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Illicit Financial Flows and its implications for Africa's structural transformation

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- What would be needed to implement the Addis Ababa Action Agenda call for redoubling efforts to substantially reduce Illicit Financial Flows by 2030?

- Structural transformation and good governance are two of the necessary elements.

I. Key development priorities for Africa for next 10 years

- Africa's mediatic growth story needs to be nuanced....
- Important challenges remain ahead......
  - Growth that is dynamic and leads to further growth and more value-added
  - Growth that is inclusive and creates jobs
  - Growth that allows a broadening of the economic base
  - Growth that reduces vulnerability to external shocks
  - Growth that allows Africa to better gain from international trade and globalization
  - Growth that enhances domestic resource mobilization
- Quality of Growth matters!!
- What you produce and export matter!!

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II. What is Structural Transformation?

Shifting resources and policy focus:

FROM

- traditional sectors
- traditional activities
- low-productivity
- low-technology
- low value-added

New sectors

New activities

Higher productivity

Higher technology

Higher value-added

Structural transformation takes place:

- within sectors
- across sectors

III. Drivers of Structural transformation?

Productive capacities

- Three elements needed
  - Productive resources (natural and human resources, physical capital)
  - Entrepreneurial capabilities
  - Productive linkages

Investment

- Infrastructure (a driver of competitiveness)
- Services (an enabler of manufacturing development)
- Skills and human resources development (a driver of productivity)

Technology acquisition, utilization, adaptation, learning & upgrading

- Technology as a determinant of process and product upgrading to enable insert ion into Global Value chains
- Critical for increased sophistication of exports
- Critical for creating dynamic comparative advantages in trade

IV. Definition of IFFs

- IFFs as “money illegally earned, transferred or used” (High Level Panel)

