## Introduction

# Illicit financial flows are a shared problem between developed and developing countries

The year 2020 is a milestone for Africa and for multilateralism. As many African countries celebrate their sixtieth anniversary of gaining independence from colonial rulers, the continent is making a significant stride towards transforming the promises of the 1960s into a reality as the African Continental Free Trade Area (AfCFTA) was due to open for trading on 1 July 2020, but had to be postponed due to the coronavirus disease 2019 outbreak. AfCFTA is a landmark achievement on the continent's journey towards greater integration and prosperity. The year 2020 also marks the celebration of the seventy-fifth anniversary of the United Nations, the twenty-fifth anniversary of the Beijing Declaration and Platform for Action, and the beginning of the decade of action towards achieving the 2030 Agenda for Sustainable Development. Finally, the fifteenth session of the United Nations Conference on Trade and Development will be held in Barbados.

# ILLICIT FINANCIAL FLOWS (IFFs)

are a shared problem between **developed** and **developing** countries

## 4 BROAD CATEGORIES OF IFFs





Curbing annual capital flight of **US$88.6 billion** from Africa could bridge half of its SDG financing gap

Beyond the milestones of 2020, the examination of illicit financial flows (IFFs) is motivated by growing concerns over its perceived effects on the world's economic, social and political stability. At dinner parties in capital cities around the world, the world's cosmopolitan elite compare notes on the best schools, the least-polluted cities, the alarming spread of insecurity, the threat of populism, and the latest on tax havens. In a parallel reality, when educated men and women from the world's disillusioned middle class meet, from the suburbs of industrialized countries to the compounds of African cities, they share common concerns about the future of their children, deep misgivings about inequality, injustice and a growing resentment towards the prosperous elite. The rhetoric is often the same: complaints about how the wealthiest individuals and the largest corporations are able to avoid paying taxes, how the poor cannot pay, and how those in the middle are increasingly squeezed. In mineral-resource-rich developing countries, including in Africa, these conversations sometimes allude to the latest press reports on unfair contract deals in the mining sector and the prevalence of IFFs, a term that has made global media headlines for the past 10 years.

This report provides an analysis of IFFs and sustainable development in Africa. It does so by considering the three dimensions of sustainable development: economic, social and environmental. As discussed in chapter 1, the report uses the definition endorsed by the Inter-Agency and Expert Group on Sustainable Development Goal Indicators as the basis for the measurement of progress towards Goal 16, target 16.4. The definition is as follows: "Illicit financial flows are financial flows that are illicit in origin, transfer or use; that reflect an exchange of value (instead of a pure money transaction); and that cross country borders" (UNCTAD and United Nations Office on Drugs and Crime (UNODC) (forthcoming)).[1]

This introduction is structured as follows: section I reviews the use of the term "illicit financial flows" in multilateral discourse, drawing on the economic and legal literature on the definitions of the term; section II highlights the key principles of the report's conceptual approach to IFFs; section III presents the objectives, overall approach and organization of the report.

## I. Illicit financial flows in multilateral discourse

The plethora of studies and forums on IFFs shows that the definitions and measurement reflect tensions between polarized views of the world embedded in a set of values,

[1] Further details on the components of this definition are presented in chapter 1.

historical legacy, legal frameworks and economic ideology. For the World Bank, for example, “the term ‘illicit financial flows’ began to appear in the 1990s to describe a number of cross-border activities. The term was initially associated with capital flight” (World Bank, 2016:1). The concern for capital flight in the least developed countries was at the time motivated by the need for capital funds from foreign loans, foreign equity and domestic sources to cater for the servicing of external debt and to provide capital for domestic investments. In a context of structural adjustment policies in most African countries, a sudden or prolonged outflow of domestic capital was likely to affect a country’s macroeconomic performance, leading to these surges being labelled “capital flight” rather than “normal” flows (Cumby and Levich, 1987; Ajayi and Khan, 2000). By the mid-2000s, studies from leading civil society organizations popularized the use of the term illicit financial flows by shedding light on the potentially significant magnitude of such hidden flows due to either the illicit origin of the capital or the illicit nature of the transactions. This strand of the literature focused on commercial tax evasion and the manipulation of trade prices as accounting for most IFFs (Baker, 2005). As a sign of the term’s legitimization, most leading multilateral institutions such as the United Nations, the World Bank, the International Monetary Fund (IMF) and the African Union now use the term illicit financial flows.

