ILLICIT FINANCIAL FLOWS AND TRADE MISINVOICING: THE CHALLENGES FOR AFRICA

AN ATAF DISCUSSION PAPER

Leading Africa in Tax Administration

AFRICAN TAX ADMINISTRATION FORUM
FORUM SUR L'ADMINISTRATION FISCALE AFRICAINE

ILLICIT FINANCIAL FLOWS AND TRADE MISINVOICING:

THE CHALLENGES FOR AFRICA

AN ATAF DISCUSSION PAPER

JUNE 2015

AFRICAN TAX ADMINISTRATION FORUM

FORUM SUR L'ADMINISTRATION FISCALE AFRICAINE

For more information:

ATAF Secretariat
Research Directorate
Hatfield Gardens, Block G, 2nd Floor
Hatfield, Pretoria, South Africa, 0181
Tel: +27 12 451 8811
E-Mail: ebras@ataftax.org ; nmonkam@ataftax.org
www.ataftax.org

TABLE OF CONTENTS

I. EXECUTIVE SUMMARY

The Millennium Development Goals (MDGs) are set to expire in 2015 and the United Nations (UN) formally transitioned to its post-2015 development agenda, known as the Sustainable Development Goals (SDGs) which will set the global development agenda for the next 15 years. Given the realization of the incapacity to achieve the MDGs through aid and most of the economic policies implemented in the last decades, African countries have to place more emphasis on Domestic Resource Mobilization (DRM) to generate the necessary savings to attain the newly stablished goals.

However, illicit financial flows (IFFs) undermine DRM. Given that developing countries lose around US$1 trillion in illicit financial flows (IFFs) per year, which accounts for 7 times the volume of aid received, there have been calls to make control of IFFs a priority within the Sustainable Development Goals (SDGs). And it is estimated that Africa alone lost over US$1.4 trillion in illicit financial outflows in the last three decades, which amounts to approximately US$50 billion to US$80 billion annually. Therefore, curbing IFFs would have positive effects on domestic resource mobilization, especially in the context of global economic developments where dependence on development assistance is no longer a sustainable option.

Since the ability of African countries to combat IFFs is seriously impeded by socioeconomic and institutional deficiencies such as corruption, poverty, crime, inadequate or non-existing rule of law, and so forth, this paper proposes some measures such as:

- Implementing corporate transparency measures
- Taxing Africa's vast income and assets held offshore
- Changing the international tax consensus that has influenced Africa's tax systems
- Exchange of Information (EoI)
- Increasing capacity building, training, and resources for institutions and regulatory agencies for work on IFFs
- Building capacity to negotiate economic contracts effectively
- Building efficient and effective tax administrations and Customs.

In line with the High Level Panel Report that synthetized the necessary actions in the report title "Track it, Stop it, Get it!", African governments are encouraged to significantly increase their tax authority capacity by investing in human resources and capacity building, improving international tax treaties that have been negatively influencing Africa's tax systems, since they maintain the tax rules that contribute to drain the continent's resources through illicit financial outflows. Furthermore, in pursuit of the development of common values, systems and institutions as well as the promotion of self-sustaining development, ATAF member states are encouraged to be signatories of ATAF Agreement on Mutual Assistance in Tax Matters (AMATM) and the ATAF Practical Guide on Exchange of Information for Developing Countries. Finally, African governments must strengthen the cooperation and increase the level of coherent operations between customs, tax, and law enforcement officials, as well as adopting the ATAF model Double Tax Agreement (DTA). ATAF is also a partner of the Global forum on transparency and exchange of information for tax purposes through the Africa Initiative, not only to combat IFFs but also improve the mobilization of domestic resource the continent.

II. INTRODUCTION

A. What is Illicit Financial Flows (IFFs)?

Illicit Financial Flows (IFF) is defined as any money that is illegally earned, transferred or utilized. They are in general in violation of laws in their origin, or during their movement or use, and are therefore considered illicit. Unlike capital flight (which includes both licit and illicit capital), IFFs are by nature unrecorded and cannot be used as public funds or private investment capital in their country of origin (AU/ECA, 2015; Global Financial Integrity, 2014a).

B. Different components of IFFs in Africa

IFFs comprises in general three major components: 1) Corruption by government officials that includes theft, bribery and other forms of abuse of entrusted authorities. This category amounted to around 5% of IFFs; 2) Criminal activities including drug trafficking, money laundering, racketeering, counterfeiting, human trafficking, illegal arms dealing, and smuggling of contraband, fraud in the financial sector, and so forth. They account for 30% of IFFs; and, 3) International commercial transactions including tax evasion, trade misinvoicing, abusive transfer pricing, and so forth, involving mostly multinational corporations. This category accounts for 65% of IFFs (AU/ECA, 2015).

Illicit capital is general moving out of the country using two primary, detectable routes: a) the deliberate misinvoicing of external trade transactions and b) leakages from the balance of payments (Global Financial Integrity, 2014a). Trade misinvoicing is the act of misrepresenting the price or quantity of imports or exports in order to hide or accumulate money in other jurisdictions; with the motive of evading taxes, avoiding customs duties, transferring a kickback or laundering money (AU/ECA, 2015).

