

# Tackling Illicit Financial Flows From and Within Africa

Following the 2015 report of the High Level Panel on Illicit Financial Flows from Africa, chaired by the former South African President Thabo Mbeki, there has been much greater awareness across Africa of the magnitude of illicit financial flows and their implications.<sup>1</sup> Now, more than ever, policymakers at the national, regional and global levels must address the core issues surrounding illicit financial flows, which reduce Africa's ability to finance its development: unfavourable natural-resource governance models, tax avoidance and tax havens, as well as weak national financial institutions. The upcoming Third International Conference on Financing for Development, to take place in Addis Ababa from 13 to 16 July 2015, is an important opportunity to address illicit financial flows, their drivers and the resulting governance challenges.

## Illicit Financial Flows in Africa: The Numbers

The global economic crisis revealed the risks for African economies of depending too much on debt financing, official development assistance and foreign direct investment. While the crisis shifted attention towards the need for greater domestic resource mobilisation, Sub-Saharan African countries still mobilise less than 17 percent of their gross domestic product in tax revenues<sup>2</sup> due to illicit financial flows – money that is illegally earned, illegally transferred or illegally utilized<sup>3</sup> – and limited capacity for collecting revenues from multinational companies, particularly those engaged in natural-resource extraction.<sup>4</sup> These financial leakages have amounted to roughly US\$528.9 billion over the decade ending in 2012, compared to US\$348.2 billion in official development assistance and US\$284 billion in net inward foreign direct investment. These illicit resource outflows reduce the total development resource base, and governments are forced to plug the gap with higher taxes that disproportionately fall on the poorest in society, as well as austerity measures that constrain the provision of public goods and services.<sup>5</sup> Beyond this, the illegality of illicit financial flows is damaging to the state, as these flows are aided by bribery and theft, which ultimately undermine governance institutions.<sup>6</sup>

## Illicit Financial Flows as a Governance Challenge in Africa

Illicit financial flows and their negative impacts on development are rooted in four central issues that many African governments currently face: (1) poor resource governance models; (2) weak tax administration coupled with multinational tax-avoidance schemes; (3) tax havens, which are beyond the influence of African governments; and (4) the lack of resources for addressing financial crimes and money laundering.

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## **Poor resource governance models**

A joint report by the African Development Bank and Global Financial Integrity confirmed that the natural resource sector is usually the main source of illicit financial flows in African countries due to a lack of good governance structures that would enable citizens to monitor the amount and use of revenues.<sup>7</sup> Moreover, there is often an information asymmetry between African governments and investors in the mining sector, which results in tax avoidance through the underreporting of the quantity, quality and composition of minerals.<sup>8</sup> This is compounded by the inability of these African governments to effectively negotiate contracts with mining companies or their affiliates, which often results in transfer mispricing.

## **Weak tax administrations coupled with multinational tax-avoidance schemes**

The engagement of multinational corporations in transfer pricing and other cross-border, intra-group transactions, the negotiation of tax holidays and incentives, as well as the use of offshore investment accounts constitute about 60 percent of illicit financial flows globally. Such aggressive transfer pricing – which involves the inflation of profits in low-tax jurisdictions and lower profits in high-tax jurisdictions – is a problem affecting developed and developing countries alike.<sup>9</sup> Despite efforts to implement the “arms length principle”<sup>10</sup> in regulating trade between related parties and affiliates, African governments are often short-changed due to the inability to monitor multinational corporations effectively. It is also often impossible for African governments to monitor or review transaction costs declared by multinational corporations – for example, with respect to intellectual property rights – which forces the governments to accept the numbers reported by corporations without verification.