By 2015, the prominence of the coalition of stakeholders combating IFFs was such that the issue was included in the 2030 Agenda for Sustainable Development, in Goal 16 with target 16.4 specifically focusing on significantly reducing illicit financial and arms flows by 2030. Building on the 2015 historic step, the indicator framework for the monitoring of progress towards the Sustainable Development Goals adopted by the United Nations General Assembly in July 2017 includes indicator 16.4.1 on total value of inward and outward IFFs.[2] Considering these significant milestones, evidence-based policy responses and regulatory measures to curb IFFs are urgently needed. However, IFFs remain a contested field characterized by broad agreements on the criminal sources and use of such financial flows but a lack of consensus on the commercial components.

The diversity of approaches in the literature reveals that estimates of the magnitude of IFFs are shaped at the nexus of dominant economic principles and legal frameworks. On one hand, without an established theoretical model on IFFs, economists rely on a combination of economic ideology and rigorous analytical methods. On the other hand, variance across jurisdictions, layers of international and domestic laws, and evolving legal frameworks problematize “distinctions between the ‘letter’ and ‘spirit’ of the law,

[2] United Nations, General Assembly, 2017, Work of the Statistical Commission pertaining to the 2030 Agenda for Sustainable Development, A/RES/71/313, New York, 10 July.

on which the illegal/illicit distinction largely rests" (Musseli and Bürgi Bonanomi, 2020:1). In effect, considering such a distinction is blurry given the primacy of the intention of the law in its interpretation. Furthermore, as will be apparent throughout this report, institutional and administrative capacities play a central role in shaping the measurement of IFFs, their regulation and the enforcement of existing laws and regulations.

In what Musseli and Bürgi Bonanomi (2020:17) termed the "common denominator definition", IFFs are "cross-border transfers of money or assets connected with some illegal activity". Multiple definitions of IFFs refer to elements of the following: movement of money and assets across borders that are illegal in their source, transfer or use. Sources are generally classified in three categories: criminal activities, commercial activities and corruption. While the illegality of corruption and most criminal activities related to different types of trafficking and smuggling gathers consensus, the legal versus illegal lens for commercial activities such as trade mispricing, tax evasion, aggressive transfer pricing and tax avoidance has been subject to an intense debate (see, for example, Cobham and Janský, 2019; Forstater, 2017). Most disagreements centre on the treatment of tax evasion and avoidance. Tax evasion involves breaking the law, whereas tax avoidance involves the exploitation of national and international tax rules to gain advantages not intended by countries when they were adopted.

On one hand, most civil society organizations push for a broad definition of IFFs, beyond the legal and illegal divide, emphasizing their harmful impact on development. These views are echoed by the Independent Commission for Reform of International Corporate Taxation, which, in a letter to the United Nations Secretary-General, states as follows (cited in Forstater, 2018:3):

> "We understand that some actors within the United Nations system are lobbying for a redefinition of the term 'illicit financial flows' in order retrospectively to exclude tax avoidance by multinational companies from the definition. Such a course of action represents a clear threat to the [Sustainable Development Goals] contribution of domestic resource mobilization, and will also undermine confidence in the [United Nations'] ability to deliver honestly on what member States have previously agreed upon."

For supporters of this view, an additional emphasis is placed on behaviours that are unethical or undesirable that result in unlawful and lawful (successful) avoidance (Picciotto, 2018).

