. The international banks sometimes facilitate IFFs even when they know that the money is tainted, as became evident in several asset recovery cases. Even where banks have an obligation to file suspicious transactions reports, this requirement is often overlooked in some countries in transactions emanating from small, rural branches (Moore, 2012). In some cases banks sometimes knowingly establish infrastructure to facilitate IFFs moving to financial secrecy jurisdictions. As gatekeepers to the financial system, banks and other financial institutions are supposed to implement a wide range of measures to combat IFFs and are an essential source of information for the government.

*c) Civil Society Organisations (CSOs)*

CSOs have been actively fighting against IFFs. They have campaigned against IFFs from Africa and other parts of the world from the perspective of social justice and also because of their effects on development and governance. CSOs have used various means to draw attention to the negative consequences of IFFs, ranging from advocacy campaigns and naming and shaming perpetrators to undertaking research and proposing policy solutions. CSOs such as Action Aid International, Global Financial Integrity, Oxfam, Pan African Lawyers Union, Tax Justice Network and Transparency International have been actively fighting against IFFs. However, these CSOs face political pressure and need to be provided with the space and support that will enable them to continue their campaigns (Kar, 2011).

*d) Criminal Networks*

Criminal networks engage actively in laundering money from Africa, with the motive of hiding their activities, facilitating payments across their illegal supply chains and concealing the resulting illicit wealth. Criminal networks by their very nature minimise contact with law enforcement agencies, tax, customs, and regulatory authorities (OECD, 2016). These networks include maritime piracy, narcotics, arms, human trafficking, and sophisticated people who run the operations, and related financial transactions. Illicit financial transactions are used to finance, and sponsor terrorist organisations such Boko Haram of Nigeria. They also use part of their resources to capture state structures such as the police, tax and customs (Thoumi and Anzola, 2012).

## V. Factors Influencing the Generation of IFFs

There are a number of factors that influence the decision to send money out of the country for each of the sources. These factors include portfolio diversification, hiding assets from government, political stability and currency controls.

*a) Portfolio Diversification*

In most cases owners wish to reduce the riskiness of their portfolio by acquiring assets in other countries whose economic fortunes are only weakly correlated with those of their home country. Tax evaders seek to maximise return on investments. The failure of the State to provide a stable investment environment encourages exit of capital, legal or illegal. A stable investment environment is one that generates predictable exchange rates, interest rates, returns on investment, and tax rates which are all necessary for investor confidence. These factors are part of the general macro-economic management, and not specific policies directed at IFFs. If a country's macroeconomic condition deteriorates or if investment rules change in ways that reduce the attractiveness of the home country relative to others, IFFs will increase along with other outward capital flows (OECD, 2016).

*b) Hiding Assets from Government*

Funds held overseas are presumably more difficult for the domestic government to track and confiscate. There are more legal hurdles for the government to go through in establishing ownership of assets, and persuading a foreign country to return the illicit funds (Manton and Daniel, 2012; Chene, 2006). There are also other multiple factors that may affect the extent to which corrupt officials will seek to hide assets overseas, for example, transparency in the domestic country's financial system. It is easy to create domestic nominee bank accounts or shell corporations for real estate holdings. This will make foreign assets not attractive. Moreover, foreign assets can be harder to liquidate or access in an emergency compared to assets concealed at home. Opacity of the domestic



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system of financial regulation may reduce incentives for sending funds out of the country. More competent law enforcement will also increase the incentive to move money out of a country. A country in which law enforcement is weak poses little threat of seizure of illegally gained assets. In 2009 Switzerland returned US$93 million to Peru from the accounts of Vladimiro Montesinos, the *defacto* Chief of Intelligence and main Advisor to former Peruvian president Albert Fujimori. In 2004 the Philippines recovered US$683 million from the Swiss accounts of Ferdinand and Imelda Marcos, the former president and first lady of the Philippines. In both cases the money recovered would have been enough to fill at least 25 percent of the nation's poverty gaps in the same year (Kar, 2010).

*c) Political Stability*

In most African countries there have been successive predatory governments, kleptocratic regimes whose primary goal is the enrichment of senior government officials. Under such circumstances corrupt officials may seek to avoid confiscation of assets by a successor government. Political instability in the predatory state may mean that the next predator may seize all illegally generated assets from the previous predatory government (Moore, 2012).