Figure 2.1
Origins of illicit financial flows

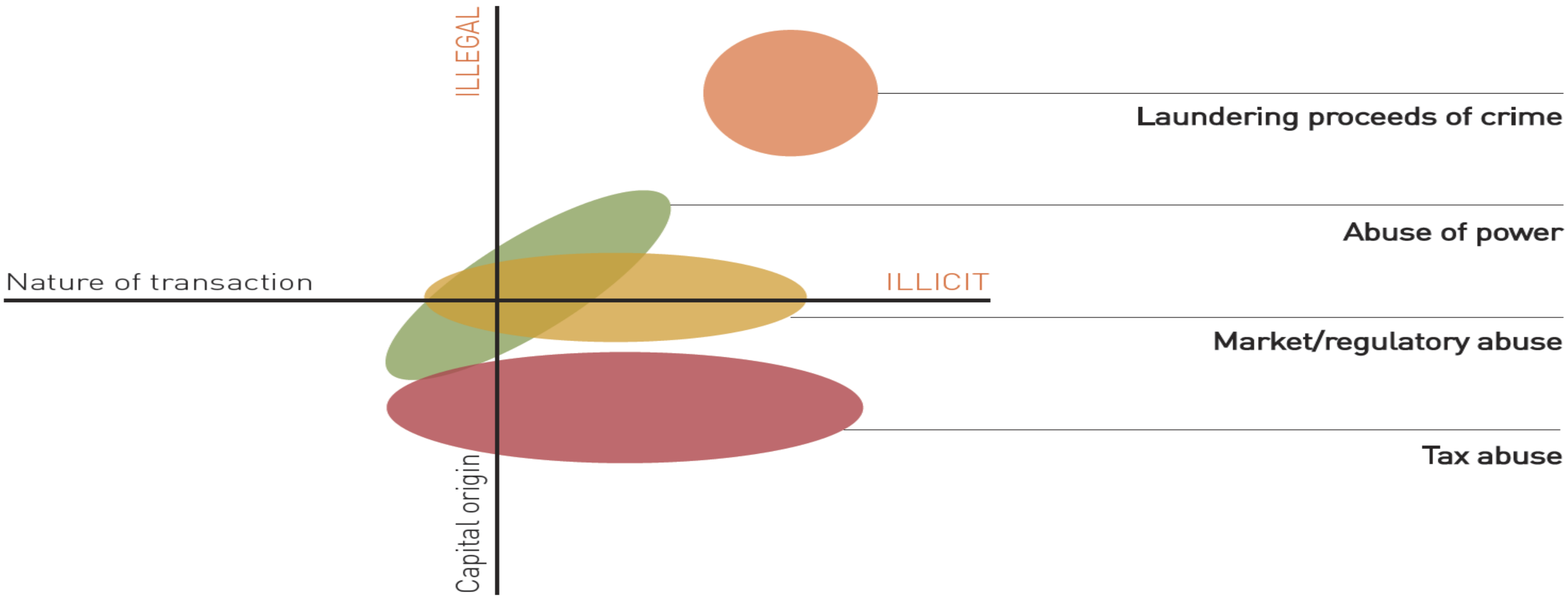
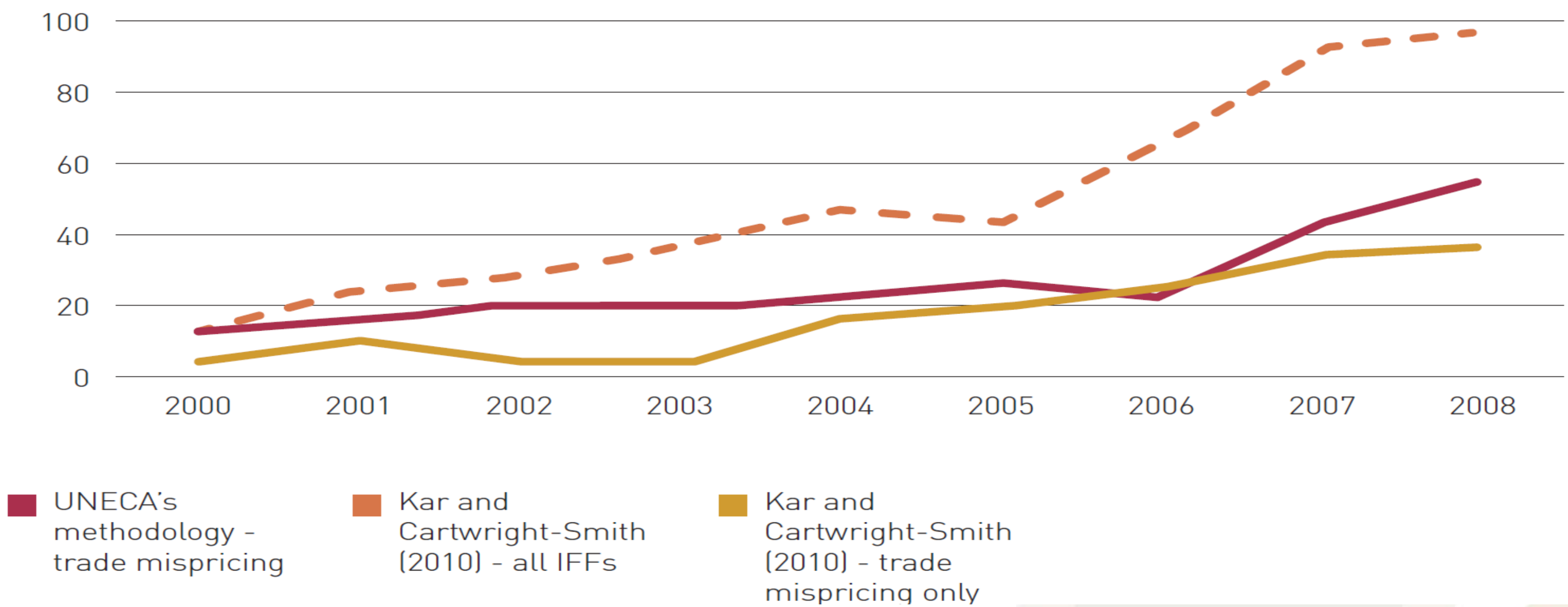


Figure 2.4
Evolution of IFFs from Africa, 2000–2008 (US$ Billion)



Of the US$50-60 billion annual illicit outflows from Africa:

- Commercial activities are by far the largest contributor
- Followed by organized crime,
- Then public sector activities. Corrupt practices play a key role in facilitating these outflows

IV. IFFs and its implications for structural transformation in Africa

- IFFs impose many costs on the continent: direct and indirect
- Direct: Huge losses of direct revenue for development finance, with implications for growth dynamics
  - Africa's capital stock would have expanded by more than 60 per cent if funds leaving Africa illicitly had remained on the continent, while GDP per capita would be up to 15 per cent more (Boyce and Ndikumana, 2012).
  - Enhances dependence on external finance such as debt (sustainability issues) and aid (predictability) that reduce policy space for African countries.