On the other hand, multilateral organizations address the tax-related dimensions of IFFs with varying degrees of caution. Such caution is motivated by fluctuating interpretations of the term across the legal, illegal, lawful and unlawful continuum. The prevalence of the presumption of innocence in most jurisdictions implies that in practical terms, conceptualizing illicit to be equivalent to illegal would mean that activities cannot legally be construed as illicit/illegal unless they have been declared to be so by a court or competent authority. It infers that such characterization would ultimately depend on the legal challenge of reaching a verdict (Quentin, 2017). Doing so would be problematic because of differences in perceptions of standards in law-making and legal interpretation (Musseli and Bürgi Bonanomi, 2020). In addition, confining tax-avoidance practices to rigid legalistic examinations does not hold in light of the context-specific, fact-intensive assessment of corporate tax filing (Picciotto, 2018). Preliminary assessments of the validity of tax claims in turn depend on the institutional capacity, including that of the revenue authority, to conduct the associated tasks.

Reflecting these challenges, elements of IFFs appear in the 2000 United Nations Convention against Transnational Organized Crime with a focus on the criminal dimensions of the transfer and concealment of assets of illicit origin. The related resolution of the United Nations Economic and Social Council in 2001 further underlines the need for stronger international cooperation in preventing and combating the transfer of funds originating in acts of corruption, whereas the 2005 United Nations Convention against Corruption includes commitments on returning stolen assets. Within the main organs of the United Nations, a close synonym of the term appears in the 2010 Salvador Declaration on Comprehensive Strategies for Global Challenges calling for "developing strategies or policies to combat illicit capital flows and to curb the harmful effects of jurisdictions and territories uncooperative in tax matters" (United Nations, General Assembly, 2011:8). By 2015, IFFs were included in the Sustainable Development Goals, amid debates on the treatment of tax-avoidance issues. In 2016, a joint UNODC–Organization for Economic Cooperation and Development (OECD) issue brief stated, in a footnote, that "the term 'illicit financial flows' is not defined in the international normative framework" (UNODC and OECD, 2016). In the same vein, the report also states in a footnote that "for the purposes of this paper, IFFs are defined broadly as all cross-border financial transfers, which contravene national or international laws. This wide category encompasses several different types of financial transfers".

United Nations research reports take a pragmatic approach to IFFs. The UNCTAD *Trade and Development Report, 2014: Global Governance and Policy Space for Development*, for example, states that "this Report refers to tax-motivated IFFs whenever the international structuring of transactions or asset portfolios has little or no economic substance, and their express purpose is to reduce tax liabilities" (UNCTAD, 2014:174). The *World Investment Report 2015* does not use the term illicit financial flows. Rather, it emphasizes, as a starting point, the critical importance of the need for greater financing for development. To this end, the report builds on the assessment by the *World Investment Report 2014* of missing funds to cover the estimated $2.5 trillion annual investment gap needed to build productive capacity, infrastructure and other sectors in developing countries. The 2015 report then provides a detailed and rigorous examination of tax avoidance by multinational enterprises (MNEs) by addressing the "key question" as follows: "how can policymakers take action against tax avoidance to ensure that MNEs pay 'the right amount of tax, at the right time, and in the right place' without resorting to measures that might have a negative impact on investment?" (UNCTAD, 2015a:176). As discussed in section II, and further developed in chapter 1, tax avoidance is considered by many constituencies as a critical component of IFFs.

Notwithstanding these conceptual variations, in December 2018, the United Nations General Assembly adopted a resolution on "Promotion of international cooperation to combat illicit financial flows and strengthen good practices on assets return to foster sustainable development". The resolution places emphasis on the development dimension by "reiterating its deep concern about the impact of illicit financial flows, in particular those caused by tax evasion, corruption and transnational organized crime, on the economic, social and political stability and development of societies, and especially on developing countries" (United Nations, General Assembly, 2019:2). In addition, the second International Expert Meeting on the Return of Stolen Assets was held in Addis Ababa in May 2019. More recently, IFFs featured prominently in the President's summary of the High-level Dialogue on Financing for Development held by the General Assembly on 26 September 2019.[3]

