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POLICY BRIEF

CURBING ILLICIT FINANCIAL FLOWS TO FINANCE SUSTAINABLE DEVELOPMENT IN AFRICA*

Curbing illicit financial flows (IFFs) can help African countries mobilize capital to finance the achievement of the Sustainable Development Goals and other national priorities. IFFs contribute to US$88.6 billion of capital flight per year from Africa. Reducing these outflows can increase the stock of capital available for businesses to build productive capacity and create jobs. Increased tax revenues can provide governments additional fiscal space to, for example, invest in infrastructure, spend on poverty reduction programmes, or assist citizens during emergencies, such as the 2020 coronavirus (COVID-19) pandemic.

This policy brief examines IFFs in Africa, including how they contribute to capital flight and tax evasion. We then recommend specific actions governments can take to curb IFFs and use the proceeds to finance sustainable development.[1]

Key points

- Curbing IFFs represents a potential source of capital to invest in the SDGs, national priorities and responses to crises such as the COVID-19 pandemic.
- Underinvoicing exports of extractive commodities, particularly gold, is an important source of capital flight from Africa.
- To curb IFFs, countries should collect more and better trade data, close loopholes in tax treaties and strengthen regulatory frameworks.
- African countries should coordinate more on data sharing, aligning regulations and engaging with international tax reform efforts.

Current situation

In Africa, UNCTAD estimates the annual financing gap to achieve the Sustainable Development Goals (SDGs) is in excess of US$200 billion.[2] In addition, as of early 2020, governments need additional funds to spend on health, social protection and economic recovery in response to the COVID-19 pandemic. In the medium to long term, they must also devote resources to the implementation of the African Continental Free Trade Area and the broader African Union Agenda 2063.

To bridge the SDG financing gap, African countries need to mobilize funds from a variety of sources. Trends in public inflows provide no immediate prospects for growth, with annual official development assistance (ODA) flows to Africa stagnant at around US$30 billion per year over the last decade.[3] Private inflows are no more promising. UNCTAD predicts that foreign direct investment (FDI) in Africa will plunge from US$45 billion in 2019 to between US$25 to 35 billion in 2020, with a recovery not expected until 2022.[4]

* This document has not been formally edited.

[1] This policy brief is based on UNCTAD, 2020, *Economic Development in Africa Report 2020: Tackling Illicit Financial Flows for Sustainable Development in Africa* (United Nations publication, Sales No. E.19.II.D.7, Geneva).

[2] https://unctad.org/en/PublicationsLibrary/aldcafrica2016_en.pdf.

[3] Source: OECD.Stat, Aid (ODA) disbursements to countries and regions, accessed 18 June 2020.

[4] https://unctad.org/en/PublicationsLibrary/wir2020_en.pdf.

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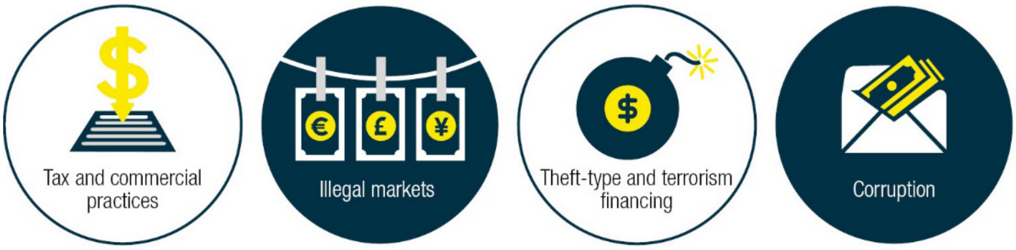
4 BROAD CATEGORIES OF IFFs