As the tax practices of multinational enterprises and wealthy individuals were being increasingly questioned and scrutinized, G20 leaders and finance ministers at the G20 summit in St. Petersburg in September 2013 endorsed the Base Erosion and Profit Shifting (BEPS) Action Plan. The Action plan is an attempt to curb efforts by multinational enterprises (MNEs) that seek to reduce their taxable income base (“base erosion”) or move profits away from economically relevant but high-tax jurisdictions to economically irrelevant but low-tax jurisdictions (“profit shifting”) in 2013.<sup>11</sup>

## **Tax havens beyond the influence of African governments**

Tax havens are major culprits in facilitating the illicit movement of resources out of developing countries and out of Africa in particular, as they create incentives for corporations to shift their profits. Apart from offering low to no taxes at all, tax havens offer very strong banking secrecy to both companies and individuals, making it extremely difficult, and in most instances impossible, for foreign authorities to obtain information about the account holders and the source of money.<sup>12</sup> As such, the opacity of tax havens prevents developing countries from obtaining the information needed to collect full taxes owed to them by individuals and multinational corporations. As a consequence of this profit shifting, African countries are experiencing an erosion of their tax bases.

Dealing with the trans-boundary flow of resources requires cooperation between source countries and tax havens, particularly on the automatic exchange of information for tax purposes. However, most tax havens are reluctant to share such information. The Swiss government, for instance, has adhered to the “upon request” system, wherein governments must send specific case-by-case requests to access information on potentially illicit tax practices. The major weakness of this approach is that members of African governments may have personal interests in refraining from

requesting such information.<sup>13</sup> Moreover, in cases where double taxation treaties exist, there is often no provision for the automatic exchange of tax information, and national tax authorities may not even have the capacity to follow up on the many tax-avoidance schemes that exist. By entering double-taxation agreements with tax havens, most African governments have renounced their right to charge withholding taxes on financial resources channeled out of their countries. Finally, the need to attract foreign direct investments from these very same countries acting as tax havens, together with a lack of political will to cancel the double-taxation agreements, has stalled progress in plugging these financial leakages from Africa.

## **Lack of resources for addressing financial crimes and money laundering**

Despite current efforts to combat money laundering, criminal activities ranging from trafficking of people, drugs and arms, to fraud in the financial sector – such as unauthorized or unsecured loans, money laundering, stock-market manipulation and outright forgery – constitute about 35 percent of illicit financial flows from the continent.<sup>14</sup> This is mainly attributed to a lack of political will and to capacity constraints on addressing the problem, despite the fact that other countries have established financial intelligence units to deal with money laundering and proceeds of financial crime. Despite high-level political commitments to work with the intergovernmental Financial Action Task Force to address money laundering, the majority of African countries have not made sufficient progress in implementing some of the action plans within the established timelines. Algeria, for instance, has fallen short in terms of adequately criminalising terrorist financing; establishing and implementing an adequate legal framework for identifying, tracing and freezing terrorist assets; and adopting customer due-diligence obligations in compliance with the Financial Action Task Force standards.<sup>15</sup>

## **Conclusion and Recommendations**

African governments must lead the fight against illicit financial flows. The adoption of the High Level Panel on Illicit Financial Flows report by African leaders is a positive step towards regional cooperation in the fight against tax evasion and avoidance, which constitute the bulk of illicit financial flows. But until African governments approach illicit financial flows from a global perspective, national and regional initiatives and processes will not yield the best outcomes. As such, reshaping the global financial architecture is necessary to reverse the problem of illicit financial flows and to subsequently mobilise the necessary domestic resources for development financing. The following recommendations point to key issues that require urgent attention:

- At the national level, African countries should strengthen the capacity of their financial institutions – particularly revenue authorities and the ministries responsible for negotiating mining contracts – to monitor transfer-pricing rules and to adhere to the “arm’s length principle.” Defining how interactions between these government authorities and multinational corporations, their affiliates or related parties is the first step in mitigating transfer-pricing abuses and curbing one of the most critical aspects of illicit financial flows.
- At the regional level, the African Union secretariat should expeditiously develop a road map and action points for the implementation of the key recommendations of the High Level Panel on Illicit Financial Flows from Africa report in view of short-, medium- and long-term priorities. Without a regional road map, the differing priorities of national governments will prevent the implementation of the recommendations and provisions.

