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UN Africa Report Reveals Startling Illicit Financial Flows

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A new, comprehensive report published by the African Union (AU) High-Level Panel on Illicit Financial Flows and the United Nations Economic Commission for Africa (UNECA) concludes that Africa loses more than $50 billion every year to illicit financial flows (IFFs). The report represents the first African initiative of its kind, and is the product of a study that began in February 2012. It analyzes various illicit practices of governments and multinational companies that deprive African countries of tax payments, facilitate the undervaluing of African trade, and perpetuate profit-shifting schemes that collectively divert billions of dollars in essential capital from the world's poorest continent every year.

According to the AU-U.N. report, Africa lost approximately $850 billion in illicit financial flows between 1970 and 2008, and over $1 trillion in IFFs over the last 50 years — a figure roughly comparable to the development assistance that Africa received during the same period. Illicit funds are often routed out of Africa to developing countries and tax havens around the world, causing Africa to function as a "net creditor to the rest of the world rather than a net debtor, as is often assumed." The report defines "illicit financial flows" as "money that is illegally earned, transferred or utilized," and that typically originate from one of three sources: (1) "commercial tax evasion, trade misinvoicing and abusive transfer pricing"; (2) "criminal activities, including the drug trade, human trafficking, illegal arms dealing, and smuggling of contraband"; and (3) "bribery and theft by corrupt government officials."

The AU-U.N. report asserts that "large commercial corporations are by far the biggest culprit of illicit outflows, followed by organized crime." Commercial IFFs addressed by the report include both illegal tax and trade-based activities, as well as the implementation of aggressive tax avoidance strategies that are permissible under certain African countries' under-developed tax regulations.

Although corrupt practices and weak governance structures are key facilitators of IFFs in Africa, the report notes that tax evasion, international trade manipulations, and organized crime constitute large portions of illicit outflows from the continent. Indeed, the Open Society Foundations' Initiative for West Africa recently stated that throughout Africa, only 3 percent of IFFs stem from government corruption, while 64 percent arise from trade manipulations and 33 percent originate from organized crime. One of the AU-U.N. researchers' methods of estimating IFFs was to compare the reported value of African exports with the higher value attributed to the same goods by non-African countries that received the goods as imports.

Development Consequences

Over the past decade, Africa has maintained an impressive economic growth rate of approximately 5 percent annually, yet the degree of financial depletion documented by the AU-U.N. panel paints a grim picture, suggesting that Africa's economic growth will elude many of the estimated 414 million Africans who live on less than $1.25 a day. A recent study by Global Financial Integrity asserts that illicit finances flow out of Africa at a much faster rate than development assistance enters into the continent, with IFFs outpacing international development funds at a ratio of at least two-to-one. IFFs drastically reduce African countries' ability to achieve their development goals, draining the continent's capital stock and shifting resources from more productive activities with strong after-tax returns to less productive activities with high pre-tax returns. According to the AU-UNECA report, sub-Saharan African countries have been most heavily impacted by IFFs. West and Central Africa shoulder the largest numbers of illicit financial streams, and Nigeria, Egypt, South Africa, Morocco and Angola have the five highest percentages of IFFs in the continent.

Governance, Oversight and Capacity Constraints

IFFs plague developing and developed nations alike, yet African governments are especially impacted by these activities because they often lack the resources, capacity, centralization and collaborative networks necessary to identify and reduce illicit practices effectively. For example, without a consistent means of exchanging financial and tax information among African countries, it is difficult for African authorities to thwart the efforts of those who evade tax payments and engage in other illegal activities. In light of these obstacles, the AU-U.N. report makes several key recommendations aimed toward African states, including the drafting of clear and concise legislation prohibiting trade mispricing, the enhancement of financial monitoring and oversight mechanisms, and the automatic exchange of tax information between African governments.

Charting a Way Forward

As a result of the increasing political momentum building behind IFFs' eradication in Africa, African states are likely to devote increasing resources to the passing of new legislation concerning trade mispricing, transfer pricing and financial transparency obligations in the future. Ideally, these new laws would be harmonized throughout the continent, either through the AU or Africa's various regional economic communities. The sharing of financial information between African states is likely to increase, as is the execution of African tax treaties. In resource-rich African nations, the revision of tax incentives and other rules specifically targeting industries like the extractive sector is also possible. South Africa and Ghana have contemplated imposing "super taxes" on excess profits from mining, and such measures could be a means employed by African nations of off-setting the tax-related impacts of IFFs.

Moreover, business actors in Africa should expect heightened enforcement of existing laws concerning transfer pricing, misinvoicing and corruption by African authorities, which will necessarily be accompanied by enhancements in financial monitoring mechanisms within the anti-corruption and internal revenue service bodies of African states. Rates of transfer pricing litigation in South Africa and Kenya are rising, and litigation rates in other countries would likely follow the prioritization of IFFs throughout the continent. Changes will not be realized immediately, but the increase in legislative and capacity-building efforts concerning IFF in recent years do indicate that African governments are more willing to take the first and most crucial steps in reducing IFFs throughout the continent.