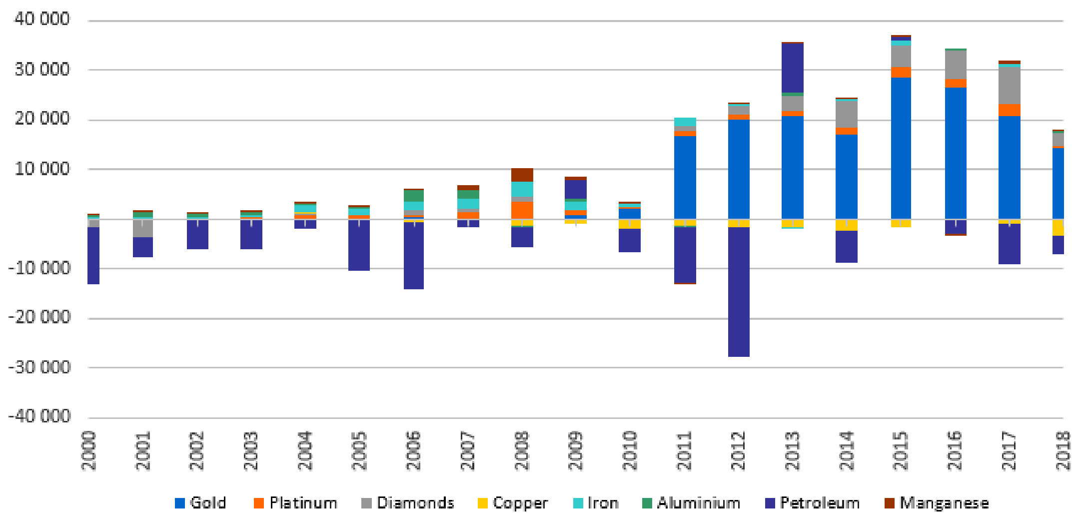
Some African countries with stronger fiscal positions have succeeded in raising new funds by opening their capital account and selling sovereign bonds on international money markets. But increased stocks of private foreign capital typically lead to negative income streams for developing countries, and liberalized capital accounts expose them to the risk of sudden, speculative outflows when market conditions change (Policy Brief 76).[5]

In this context, African countries need to mobilize more domestic capital to bridge the SDG financing gap. These efforts are undermined by capital flight, by which private wealth is sent and held abroad. UNCTAD estimates capital flight from Africa at US$88.6 billion per year from 2013-15, equivalent to 3.7 per cent of the continent's GDP.[6]

While some capital flight leaves through legal channels, some leaves in the form of illicit financial flows (IFFs). UNCTAD defines IFFs as movements of money and goods across borders that are illegal in source, transfer or use. IFFs can include criminal activities, such as corruption or smuggling; commercial practices, such as the misinvoicing of trade shipments; or tax practices, such as the abusive use of transfer pricing. Since most countries in Africa are dependent on exports of raw commodities, commercial flows related to commodities are a focal area in the study of IFFs.

UNCTAD estimates annual trade misinvoicing in Africa of US$30 to 52 billion, with the bulk from the underinvoicing of exports of extractive commodities. While patterns by country vary considerably, patterns by commodity group are consistent. As shown in the figure below, gold contributes an estimated 77 per cent of total underinvoicing of exports of extractives from Africa, followed by diamonds (12 per cent) and platinum (6 per cent), underlining the concentration of misinvoicing on high-value, low-weight commodities.[7]

Sum of partner-country trade gaps by commodity group
(Millions of dollars)



Source: UNCTAD, 2020.

5 https://unctad.org/en/PublicationsLibrary/presspb2019d5_en.pdf.
6 UNCTAD, 2020.
7 Ibid.

In countries with large illicit flows of money and goods, UNCTAD estimates that governments spend, per person, only 75 per cent on health and 42 per cent on education, compared to countries with low IFFs.[8] Women and girls suffer most from these fiscal effects, since they are the main beneficiaries of public spending on health and education. These shortfalls also have a long-term impact on labour productivity growth, as they increase the time women must devote to caring for their families, at the expense of education, training and paid work. These effects are compounded during economic or health crises, such as the COVID-19 pandemic. In addition to the health risks from COVID-19, women are likely to suffer a disproportionate share of the socioeconomic consequences from containment and economic recovery efforts.

Overall, tax revenues lost to IFFs are especially costly in Africa, where public investments and spending on the SDGs are most lacking. African governments raise taxes equivalent to 18 per cent of their GDP, well below the average of 33 per cent in developed countries. Nevertheless, by some estimates, improving tax collection, while curbing capital fight and IFFs could raise annual tax revenue by an additional 3.9 per cent of GDP, or US$110 billion a year,[9] representing roughly half of Africa's annual SDG financing gap.

Challenges

Collecting data on illicit activities is inherently difficult. Methodologies to estimate trade misinvoicing rely on, for example, publicly available trade and pricing data. These methodologies identify wide and persistent gaps in reported trade flows between counterparties, which can be useful to policy makers as "red flags" for further investigation. Nevertheless, the absence of comprehensive, publicly available transaction-level data largely precludes using statistical methods to identify the transaction-level patterns of illicit behaviour that customs or tax officials could use to combat trade misinvoicing.