*d) Currency Controls*

Restrictions on repatriation of corporate profits will increase the incentives for corporate profit shifting. The stricter the currency controls for individuals, the greater the incentive to violate them for purposes that might otherwise be regarded as legitimate (GFI, 2013). Such restrictions also make it difficult to move assets overseas legitimately and encourage illegal methods. Non African governments have a crucial role to play in stemming IFFs from the continent by ensuring that their jurisdictions are not used as conduits or destinations for IFFs. Some developed countries have taken a firm stance against some aspects of IFFs while others have put in place institutional mechanisms that encourage such flows and that can qualify them as financial secrecy jurisdictions. Apart from helping to establish a global norm against IFFs, non African governments have a key role to play in assisting African countries acquire the capacities to fight the scourge of IFFs (GFI, 2008).

## VI. The Case of the Panama Papers

In 2016, 11.5 million confidential documents were leaked from a private legal firm based in Panama. The documents contained information on assets held in offshore companies in more than 40 countries by wealthy individuals, including public officials. Although holding assets in a tax haven is not illegal *perse*, the prevailing sentiments expressed in newspaper articles and the reaction from the public mainly took the form of condemnation and criticism of a practice interpreted as powerful economic and political elites concealing taxable income from domestic fiscal authorities, with the assistance of the financial systems of many developed countries. After the leak of the documents, the top five European economies (France, Germany, Italy, Spain and United Kingdom) announced actions to improve information sharing in order to fight tax evasion and money laundering. Of these economies, United Kingdom plays a particularly important role in this respect because a number of its Overseas Territories and Crown Dependencies such as the British Virgin Islands and Jersey derive a substantial share of the GDP from providing financial non-resident depositor services. Recently all such offshore jurisdictions have joined this initiative and started to implement rising transparency standards. Panama has also recently taken steps to strengthen its tax transparency and financial integrity frameworks. Fundamental reforms that seemed imaginary just 10 years ago are now being considered as active proposals by powerful bodies such as the G-7 and G-20. These proposals include country by country reporting of corporate profits which facilitate detection of transfer pricing abuse and other instruments to shift profits to low tax jurisdictions and the creation of public lists of beneficial ownership to prevent concealment through shell corporations (OECD, 2016).

## VII. Africa's Financial Illicit Flows

Existing research shows that African countries have experienced massive outflows of illicit capital mainly to Western financial institutions. The continent has turned into a net creditor to the rest of the world (Ndikumana and Boyce, 2003; 2008). Other researchers such as Collier, Hoeffler and Pattilo (2001) indicate that many African investors seem to prefer foreign over domestic assets to the extent that the continent now has the highest share of private external assets among developing countries with serious ramifications for self-sustaining economic growth which allow countries to graduate from aid dependence.

A 2008 estimate by GFI and the ADB on illicit outflows suggest that Africa lost US$1, 2-3 trillion on an inflation adjusted basis over the period 1980-2009. GFI also estimated that South Africa lost more than US$100,7 billion during the period 2002-2011. South Africa is ranked number 13 in terms of illicit outflows among developing countries. At continental level, illicit financial outflows continue to deny Africa much needed capital for its economic and social development. Estimates presented by GFI (2008) indicated that Africa lost an astonishing US$854 billion in cumulative capital flight over a period of 38 years from 1970 to 2008. This amount was enough to repay the continent's debt of around US$250 billion and potentially leave US$600 billion for poverty alleviation and economic growth.



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Instead, cumulative illicit flows from the continent increased from about US$57 billion during the period 1970 to 1980 to over US$437 billion during the period 2000-2008 (Global Financial Integrity, 2008).

*Table 1:* Africa's Illicit Financial Flows from 1970-2008

| Group | 1970s | 1980s | 1990s | 2000-2008 | 1970-2008 |
|---|---|---|---|---|---|
| Africa | 57,291 | 203,859 | 155,740 | 437,171 | 854,061 |
| North Africa | 19,161 | 72,020 | 59,813 | 78,742 | 229,737 |
| Sub-Saharan | 38,130 | 131,839 | 95,927 | 358,429 | 624,324 |
| Horn of Africa | 2,354 | 14,131 | 5,108 | 15,603 | 37,197 |
| Great Lakes | 6,925 | 16,079 | 4,978 | 10,285 | 38,267 |
| Southern | 5,894 | 20,581 | 31,447 | 116,826 | 174,751 |
| Western and Central | 22,956 | 81,047 | 54,394 | 215,712 | 374,109 |
| Fuel Exporters | 20,105 | 67,685 | 48,157 | 218,970 | 354,9155 |
| Non-fuel exporters | 7,867 | 26,517 | 22,375 | 23,342 | 80,102 |

