Tackling Illicit Capital Flows for Economic Transformation

1. Introduction/Context

1. In finance literature, illicit finance is generally described as a form of illegal and is often associated with money that is illegally earned, transferred, or utilized. The movement of such types of money is made with clear intention to make it disappear from any record in the country of origin. Illicit financial flows can be generated through a number of means that are not revealed in national accounts or figures, including trade mis-pricing, bulk cash movements, hawala1 transactions, smuggling and more. By some expert's estimate, illicit flows from Africa each year could be as much as double what ODA allocate to Africa and this estimate may well be short of reality as accurate data does not exist for many African countries. Illicit financial outflows drain hard currency reserves, heighten inflation, reduce tax collection, cancel investment, undermine trade, worsen poverty, and widen income gaps. Most illicit financial flows today are facilitated by some 60 international tax havens, secrecy jurisdictions creating and operating disguised corporations, shell companies numbering in the millions, anonymous trust accounts, fake charitable foundations, money laundering techniques and trade mis-pricing.

2. The origin of illicit financial flows in Africa dates back to around the 1960s. There were two separate but inter-related factors that contributed to the beginning and later to the fast growth of this phenomenon. First, the elite class of the newly decolonized countries felt uncertain about political stability and the duration of their reign on power. Therefore, they increasingly looked for financial institutions in the West that can provide them with a secure place to stash away their newly found fortune. And secondly, during the 1960s a significant number of large corporations grew to become multinationals, which meant establishing operations in hundreds of locations in different parts of the world. As a result, "Tax planning"—devising creative ways to reduce or avoid corporate taxes—became a normal practice. Thus, decolonization and the growing international reach of corporations propelled the development of a whole system of offshore finance that was designed to avoid taxes and regulation. In the process, the system also obscures the origin and destination of the increasingly large sums of money passing through it[2].

3. A recent ground breaking study by Global Financial Integrity (GFI) entitled 'Illicit Financial Flows from Africa: Hidden Resource for Development' made the following conclusions:

- Total illicit financial outflows from Africa, conservatively estimated, were approximately $854 billion during the period 1970 to 2008;
- Total illicit outflows from Africa may be as high as $1.8 trillion;
- Sub-Saharan African countries experienced the bulk of illicit financial outflows with the West and Central African region posting the largest outflow numbers;
- The top five countries with the highest outflow measured were: Nigeria ($89.5 billion) Egypt ($70.5 billion), Algeria ($25.7 billion), Morocco ($25 billion), and South Africa ($24.9 billion);
- Illicit financial outflows from the entire region outpaced official development assistance going into the region at a ratio of at least 2 to 1;
- Illicit financial outflows from Africa grew at an average rate of 11.9 percent per year.

4. Curtailing illicit financial outflows from Africa can produce the largest source of new funds for poverty alleviation and economic growth in the near future. The key to achieving success is adopting laws, regulations and policies that encourage transparent financial transactions. African countries must also impress upon the G-20 the need for better transparency and tighter oversight of international banks and offshore financial centers that absorb these flows.

2. Scope of the problem of illicit financial flow from Africa

There are only handful studies that have made proper evaluation of the extent of illicit transfers 5. from Africa. Contributing factors for this are the unavailability of data combined with lack of transparency on the part of institution involved in these transactions. Of the few available reports is the recent study carried out by Global Financial Integrity (GFI) where it was revealed that in over 39 year period Africa lost a staggering US 854 billion in cumulative capital flight. The report also pointed out that even though the overwhelming bulk of this loss in capital through illicit means was from Sub-Saharan African countries, there are significant regional differences with Western African countries particularly those endowed with natural resources representing the highest amount of illicit transfers.

5. Africa spiked from 2000-2008 relative to the earlier decades. This was driven mostly by increased average outflows from the West and Central-Africa and Southern regions. A large part of this sharp increase in illicit flows seems to have been financed by rising income levels fueled by global price increase of commodities.

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7. Another study with almost similar conclusions was carried out by 7. Ndikumana where he noted that the total real capital flight 1970-2004 amounted to $444 billion. This is equivalent to 104% of Africa's exports (2007 value) and 124% of Africa's imports (2007 value). The study further found that the annual capital flight amounts to $49billion/year averaging over 2000-2008 which would fill 54% of Africa's infrastructure financing gap

8. There are several economic models used to provide estimates of illicit financial flows and capital flight. The most widely used models is the , it subtracts the total of funds actually used by a country from the total of funds entering that country. The in flow of funds is defined as any increase in foreign debt plus incoming foreign direct investment (FDI) .Funds used are those necessary to finance the deficit in the current account(one of the components of the Balance of Payments(BOP)) and to add to the country's official reserves. If there are more funds coming in than funds being used, the resulting short fall is considered to be illicit flows (Kar and Cartwright-Smith 2008, NOU 2009).***Illicit flows (World Bank Residual) = (increase in foreign debt + increase in FDI) – (financing of the current account deficit + additions to the country's reserves)***