In most countries, governments have some raw data at their disposal to investigate commercial IFFs, from transaction-level customs data on the physical flows of goods, to accrual-based tax filings on financial flows. Nevertheless, auditing these data to identify IFFs requires detailed knowledge of the underlying industries and supply chains. For example, when assessing a shipment of iron ore from Guinea, an official must understand what is a fair Free On Board (FOB) price for the mineral at its declared grade, relative to the appropriate benchmark price, less the market rates for transportation and insurance. Building this level of specialist knowledge in customs or tax authorities is costly and time-consuming.

IFFs involve cross-border flows, so national governments can only obtain data on these flows and, eventually, combat illicit practices, by sharing data and cooperating with their neighbours and trading partners. To date, regional cooperation on data and enforcement related to IFFs is limited in Africa.

Compounding the problem of data scarcity, commercial IFFs are woven within a legal complex of: bilateral agreements; concessions for natural resource exploitation; and commercial contracts. Therefore, a long-term approach to enforcement must not only scrutinise individual deals, but also redress loopholes in treaties and legal frameworks.

In trade deals between private entities, a degree of confidentiality is appropriate to protect their competitive information and intellectual property. By contrast, trade in extractive commodities involves a public asset, for which a greater degree of disclosure is required. Where governments or state-owned companies are counterparty in trade deals for extractive commodities, there is a potential conflict of interest with their regulatory and fiduciary roles. In response, models of multi-stakeholder oversight bodies have appeared in recent years, such as the national committees established by member countries of the Extractive Industries Transparency Initiative (EITI). Nevertheless, establishing capable, independent oversight bodies often requires a cultural shift in how governments and multinational enterprises engage with local communities, civil society

[8] Ibid.

[9] https://www.brookings.edu/research/mobilization-of-tax-revenues-in-africa/.

and other stakeholders and may even require legal protections and capacity-building for oversight committees to fulfil their mandate.

Recommendations

To overcome these challenges, better combat IFFs and invest the proceeds in sustainable development, policy makers at the national, regional and international level should consider the following recommended policies and actions.

Government revenue authorities, policy makers and researchers need to:

Treat wide and persistent trade gaps for a commodity group as a "red flag" for further investigation by:

- Detailing the many factors, including those outside of illicit behaviour, that can contribute to a trade or price gap;
- Using available sources of transaction-level data to parse the causes of the macro gaps identified; and
- Engaging the private sector, where possible, to obtain new transaction-level data to break down macro gaps.

African governments need to:

Collect more and better trade data by:

- Investing in data collection infrastructure, including for gender-disaggregated data;
- Building the capacity of personnel at port, customs and tax authorities to better collect and analyse trade data;
- Contributing continuous trade data to UN Comtrade and participate in the metadata survey; and
- Accelerating progress on tax reporting.

Strengthen domestic regulatory frameworks by:

- Weighing the costs and benefits of investing in the expertise and facilities to detect, investigate and prosecute IFFs;
- Designing a specific policy and regulatory framework to combat IFFs, drawing from best practices and model treaties and contracts;
- Adopting multi-stakeholder oversight of the exploitation and trade of natural resources, including leveraging existing structures in member countries of the Extractive Industries Transparency Initiative (EITI);
- Domesticating the African Mining Vision; and
- Establishing cross-institutional collaboration.

Intensify the fight against corruption and money-laundering by:

- Devoting more resources to the recovery of stolen assets; and
- Protecting and supporting civil society organizations, whistle-blowers and investigative journalists.

Improve regional cooperation on IFFs and tax by:

- Building regional knowledge networks to enhance national capacities to tackle IFFs;
- Sharing trade and tax data and align regulations on sectors at high risk of IFFs, such as extractives, telecommunications and banking; and
- Agreeing on continental regulations on new technologies, such as digital payment platforms, blockchain and cryptocurrencies.

Engage with international taxation reform by:

- Coordinating an inter-governmental African position on OECD/G20 proposals;
- Reviewing tax treaties to increase taxing rights; and
- Making tax competition consistent with protocols of the African Continental Free Trade Area.

The international community needs to:

Rekindle trust in multilateralism by:

- Supporting multilateralism to curb IFFs at the level of the Economic and Social Council and the General Assembly of the United Nations; and
- Devoting more resources to international cooperation on illicit financial flows and tax evasion, including capacity-building for tax and customs authorities in developing countries.

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