Illicit Financial Flows and Capital Flight in Africa

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Briefing Note to the UN Economic Commission for Africa on Illicit Financial Flows and Capital Flight in Africa

Between 2002 and 2006, Global Financial Integrity (GFI) provided the conservative estimate that Illicit Financial Flows (IFFs) from developing countries were between $859 billion to $1.06 trillion annually[1]. The continent of Africa, arguably one of the hardest hit areas of the world by IFFs, is all too familiar with seeing development aid, tax, and trade revenues vanish into tax havens and secrecy jurisdictions the world over. Names like Mobutu Sese Seko, General Sani Abacha, and Hosni Mubarak carry the stigma of leaders who siphoned off billions of dollars from government coffers, storing them in Swiss and Cayman bank accounts far from prying eyes of citizens and international observers.

The impacts of IFFs are clear. Peter Reuter's report on IFFs refers to the practice as *Draining Development*, as developed countries, international organizations, and NGOs pour aid money into corrupt heads of state who then illicitly move state funds into private accounts to enrich themselves[2]. Subsequently, economic growth is diminished, state capacity stagnates, and income inequality grows[3]. GFI refers to the IFFs out of Africa as Africa's hidden resource for development[4] while academics James K. Boyce and Leonce Ndikumana, who frequently write on IFFs and capital flight from Africa, assert that through IFFs Africa has become a net creditor to the rest of the world through the private external assets of the continent's political and economic elites[5].

IFFs from Africa also contribute to broader concerns surrounding international security. In February 2013, the Council of the European Union expressed its concern that IFFs played a sizable role in funding extremist groups in the Sahel as well as organizations such as the National Movement for the Liberation of Azawad (MNLA) and Ansar Dine, which are currently involved in the Northern Mali conflict[6]. IFFs from Africa not only act as a hurdle to continental and state development and citizens of African states, but also pose a risk to international and regional security.

The intent of this briefing note is to provide the United Nations Economic Commission for Africa (UNECA) with necessary background information on African IFFs, the current status of IFFs on the continent, jurisdictional analysis, stakeholders involved in combatting IFFs and capital flight, as well as policy recommendations and next steps. Given that reducing IFFs is set to be an upcoming post-2015 MDG and that IFFs hamstring the efforts of African states to tackle issues such as poverty alleviation and economic development, addressing the issue of IFFs and the impact it has on the continent should be of the utmost importance to UNECA.

Background: IFFs in Africa

IFFs in Africa are no new phenomenon. Some of the world's most prolific autocrats who have piped billions in public funds into private accounts have come from Africa. Mobutu Sese Seko of Zaire was said to have amassed upwards of $4 billion[7] during his 32 year tenure as president; General Sani Abacha of Nigeria looted the Nigerian Central Bank stealing an estimated $2 billion[8] only part of which has been recovered by Nigeria today; the Arab Spring exposed the offshore assets many other African leaders including Tunisian president Ben Ali, whose family has hidden an estimated $18 billion from Tunisian authorities[9]; and deceased *de facto* ruler of Libya Muammar

Gaddafi, who had assets hidden globally at a conservative estimate of $200 billion[10][11].

This brief attempts to answer the question "How and why are IFFs so prevalent in Africa?" in a manner that is by no means exhaustive but in a way which will provide some context to the UNECA. A common thread that provides some historical context for the prevalence of IFFs in Africa is the presence of extractive industries across the continent. Dating back to the Scramble for Africa in the late 19th century, Africa has long been the target for resource exploitation by large multinational corporations as the continent is abundant in diamonds, rubber, minerals, and fuels. A report issued by the Chr. Michelsen Institute (CMI) suggests that given existing evidence, extractive industries are often associated with high levels of IFFs[12]. Reports from diamond importing countries suggest that global production of diamonds has been routinely underreported from African exporters for smuggling and tax evasion purposes, while fuel exports accounted for almost half of IFFs from Africa between 1970 and 2008[13]. To be more specific, the CMI proposes four factors which make extractive industries prone to IFFs: (1) extractive industries fall under high-level discretionary political control such as a president or executive committee and are often prone to secrecy, (2) state companies in extractive sectors often blur lines between personal and public interests, (3) limited competition in extractive sectors leads to fewer corporate checks and balances, and (4) extractive sectors often require high degrees of technical expertise and make mispricing, and falsifying reports easier[14].