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IV. IFFs and its implications for structural transformation in Africa

- But also «indirect» losses.....
  - IFFs reduce incentives for policy makers and the private sector to engage in structural transformation
  - IFFs can retard the reforms needed to facilitate ST- policy reforms, regulatory and governance reforms.
  - By delaying the process of structural transformation, IFFs reduce *future potential streams of fiscal and export revenues to the country*
  - *Undermine the 3 drivers of structural transformation: productive capacities, investment and technology*

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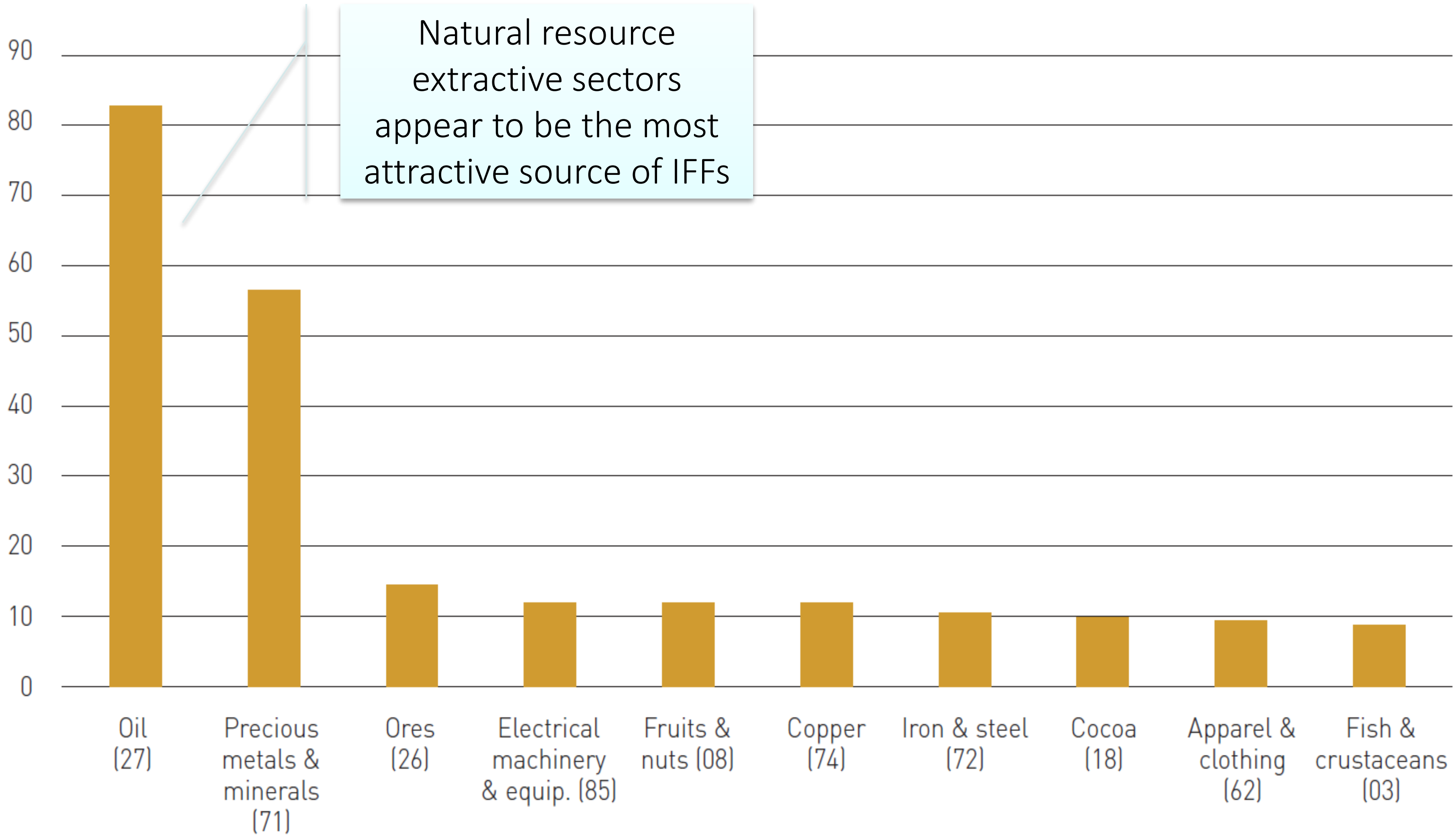
Table AIII.4