Transfer Pricing

One source of IFFs that is likely to receive particular attention by African states is transfer pricing. Approximately two-thirds of the world's business transactions take place between related parties, and these transactions within Africa represent a tremendous source of lost financial opportunity. Countries such as Egypt, Kenya, Morocco and South Africa have established wide-ranging transfer pricing regimes that implement the international arm's length standard (ALS) that most developed countries and the Organization for Economic Cooperation and Economic Development's Transfer Pricing Guidelines endorse. While more African countries are expected to incorporate this standard into their emerging transfer price regulations, the implementation of ALS standards is likely to remain challenging due to associated implementation costs and the lack of easily accessible, Africa-based comparable transactions to establish transfer price units. The evolution of Africa's transfer pricing regimes will be inconsistent, as African regimes vary in their level of maturity; some countries possess transfer pricing audit units, capacity building initiatives and legislation, while others have yet to pass legislation or to subject companies to significant transfer pricing assessments or litigation.

Another potential source of policy mobilization is the African Tax Administration Forum, a platform uniting the heads of African tax administrations to promote efficient, effective economic tax administration throughout Africa. The ATAF has a Transfer Pricing Project and Working Group, and is also formulating an Agreement on Mutual Assistance in Tax Matters and a Model Double Taxation Agreement. These measures would help facilitate an Africa-wide framework to address IFFs, including the issue of transfer pricing as it relates to IFFs. Their execution would also further prompt African countries to strengthen the oftentimes complicated and legislatively weak transfer pricing regimes that multinational corporations currently navigate.

Political Will and Consensus Outside of Africa

In addition to making recommendations toward African leaders, the AU-U.N. report calls on countries that receive illicit outflows to help prevent these financial streams, assist Africa in repatriating illicit funds, and to prosecute perpetrators. The international nature of IFFs and the capacity constraints of most African states will prohibit a meaningful reduction in IFFs without the political support of the international community and the leadership of entities such as the UN, G8, G20, European Parliament, OECD, World Bank and International Monetary Fund. Recent remarks before the Assembly of the African Union by Thabo Mbeki, South Africa's former president and chairman of the AU-UNECA panel, summarize the report's call for political mobilization on a global scale: "[W]hile the study of illicit financial flows seems technically complex, it is ultimately a political matter requiring decisions at various levels of governance. It can indeed be said that illicit financial flows are an 'African problem with a global solution.'"

The international community is equipped with several tools that could address IFFs in Africa, yet the degree of political commitment to the issue has yet to be fully demonstrated. One source of assistance is the African Development Bank's African Legal Support Facility (ALSF), which addresses African nations' legal capacity constraints by providing short-term, world-class legal advisory services to African governments. Similarly, the OECD's Tax Inspectors Without Borders makes tax audit experts available to work directly with developing country authorities to execute tax audits and provide instruction concerning audit practices. The relative lack of sophisticated legal and accounting expertise available to African nations is an obstacle to the eradication of IFFs in Africa, and the increased involvement of organizations like ALSF and Tax Inspectors Without Borders could yield significant returns. Collaboration and support could also arise from the U.S.-Africa Partnership to Combat Illicit Finance, which was established during the August 2014 U.S.-Africa Leaders Summit.

African states' increasing commitment to eradicating IFFs, as reflected by the AU-U.N. report, poses an excellent opportunity for the U.S.-African partnership to commence its activities, particularly regarding trade misinvoicing and the role of U.S. entities in facilitating IFFs. Yet another noteworthy example of potential international support is the European Parliament's recent issuance of a draft resolution requiring beneficial owners of companies, foundations and trusts to be identified on public registers. If passed, the resolution would reduce the ability of individuals to utilize shell companies to launder money and hide illicit wealth.

In addition to these preventative measures, developed countries can play an essential role in facilitating the recovery of African assets that have already exited the continent. Bilateral efforts between originating and destination countries in returning illicit finances and prosecuting perpetrators of corrupt practices are increasing worldwide, and this collaboration offers an excellent opportunity to reverse IFFs from Africa. For example, in March 2014, the U.S. Department of Justice froze over $458 million in corruption proceeds located in accounts in the United States and other countries held by the late Nigerian dictator Sani Abacha and his conspirators. The DOJ's investigation was part of the agency's Kleptocracy Asset Recovery Initiative, which seeks to seize and recover assets possessed by foreign leaders that rightfully belong to foreign leaders' citizens.

While the ultimate fate of IFFs in Africa remains unseen, the recent AU-U.N. report sets the stage for further African and international efforts to address their perpetuation. Two of the most seminal obstacles to African countries in combatting IFFs are the general lack of knowledge concerning the ways that IFFs operate in Africa specifically, and a lack of political will to address the issue — in both of these regards, the report reflects tremendous steps forward. The target period of the U.N. millennium development goals is scheduled to end at the close of this year, and African governments are now looking towards the design of a post-2015 development agenda. The prevention and recovery of IFFs will almost certainly be viewed as a significant method of financing Africa's development goals, and African leaders will be eager to address this issue through national and collaborative approaches.

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