A lack of state capacity to enforce taxation is also another cause of IFFs in Africa. This is best illustrated through tax revenues being lost in foreign trade through the illicit practice of trade mispricing. Between 2005 and 2007, Nigeria, Ivory Coast, and Ghana lost $821 million, $260 million, and $121 million, respectively, through trade mispricing to the EU and U.S.[15]. The OECD attributes tax evasion through trade mispricing in developing countries to a lack of respect for the rule of law, corruption, and poor governance[16].

Corruption is also frequently listed as one of the main causes of IFFs in Africa, as it is interrelated to IFFs stemming from tax evasion and the extractive industry sector. Corruption exists in a symbiotic relationship with the practice of money laundering— the greater importance of corruption and money laundering to IFFs in Africa is that recent studies have noted the corrosivity of corruption on the adherence of Anti-Money Laundering (AML) controls and strategies to combat IFFs[17]. It is also worth noting that most African states rank in the lower strata of Transparency International's 2012 Corruption Perceptions Index[18].

Therefore, as not to lay all the blame of IFFs on African states, it is worth noting that during the 1944 Bretton Woods conference, economists Harry Dexter White and John Maynard Keynes believed that regulation of capital flight was a key pillar in maintaining international financial order[19]. While Keynes and White were less concerned about IFFs and capital flight from Africa and more from war-torn European countries to the U.S., the principles for capital flight protection proposed by White and Keynes apply to Africa. Keynes and White called for bilateral controls on capital flight, specifically that receiving countries of capital were to share information with governments, in which capital flight originated so that the knowledge foreign holdings would be shared with citizens[20]. Ultimately, this proposition was watered-down and opposed by the IMF and U.S. at the Bretton Woods conference, and co-operation between states on reducing capital became more of a suggestion than a formal requirement[21].

Current Status of IFFs in Africa

Tracking the status of IFFs in Africa can prove to be problematic. As IFFs are illicit in nature and conducted outside of official records, providing exact figures as to how much capital is lost through IFFs can be difficult. GFI's 2008 report, which tracked IFFs out of Africa between 1970 and 2008, provides traditional U.S. Purchasing Power Index (PPI) and Gross Excluding Reversals (GER) modeled estimates for outflows over the 38-year span. The PPI measure puts total IFFs out of Africa between 1970 and 2008 at $854 billion, while the GER model places it at $1.8 trillion[22]. The report also notes that IFFs grew at 11.9% per annum over the 39 year period and that sub-Saharan Africa was the worst affected by illicit outflows at a cost of 82% of the region's GDP between 1970 and 2004[23].

In a joint report between GFI and the African Development Bank (AfDB) published in 2013, the figures detailing IFFs from Africa rose. Adjusting for inflation, Africa lost between $1.2 – 1.4 trillion between 1980 and 2009 through IFFs—with West and Central Africa accounting for 37%, North Africa for 31%, and Southern Africa for 27% over the

30-year period[24]. GFI and the AfDB determined that the three largest exporters of illicit capital based on volume of outflow were Nigeria, South Africa, and Egypt while the largest regional players were: (1) Nigeria, Republic of Congo, and Ivory Coast in the West and Central region; (2) Egypt, Algeria, and Libya in the North region; and (3) South Africa, Mauritius, and Angola in the South region[25].

The report also found that during the period of 1980-2009, Africa acted as a net creditor to the world through massive net resource transfers (NRT), which are calculated by the difference between legitimate net recorded transfers (NRecT) and IFFs[26]. GFI and the AfDB estimate that Africa provided net resources to the world ranged from $597 billion by narrow NRT estimates to as much as $1.4 trillion by robust NRT estimates[27]. While some African nations made financial gains from NRT's between 1980 and 2009, distribution is largely asymmetrical[28].