Top 10 sectors by cumulative illicit financial flows for Africa, 2000–2010 (billions of dollars, trade mispricing only)



IV. IFFs and its implications for structural transformation in Africa

- **Illustration 1: IFFs in Africa are closely linked to the natural extractive industry.**

  - Lobbying by powerful vested interest groups to keep a country exporting raw materials rather than process raw materials domestically for higher value-added products.
  - «Blood Diamonds» in Sierra Leone.
  - Diamond mining in Zimbabwe v/s Diamond processing in Botswana, though in both, industry is led by DeBeers
  - Government leadership, vision and governance matter!!

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Sierra Leone: Tax breaks for mining companies costing the State…

- According to Health Poverty Action (HPA), IFFs have cost Sierra Leone $71 million a year since 2004/05.
- HPA estimates that Sierra Leone could gain an additional $94 million through reductions in just three tax incentives over the next few years.
- The Budget Advocacy Network and National Advocacy Coalition on Extractives in Sierra Leone, estimate it is losing $199 million a year due to tax incentives; i.e. triple the health budget for 2015.
- Increased tax revenues from the extractive sector (through fewer tax incentives and transparency in mining agreements) and reduced IFFs could finance Universal Health Coverage and better health systems.

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IV. IFFs and its implications for structural transformation in Africa

- **Illustration 2: IFFs in Africa are linked to trade mispricing and tax evasion**
  - Actors with vested interests in IFFs (e.g. customs officials) likely to block investments in soft infrastructure and in trade facilitation. These foregone investments have adverse effects on competitiveness, which in turn affect incentives for domestic and foreign entrepreneurs to trade and invest in country
  - When revenue authorities have to raise tax rates to make up for losses/evasion of tax revenues by MNCs under IFFs, these higher tax rates distort incentives for economic activities

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IV. IFFs and its implications for structural transformation in Africa

- **Illustration 3**: **IFFs through Base Erosion and Profit Shifting**

  - By not combating IFFs, governments make it lucrative for MNCs not to invest profits back into local economies: loss of potential source of investment funds into infrastructure and technology

  - By fostering even more a dependence on primary commodity exports, IFFs inhibit the building of linkages across economic sectors

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V. Policy implications

- **IFFs reinforce the case for structural transformation in Africa!**
  - Scope for IFFs can be reduced if countries shift away from exporting raw primary commodities to exporting high value-added goods and services
  - But need to be accompanied by efforts at strengthening governance and institutions
  - Role of civil society as watchdogs

- Political will needed to take on board the recommendations of the High Level Panel Report.
- The AMDC says .... ?

- Governments should engage MNCs to reinvest profits into local economies (e.g. infrastructure, social services)

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V. Policy implications

- Creation of Sovereign Wealth Funds to better protect and invest revenues from natural resources.

- Public auctioning of natural resources like Diamonds

- Role for Corporate Social Responsibility

Cooperate with foreign banks and governments

- Increased cooperation and dialogue with banks combined with appeals for assistance from governments of countries in which the assets are held
- “naming and shaming” approach

- Regional integration and improved regulation have an important role to play.

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VI. Policies on IFFs: High Level Panel

Trade mispricing

•Make illegal, intentional or inaccurate stating of price quantity, quality or other aspect of trade in goods and services to manipulate or evade taxation

•Register companies for tax purposes

•Customs to use available databases to compare prices

•States to start collecting trade transaction data

Transfer pricing

•National and multilateral agencies to make fully and freely available, and in a timely manner, data on pricing of goods and services in international transactions

•African countries should urgently establish transfer pricing units

•Require MNCs to provide the transfer pricing units with a comprehensive report showing their disaggregated financial reporting on a country-by-country or subsidiary-by-subsidiary basis.

Base erosion and profit shifting (BEPS)

•Automatic exchange of tax information among African countries

•Call for an automatic exchange of tax information globally, subject to national capacity and attention to necessary confidentiality.