*Source: Global Financial Integrity (2008)*

While the overwhelming bulk of the above losses in capital through illicit channels over the period 1970-2008 were from Sub-Saharan African countries, there are significant disparities in the regional pattern of illicit flows. For example, capital flight from Western and Central Africa, by far the dominant driver of illicit flows from the Sub-Saharan Africa region, is mainly driven by Nigeria which is also included in the economic group 'fuel exporters'. In fact, the proportion of illicit flows from West and Central African countries that are poor reporters of data and thereby underestimate their contributions to illicit flows. For example flows from the Horn of Africa are likely to be understated particularly in the earlier decades due to incomplete balance of payments and bilateral trade data from Eritrea, Somalia, and Sudan, which have been historically unstable, and prone to conflict. By the same token, civil strife for some periods in the Democratic Republic of Congo, Rwanda, and Uganda are reflected in incomplete and poor quality data which likely underestimate the volume of illicit transactions from the Great Lakes region. Hence, the long-term evolution of illicit flows from the different regions of Africa need to be interpreted with caution in light of such data deficiencies (OECD, 2016).

Some data on IFFs from developing countries are also provided by Non-Governmental Organisations (NGOs). The most prominent come from the GFI. In its 2017 report from 2014, the GFI estimated that, between 2003 and 2012, developing countries lost about US$6.6 trillion in illicit financial outflows. In the analysed period, these flows were estimated to increase at 9.4 per cent per annum. Although a brief slowdown was recorded during the financial crisis, in 2010, the recorded trend was again growing and, in 2012, the illicit outflows were estimated to be US$991.2 billion. In reference to Sub-Saharan countries, about US$68.6 billion out flew just in 2012. It is noteworthy that countries from this region received $39.9 billion in official development aid. These numbers prove that IFFs exceed even the help received from developed countries. According to data provided by the GFI, the largest scale of these illicit outflow activities are from Asia estimated at the level of $473, 9 billion, followed by the Western Hemisphere and thirdly by Europe (GFI, 2016).

*a) The Zimbabwean Experience*

According to AFRODAD (2016), Zimbabwe is estimated to have lost US$2.83 billion through IFFs during the period 2009-2013. This translates to an annual average loss of US$570.75 million. These IFFs were mainly from mining, timber, fisheries and wildlife. Of the cumulative outflows 97.88 percent (US$2.793 billion) was from the mining sector. IFFs in wildlife accounted for 0.53 percent (US$15.07 million) while fisheries and timber accounted for 0.98 percent (US$28.04 million) and 0.61 percent (US$17.30 million) respectively. These estimates are based on the analysis of data sets for partner-country trade from the United Nations Commodity Trade Statistics Data base (UNCOMTRADE) and Convention on International Trade in Endangered Species (CITES).

In Zimbabwe IFFs are mainly underpinned by a number of factors such as legal and institutional lapse in the domestic fiscal and financial systems, leading to corruption and other forms of trade malpractices. Other key drivers of IFFs in the wildlife and fisheries sectors include demand and supply mismatches resulting from price controls, tax and exchange control loopholes. In the mining sector IFFs are mainly a result of corruption, dysfunctional regulations, weak enforcement of rules, tax evasion, and tax avoidance, and smuggling, lack of transparency and accountability in the collection and management of natural resources revenue. The government's limited information on the quantity and quality of geological deposits and shortcomings of the Mines and Minerals Act [Chapter 21:05] create room for rent seeking behaviour and under declarations of quantity and quality of minerals. Such a scenario aids the illicit outflows of money from the county.

*b) The Chinese Experience*

Wang (2008) provides an interesting assessment of illicit outflows from China through commercial activities. He suggests strong links between trade misinvoicing, transfer pricing, tax dodging and reducing interest rate costs. In the case of China, firms sell their goods at inflated prices to subsidiaries located in tax havens as a means to inflate production costs,



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thereby minimising profits and ultimately their taxes. Wang (2008) further notes that given the deductibility of interest rate costs from their taxable incomes, firms can over-borrow at low costs and subsequently transfer assets overseas to meet 'debt service obligations'. What this effectively suggests is that firms utilise a variety of instruments comprising parallel loans, currency swaps, and quasi-money loans between subsidiaries and their joint venture partners to maximise their profits. Despite the compelling high levels of illicit flows from China, where it lost 10.2 percent of GDP or US$ 109 billion in 1999 alone, it has maintained strong capital formation. Murphy (2007) suggests that this is due to the fact that China offers investors lower tax rates, favourable land use rights, convenient administrative support, and financial services, which collectively act as incentives for re-investment. Accordingly it is estimated that US$25 billion of China's US$ 100 billion of its illicit outflows return each year in the form of 'round tripping FDI'.