Over the course of five years, the real amounts of financial loss in Africa, as a result of IFFs, have grown at a staggering rate. Attempting to prevent IFFs has also proven difficult in certain areas. The Inter-Governmental Action Group against Money Laundering in West Africa (GIABA) has noted that despite efforts to implement AML controls, extremists in the Sahel as well as insurgency in Mali, Niger, Chad, and Cameroon have presented problems in dealing with illicit funds related to terrorism[29]. GIABA has also stated that refugees, as a result of insurgency, have also created hurdles towards implementing AML and Combating the Financing of Terrorism (CFT) legislation and controls[30]. A KPMG survey of financial firms in Africa and the Middle East found that while there is growing support and desire among African states to implement AML controls, primarily because of AML actions taken by South Africa and Nigeria, state capacity and infrastructure acts as a barrier to compliance due to the absence of national identity systems and proper address verification documentation[31].

Despite being the worst affected by NRT's and IFFs, Nigeria has led from the front in enacting new AML controls in the form of the *Money Laundering Prohibition Act* (MLPA). The MLPA holds legal and natural persons in Nigeria liable to conviction for violation of its provisions[32]. These include violations of record keeping and reporting requirements, which can carry a maximum prison sentence of 3 years or a maximum fine of $165 thousand to individuals[33]. Institutions are also liable—if they fail to maintain proper internal AML controls (including trade mispricing), institutional violation of the MLPA can lead to a minimum penalty of $6,500 for firms[34].

Overall, the current status of IFFs in Africa does not solely fall on African states. Numerous jurisdictions and parties are involved with capital outflows from Africa making the issue more nuanced than one of state capacity to regulate public assets and private finances. Countries who are receiving exorbitant capital flight from African states have just as much obligation to report it, as African states have an obligation to adhere to the rule of law, prevent corruption, and deter individuals from practices such as money laundering or trade mispricing. Until IFFs in Africa are addressed bi and multilaterally, the current status of massive capital IFFs from the continent on an annual basis is likely to remain.

Stakeholders

Journalists

The UNECA has already articulated that the press and the media at large have a role to play in preventing IFFs in Africa. Senior officials at the Eighth African Development Forum (ADF VIII) urged journalists to assume the role of the public watchdog in exposing the sources of IFFs through credible journalism, investigative reporting, and to follow the mission statement adopted by the High Level Panel of "Track it. Stop it. Get it."[35] The role of the media is one that interlinks institutions and people, through reporting on IFFs and capital outflows the goal, established by the ADF VIII to better arm citizens with knowledge in order to hold governments, bureaucrats, and executive branch politicians accountable[36].

AfDB

The AfDB plays a major role in providing guidance to African states with regards to policy recommendations to curtail IFFs. The AfDB has called for the strengthening of African civil society in order to better promote and implement transparency initiatives, open budgeting processes, the Extractive Industries Transparency Initiative (EITI), and the publication of African financial activities by multinational corporations (MNC)[37]. Establishing a tax culture with pro-poor taxes is also cited by the AfDB as necessary in order to more effectively catch funds which are otherwise lost in trade mispricing and tax evasion schemes, and to encourage legal tax compliance over informal/indirect taxation methods which are not formally recorded and also have embedded incentives for evasion[38]. Customs services are also held to task; as the AfDB notes that the best way to curtail trade mispricing and tax evasion through trade is to have properly trained customs officials who are given incentive not to accept bribes or misprice exports[39]. The removal of ad hoc exemptions from duties and the increased capacity of customs services[40] are seen by the AfDB as crucial to lowering IFF rates.

Extractive Industry Firms (EIF's)

State owned firms and corporations involved in the extractive industry sector are major stakeholders in capital flight and IFFs, as such they are able to play a large role assisting in the reduction therein. Given that EIF's are not homogenous, it is likely that in private certain EIF elites benefit from IFF practices like trade mispricing, ad hoc customs exemptions, and NRTs, thus making a consistent stakeholder position for EIF's hard to establish. This is best illustrated by an example provided in the memoirs of former BP CEO, Lord Browne.