- At the regional level, African countries should utilise the existing regional structures, especially the African Union, to collaborate and engage the United Nations and push for the review of international tax standards (specifically double taxation treaties) to ensure that multinational companies pay taxes at the source country rather than the resident country.
- At the global level, the African Union should consider engaging the G20 and OECD members that adopted the Action Plan on Base Erosion and Profit Shifting, a plan which included recommendations similar to those of the Mbeki report. This should include the implementation of country-by-country reporting obligations for multinational corporations to publicly disclose, as part of annual reports for each country in which they operate, profits made and taxes paid. Among other financial information, public registry of beneficial owners of companies, trusts, foundations and similar legal structures should be disclosed. Finally, the automatic exchange of information for tax purposes must become standard practice among tax authorities.

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## About the African Civil Society Circle

This publication is a joint output of the African Civil Society Circle, a group of nine civil society organizations and think tanks from Southern Africa whose goal is to strengthen Sub-Saharan voices in global, continental, regional and national development debates and promote good governance through critical reflection and innovative ideas. Input to the position paper was provided by:

- African Capacity Building Foundation (ACBF)
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## End Notes

1. The Mbeki report, put together following an extensive consultative process, provides sound and concrete recommendations that are applicable continentally and globally. The inclusiveness of the consultations is expected to unify the roles of government and of civil society in the fight against illicit financial flows. African leaders adopted the report at the African Union Summit in January 2015.
2. OECD (2014), "Illicit Financial Flows from Developing countries: Measuring OECD Responses."
3. Baker, R. W. (2005), *Capitalism's Achilles Heel: Dirty Money and How to Renew the Free-Market System*, Hoboken, New Jersey: John Wiley & Sons, Inc. This definition has been reiterated by the African Union High Level Panel on Illicit Financial Flows in its report, "2015 Illicit Financial Flows: Report of the High Level Panel on Illicit Financial Flows from Africa; Commissioned by the AU/ECA Conference of Ministers of Finance, Planning and Economic Development."
4. The World Bank Group (2013), "Financing for Development Post-2015."
5. Ajayi, S. I. (1997). "An Analysis of External Debt and Capital Flight in the Severely Indebted Low Income Countries in Sub-Saharan Africa," Washington DC: International Monetary Fund.
6. Banks, financial intelligence units and legal systems.
7. African Development Bank and Global Financial Integrity (2013), "Illicit Financial Flows and the Problem of Net Resource Transfers from Africa: 1980-2009."
8. African Union High Level Panel on Illicit Financial Flows, *op. cit.*
9. The World Bank Group, *op. cit.*, p. 10.
10. The "arm's length principle" was endorsed by the OECD and UN, and widely used as the basis for bilateral treaties between governments. In order to achieve a fair division of taxing profits and to address international double taxation, transactions between connected parties should be treated for tax purposes by reference to the amount of profit that would have arisen if the same transactions had been executed by unconnected parties.
11. OECD (2013), "Action Plan on Base Erosion and Profit Shifting," OECD Publishing, available: <<http://dx.doi.org/10.1787/9789264202719-en>>.
12. Eurodad (2014), "Tax and transparency fact-finding mission: Obstacles, solutions and windows of opportunity for progress towards financial transparency and tax justice" Report by an independent delegation of experts from Asia, Africa and Latin America, organised by AFRODAD, EURODAD and LATINDADD.
13. *Ibid.*
14. For example: the Inter-Governmental Action Group against Money Laundering in West Africa, the Eastern and Southern African Anti-Money Laundering Group, the Global Counterterrorism Forum, the UN Counter-Terrorism Implementation Task Force, the Financial Crimes Enforcement Network and the Egmont Group of Financial Intelligence Units.
15. Financial Action Task Force (2014), "Public Statement," available: <<http://www.fatf-gafi.org/documents/news/public-statement-oct2014.html>>.