The IFFs discourse in the intergovernmental African context is shaped by the High-level Panel on Illicit Financial Flows from Africa, commissioned by the African Union and the United Nations Economic Commission for Africa (UNECA) Conference of African Ministers of Finance, Planning and Economic Development. Marking a departure from the ambivalent treatment of IFFs by most multilateral institutions, the ensuing 2015 report, also known as the Mbeki Report, states that "the various means by which IFFs take place in Africa include abusive transfer pricing, trade mispricing, misinvoicing of services and intangibles and using unequal contracts, all for purposes of tax evasion, aggressive tax avoidance and illegal export of foreign exchange" (UNECA, 2015:24). Some of these concerns are shared by OECD as reiterated in a 2016 joint statement issued by the Secretary-General of OECD and the chair of the High-level Panel:

[3] United Nations, General Assembly, 2019, Summary by the President of the General Assembly of the High-level Dialogue on Financing for Development (New York, 26 September 2019), A/74/559, New York, 21 November.

"The issue of illicit financial flows is at the forefront of the international agenda".[4] The joint statement calls on the international community to come together as "money-laundering, tax evasion and international bribery which form the bulk of illicit financial flows, affect all countries". The statement does not mention tax avoidance, aggressive or otherwise.

With regard to the treatment of IFFs in Bretton Woods institutions, in a factsheet, "The IMF and the Fight against Illicit Financial Flows", IMF lists combating tax-avoidance activities as part of its mandate to ensure the stability of the international monetary system. This role includes helping member countries guard against "base erosion and profit shifting" (BEPS).[5] The World Bank recognizes that in the international development community, the term illicit financial flows has become "a powerful and constructive umbrella to bring together previously disconnected issues" (World Bank, 2017a). It considers that cross-border movements of financial assets are illicit only when they are associated with activities that are deemed to be illegal in the local jurisdiction (World Bank, 2016). It specifies that "tax avoidance activities, such as legal tax planning and optimization, do not belong to illicit financial flows" (World Bank, 2016:2) while adding, in a footnote, that "the clarity of these distinctions is easier to maintain conceptually than in real life". It further acknowledges that it is the nature of tax crimes that determines the degree of level of "opaqueness" in defining IFFs and states that the differences between legal tax avoidance and illegal tax evasion can only be ascertained further to a legal ruling. Despite conceptual difficulties, the institution acknowledges dealing with tax avoidance in multiple ways through its work on international tax policy and its country-level support for improved tax administration and preventive measures for tackling abusive transfer pricing.

## II. Conceptual contours of illicit financial flows in the *Economic Development in Africa Report 2020*

The report builds on the increasing engagement on IFFs in multilateral circles, sensitivities associated with the use of the term and the new body of work on the legal and illegal divide on tax-related matters. As elaborated on in chapter 1, the report considers the developmental impact of IFFs, reviews existing evidence on selected criminal

4 See www.oecd.org/g20/topics/international-taxation/joint-statement-on-the-fight-against-illicit-financial-flows-by-angel-gurria-and-thabo-mbeki.htm.
*Note:* All websites referred to in footnotes were accesses in April 2020.

5 See https://www.imf.org/en/About/Factsheets/Sheets/2018/10/07/imf-and-the-fight-against-illicit-financial-flows.

activities associated with such flows, addresses trade-related commercial activities, and considers corruption as a cross-cutting issue. It also investigates channels of IFFs through the global network of actors and analyses the roots of IFFs in the international legal and economic order.

As a starting point, the report takes note of the indications of the Mbeki Report, including its treatment of IFFs originating in commercial activities, as cited previously in section I. This definition has led to findings that show that 65 per cent of IFFs in Africa originate in commercial activities (UNECA, 2015). The magnitude of this estimate illustrates the central role that definitions play in the measurement of such flows and ultimately in the design of appropriate regulations. In addition, the political legitimacy of the High-level Panel in the African context has established this definition as the basis for Africa-based intergovernmental meetings. However, a full account of the Mbeki Report definition would imply a consideration of the capacity of domestic legal systems in Africa to address aggressive and developmentally harmful tax avoidance. In this regard, regulators' ability to play cat and mouse with businesses has resulted in what has become known as the "balloon effect", that is, filling a regulatory gap in one place merely leads to new loopholes elsewhere (Musseli and Bürgi Bonanomi, 2020). This feeds into a never-ending game that constantly requires alertness and regulatory adjustments, even in countries with well-developed legal systems.