3. **Capital flight and illicit financial outflows**

9. Capital flight is among the major contributor for the erosion of the tax base in Africa. Though accurate estimation is difficult to obtain, various studies do indicate that African countries have lost significant amount of resources to capital flight. According to UNCTAD (2009) estimates that Africa's cumulated stock of capital flight for the period 1970–2004 was $607 billion, which is almost as much as three times the region's external debt. While the severity of the problem varies from country to country, the report notes "in Sierra Leone, accumulated capital flight was worth 425 per cent of the country's GDP in 2004. The comparable figures were 344 per cent in both the Congo and Zimbabwe and 312 per cent in Burundi. However, in Benin, Niger, Senegal and Togo, capital flight is negative, implying that these countries experienced higher capital inflows than outflows" (UNCTAD: 2009 P. 13).
10. vironment and capital flight, a recent ECA report, for instance, summarized these relationships in an effort to identify the root causes of capital flight (ECA:2008) :

- Weak financial management and enforcement systems, which make it possible to repatriate resources through theft and tax evasion.
- Political instability, which makes the holding of domestic assets risky and therefore leads to a search for a safer home for these assets.
- Search for better returns on investment outside the country
- Financial liberalization which has made it easier to externalize financial resources
- Limited financial instruments in the domestic market which limit the available investment opportunities in the local market.
- Macroeconomic instability manifested in the form of high inflation, exchange rate volatility and the high cost of borrowing.
- Heavy and capricious taxing of investments and deposits, which make the option of investing in markets where such taxes do not exist attractive.

11. The report published by **Global Financial Integrity** also presented a detail analysis of the origin and impact of illicit financial flows in Africa. The report disproved the generally held notion that most of the illegal money transfers are carried out by corrupt public officials, according to the above cited publication, however, money stolen by corrupt government officials amounts to just 3 percent. Organized crime accounts for about a third of illicit money flows. The most common way illicit money is moved across borders— accounting for some 60 to 65 percent of all illicit flows—is through international trade. Falsified pricing and other money-laundering techniques have been facilitated by the rapid growth of tax havens and secrecy jurisdictions that have sprung all over the globe.

4. Some recent developments on combating illicit financial flows

A panel discussion was organized by UNECA in collaboration with the Task Force on Financial
12. Integrity and Economic Development. The task force, which is currently chaired by the government of Norway, is composed of civil society, governments and international organizations. Its main aim is to curtail illicit financial outflows form Africa and re-direct the resources towards the efforts to alleviate poverty and bring about development.

13. The outcomes of the subsequent meetings was to establish a **High Level Panel** to be hosted by the ECA that would be responsible for the coordination of efforts to combat illicit financial transfers. In this regard, the participants made the following recommendations:

- The Panel needs to be pitched at high level and has to have muscle;
- Need for extensive and elaborate consultations, including civil society;
- Need to develop a clear communication strategy with the media; and
- The Panel functions need to be bound by time

14. The primary role of the Panel will be to complement and support the work on illicit financial flows currently undertaken by other African and non-African institutions particularly in areas of: commercial tax evasion; criminal activities; and corruption. Specifically, the Panel in partnership with ECA's external partners will promote national and multilateral policies (safeguards and agreements) aimed at curtailing cross-border flow of illegal money. In addition, it will put forward solutions, facilitate strategic partnerships and commission research on various aspects of the subject. The Panel will make its findings public through electronic and print publications. The general aims of the Panel are:

- to determine the nature and patterns of illicit financial outflows;
- to determine the level of illicit financial outflows from Africa;
- to asses the complex and long-term implications of illicit financial flows on development: and
- Sensitize African governments, citizens and international development partners on the • scale, and effect of financial outflows on development and also mobilize political will in support of putting in place rules and regulations which are necessary to combat illicit financial outflows.

15. The long-term aim of the **High Level Board** is to address factors underlying illicit outflows and also impress upon the G-20 of the need for better transparency and tighter oversight of international banks and offshore financial centers that absorb these flows. Furthermore, the commission seeks to mobilize political will amongst African governments, regional and international organizations, civil society, business and other stakeholders in support of adopting the necessary policies to curtail illicit financial outflows.

5. Issues for discussion

- The relevance of reaching agreement on a global methodology for evaluating the amounts • involved in ILLICIT FINANCIAL FLOWS FROM Africa. What are the key steps? How should Africa engage?

- Articulate the necessary steps that need to be taken by countries to eliminate illicit financial • flows. To what extent, countries actions can be efficient?

- Work toward harmonization of laws and regulations in different countries. How can re• gional integration help?

http://www.thabombekifoundation.org.za/Pages/Tackling-Illicit-Capital-Flows-for-Economic-Transformation.aspx