Browne had made a BP EITI compliant in 2001 and published BP financial transactions made to the Government of Angola. The reaction to Browne's actions was unfavorable and issued to him in a letter from Angolan national oil company, Sonangol, which stated that "…it was with great surprise, and some disbelief … that we found out your company has been disclosing information about oil-related activities in Angola."[41] In light of this, Browne called for global transparency efforts by EIF's to disclose payments and create a culture of transparency, rather than piecemeal initiatives to publish payments.

African States

African States have already taken steps to curtail IFFs through implementing AML/CFT controls. This is best seen in Nigeria, in initiatives undertaken GIABA, and in responses to the KPMG survey on AML controls, which saw 79% of African and Middle Eastern financial firm respondents claim that their financial institutions had taken active interest in pursuing AML controls[42]. A number of African states have taken proactive steps to promote financial transparency and promote tax compliance. Currently, 14 African states are EITI compliant countries while 2 states are EITI candidate countries[43]; 8 African countries are a party to the International Alliance on Natural Resources in Africa's *Lusaka Declaration on Mining Taxation*[44]; and 16 African states are signatories to the TJN's *Nairobi Declaration on Taxation and Development* ***[45]***.

Developed Countries

The developed world has a great role to play in preventing IFFs and, at times, has shown that developed states are willing to assist in curtailing capital flight into their banks. Most visibly through the freezing of private assets from autocrats. At the epicenter of this is the U.S. and the proposed *Stop Tax Haven Abuse Act of 2011* (herein Act) which, if passed, would allow the U.S. Treasury to take specified steps against foreign jurisdictions that impede U.S. tax enforcement, require all corporations registered with the SEC to annually publish tax payments, financing, sales, and tax obligations, and strengthen the detection of foreign holdings and offshore activities[46]. Given the U.S. hegemonic power and role as a global financial hub, if passed the Act could expose incriminating details surrounding shell corporations and individuals who move IFFs through the U.S. directly or indirectly.

States that have been routinely referred to as tax havens have even taken an active role in curtailing IFFs. The Crown Dependency of Guernsey has established tax information exchange agreements (TIEAs) with over 50 states including known tax havens Cayman Islands, British Virgin Islands, Bermuda, and Gibraltar[47]. That being said, only a handful of states (5) in Guernsey's TIEAs are African. Guernsey's willingness to share tax information is by no means the norm for tax havens and is not replicated in other offshore financial centers like Luxembourg, Switzerland, or Hong Kong.

Recommendations to the UNECA

(1) The UNECA as well as other regional multilateral bodies like the African Union, AfDB, and GIABA must lobby developed nations to adopt AML/CFT controls so that individuals who pipe funds out of Africa and into tax havens and secrecy jurisdictions can be exposed to African populations and to the world. This would mark a return to the goals of Keynes and White, who saw the disclosure of foreign holdings vis-à-vis capital flight as an obligation of recipient countries.

(2) African states involved in the export of natural resources need to develop customs capacity in order to fight the massive outflows of capital through illicit practices such as trade mispricing and illegal duties exceptions. Removal of ad hoc customs processes, proper training of customs officials, and incentives to avoid corruption among customs agents could potentially greatly reduce IFFs through NRT's.

(3) Creating a culture of formal tax compliance in African states has the potential to only hold political and economic elites accountable but to catch revenues lost in trade mispricing IFFs. Establishing formal pro-poor tax policies (negative income tax/progressive taxation) and state infrastructure create transparency in public finance that would create accountability among top wealth holders, broaden the tax base, and reduce funds lost in capital flight.

(4) African states should consider making the case for IFF reduction and international AML controls under the umbrella of CFT and anti-terrorism. GIABA and the EU have expressed that terrorist financing through IFFs pose a threat to regional and international security. It is the opinion of this policy brief that attaching IFF reduction and AML policies to CFT and the prospect of reducing terrorist organization funding will attract more attention from the international community under the interest of protecting global security and combating terrorism. This could provide the potential for broader intervention into IFFs, increased financial regulation of offshore centers, foreign holdings, and shell corporations as well as better record keeping in global trade transactions.

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