## VIII. International Instruments on the Governance of Illicit Financial Flows

There are various international instruments and agreements that aim to curtail the various forms of IFFs. These include: (i) United Nations Convention against Transnational Organised Crime; (ii) United Nations Convention against Corruption; (iii) United Nations Model Taxation Convention between Developed and Developing Countries; (iv) Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries; (v) Addis Ababa Action Agenda and the (vi) Stolen Asset Recovery Initiative.

The 2030 Agenda for Sustainable Development and the Sustainable Development Goals (SDGs) call on countries to significantly reduce illicit financial and arms flows by 2030 (SDG target 16.4); to substantially reduce corruption and bribery in all their forms (16.5); to develop effective, accountable and transparent institutions (16.6); to strengthen domestic resource mobilisation, including through international support to developing countries (17.1); and to enhance global macro-economic stability (17.13). The 2030 Agenda also calls on countries to enhance policy coherence for sustainable development (17.14); and to respect each countries policy space and leadership to establish and implement policies for poverty eradication and sustainable development (17.15).

There are also some initiatives by OECD which prepared a model bilateral agreement that requires transparency and exchange of tax information between the signing countries. There are also agreements between the EU and tax haven jurisdictions with regard to exchange of information on suspicious money transfers.

## IX. Conclusions

It is arguably clear that the social and economic impact of IFFs is particularly severe for African countries. The transfer of proceeds from corruption, tax evasion, and other crimes drain resources from economies and thereby stifle development and enhancement of infrastructure. Illicit outflows strip resources that could be used to finance much-needed public services. The reduction in domestic expenditure and investment affects the everyday lives of people since it means fewer hospitals, schools, and other essential facilities. While IFFs occur in many countries around the world, their social and economic impact on Africa is far more severe given its smaller financial resources base and markets. IFFs impact adversely on both public and private domestic expenditure and investment. This implies fewer hospitals and schools, less roads and bridges and fewer power plants. Many of the activities which generate illicit funds are criminal. IFFs out of Africa are becoming of growing concern given the scale and negative impact of such flows on Africa's governance and development agenda.

When commenting on the scale of IFFs, it has to be underlined that proceeds of these activities are difficult to measure. Estimates vary greatly and are heavily debated. This is due to the secret nature of illicit finances. Nevertheless, it is worth analysing data provided by different bodies to help in understanding why this phenomenon deserves in-depth research and widespread recognition as they clearly indicate that IFFs are a global issue.

Good governance offers the solution to most drivers and enablers of illicit financial flows. It contributes significantly to combating IFFs at all levels. Good governance is at the centre of the effective, efficient, and transparent mobilisation and use of resources. To ensure the shift towards good governance and, in the aftermath, to sustainable economic development and poverty eradication, appropriate steps have to be undertaken. It requires strengthening national and international policy environments and regulatory frameworks and their coherence, harnessing the potential of science, technology and innovation, closing technology gaps, and scaling up capacity-building at all levels. A potential disabler of development efforts are IFFs that thrive on weak institutions, lack of cooperation between main stakeholders, and secrecy in legal framework.

The capacity to contain IFFs in Africa is limited and further complicated by the need to significantly improve cooperation between existing institutions. The effective fight against IFFs demands participation of different sets of actors. Among them, tax authorities, customs administrations, the police, financial intelligence units, and anti-corruption agencies play the



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most significant role. However, in many African countries, there is a lack of cooperation between these institutions. Responsibilities are duplicated and information is very limited. As Grace Perez-Navarro, deputy director at the Organisation for Economic and Social Development (OECD) said, "Tax administrations are trapped by their national borders, and they need some way to overcome that." (Chrispin, 2015).

Illicit financial outflows from developing countries not only have damaging economic impact but also have a subversive effect on governance, level of crime, and tax revenues. Legal tools, even the best tailored, might not be effective if they are not understood and not applied in a consistent and effective manner (Cobham, 2014). Raising awareness of risks related to IFFs is of highest importance. The very first step should be to educate society on how such flows have pernicious effects on society, businesses, and governments. Corruption, money laundering, and other types of IFFs undermine the foundation of existing political, legal, and institutional systems. They have a spill over effect on all areas of social life. Their wider implication on political and civil society contributes to creation of a so-called vicious circle of IFFs (Moore, 2012).

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