The present report posits that a definition of IFFs for analytical purposes should acknowledge the evolving nature of the concept in a changing global environment on international corporate taxation. These developments happen concurrently with progress in the conceptualization of tax avoidance in the legal literature as shown in the latest research conducted by Musseli and Bürgi Bonanomi (2020) as part of the project Curbing Illicit Financial Flows from Resource-rich Developing Countries. These authors argue, for instance, that the evolving nature of regulatory reform of tax law, including the OECD-led BEPS agenda, further challenges the distinction between illegal and legal tax schemes. They contend that the BEPS general anti-abuse rules contribute to making this distinction increasingly irrelevant as they enable previously lawful practices based on the exploitation of loopholes to be turned into unlawful ones. The pragmatic inclusion of anti-tax-avoidance activities in the technical assistance programmes of major multilateral organizations somehow echoes Musseli and Bürgi Bonanomi's deconstruction of the illusion of a clear dichotomy between legal and illegal.

Finally, the present report takes the view that the measurement and monitoring of IFFs, and the definition of appropriate policy and regulatory measures to curb them, depends on the consideration of both sets of commercial and criminal activities. In this regard, the dominant emphasis on tax-related IFFs should not divert attention away from criminal activities, illicit trade and corruption, as these compromise the international financial system for money-laundering purposes and negatively impact prospects for achieving all 17 Sustainable Development Goals.

## III. Objectives and organization of the *Economic Development in Africa Report 2020*

The report aims to equip African Governments and their partners with renewed arguments to address IFFs and sustainable development in international forums. In so doing, the report adds to the extensive literature on IFFs by deepening knowledge on its Africa-specific characteristics. Chapter 1 presents the report's conceptual framework.

The report's core analytical chapters aim to provide answers to the following questions:

(a) What is the state of play of the measurement of trade-related IFFs in the context of the Sustainable Development Goals? What is the magnitude of specific components of trade-related intracontinental and extracontinental IFFs in Africa? (chapter 2);

(b) What are the financial institutional mechanisms and regulatory loopholes behind the engineering of IFFs, including in the mining sector in Africa? (chapter 3);

(c) What are the root causes of IFFs in the international legal and economic order? What is the place of Africa in multilateral engagement related to IFFs? (chapter 4);

(d) To what extent are IFFs associated with missed opportunities for sustainable economic, social and environmental development in Africa? (chapter 5);

(e) How do IFFs feature in the landscape of domestic resource mobilization in Africa? What would it mean to reclaim IFFs for financing the Sustainable Development Goals at the regional level, or within a country, for example in Nigeria? (chapter 6);

(f) What should be done at the multilateral, continental and national level to fast track the curbing of IFFs? (chapter 7).

The report adopts an interdisciplinary approach that blends traditional economic tools with insights from international law, international relations and political economy perspectives and sets out to add value in the following ways. First, it seeks to revisit current estimates of the magnitude of trade-related commodity-based IFFs in Africa, accounting for new methodological and data insights (chapter 2). Second, it integrates gender-based and environmental considerations related to climate change in the analysis of the relationship between IFFs and sustainable socioeconomic development in Africa (chapter 5). Third, it adopts a balanced approach to a topic that has been subject to polarized views. The overall approach seeks to be inclusive of the vantage points of different actors across the spectrum of IFFs (chapter 3). It investigates the global web of actors involved in the facilitation and regulation of IFFs while also identifying policy and institutional loopholes in Africa (chapter 3). Fourth, the analysis sheds light on the historical and geopolitical foundations of some of the drivers of IFFs (chapter 4). The report brings these issues to life by examining the implications of curbing IFFs at the local level in Nigeria (chapter 6). Finally, in chapter 7, the report reviews existing initiatives to curb IFFs including ongoing efforts on the reform of the global corporate taxation system. This final chapter then offers new recommendations for tackling IFFs, drawing on two narrative threads: (a) IFFs are a shared responsibility between developed and developing countries; and (b) Africa should take its responsibility to new heights at the international, continental and national levels.