C. Drivers and enablers of IFFs

Some drivers and enablers of IFFs have been identified in the literature. They include:

- The desire to hide illicit wealth: the primary objective of actors engaged in IFFs is to conceal the ways and means by which illicit wealth is created and to hide the proceeds away from the public eye and law enforcement agencies.
- Poor governance: a poor business environment with high levels of corruption for example, would encourage IFFs while strong legal frameworks and enforcement agencies make it difficult for individuals and companies to move illicit resources.
- Weak regulatory structures: institutions and regulatory agencies such as financial intelligence units or anti-corruption agencies are less likely to be implemented in post-conflict countries, thus facilitating illicit financial outflows.
- Double taxation agreements (DTAs): in spite of the acknowledged benefits of such agreements, they nevertheless often include provisions that encourage IFFs such as provisions to remove or lower withholding taxes on management fees and remove limitations on intracompany loans. Additionally, the bargaining power of African countries is often undermined by inherent weak capacities.
- Tax incentives: although they often have a positive impact, they tend to be abused and thus enable IFFs. Therefore, it is essential that African countries establish regional and sub-regional standards for tax incentives to end the existing "race to the bottom".
- Existence of financial secrecy jurisdictions and/or tax havens: they result in a lack of transparency by putting in place an elaborate framework to attract financial resources irrespective of their provenance or by exploiting differences in tax rates across different jurisdictions (AU/ECA, 2015).

III. THE SCALE OF ILLICIT FINANCIAL FLOWS IN DEVELOPING COUNTRIES

A. IFFs in the international discourse on DRM

Domestic resource mobilization (DRM) is the "generation of savings domestically, as opposed to investment, loans, grants or remittances received from external sources, and their allocation to socially productive investments within the country" (AEO 2010). There are two aspects of domestic resource mobilization: the private domestic savings and the public savings. Private domestic savings are channelled by the financial sector (e.g. private banks) towards investment. The public resource mobilization is about public savings, i.e. the excess of public revenues over current government expenditure, available for governments to fund public investment in infrastructure such as roads, power plants, schools, health facilities, and so forth. Public savings come from either borrowing or taxation (AEO 2010). In this paper, we focus on how the IFFs affect the domestic revenue mobilization through taxation.

Given that the Millennium Development Goals (MDGs) are set to expire in 2015, the United Nations (UN) formally transitioned to its post-2015 development agenda, known as the Sustainable Development Goals (SDGs) which will set the global development agenda for the next 15[1] years. In an effort to support DRM in developing countries, and given that developing and emerging economies haemorrhage around US$1 trillion in illicit financial flows per year which comes to 7 times the volume of aid they receive, there have been calls to make control of IFFs a priority within the Sustainable Development Goals (SDGs) and other international initiatives (Global Financial Integrity, 2014a):

- The Global Financial Integrity (2014a) is urging the United Nations to adopt a clear and concise target stating: "by 2030, reduce illicit financial flows related to trade misinvoicing by 50 percent."
- The Zero Draft of the outcome document of the third International Conference on Financing for Development (16 March 2015) to be held in Addis Ababa, Ethiopia, from 13 to 16 July 2015[2], suggested to "strengthen national regulation and international cooperation to combat illicit financial flows (IFF), tax evasion and corruption, with the aim to substantially reduce such flows over the next 15 years, and agree to work to progressively reduce

1 In the Rio+20 outcome document, "The Future We Want" (UN Conference on Sustainable Development or Rio+20, 20-22 June 2012), member States agreed to launch a process to develop a set of Sustainable Development Goals (SDGs) which will build upon the Millennium Development Goals and converge with the post-2015 development agenda. See https://sustainabledevelopment.un.org/?menu=1300 accessed on 6 April 2015.

opportunities for tax evasion, as well as tax avoidance. We will increase transparency, including by ensuring that all payments to governments from large companies are fully transparent" (UN Zero Draft, 2015).

- The Report of the High Level Panel on Illicit Financial Flows (IFFs) from Africa, as the first African initiative to comprehensively address IFFs throughout the continent, argued that the study of illicit financial flows "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" and they represent a potential source of domestic resource mobilization for the continent, which if tapped will have positive impacts for the 2015 development agenda of Africa and beyond (AU/ECA, 2015).

B. Estimated losses from IFFs in developing countries

Arriving at credible and evidence-based estimates of illicit financial flows is not an easy task due to the difficulties inherent to the very nature of IFFs, which by definition are mostly hidden and therefore difficult to track. It is nonetheless possible to track a significant amount of IFFs based on existing work and on discrepancies in economic transactions recorded between Africa and the rest of the world (AU/ECA, 2015). One way to track IFFs is by using data governments' records of the balance of payment data and the bilateral direction of trade statistics at the World Bank and the IMF. These records reveal the gaps resulting from the fraudulent efforts to conceal the illicit capital.

According to Global Financial Integrity (GFI), illicit financial flows from developing countries and emerging economies totalled US$6.6 trillion from 2003 through 2012, with illicit outflows increasing at an average inflation-adjusted rate of 9.4% per year, roughly twice as fast as the global GDP.

In 2012, the estimated illicit financial flows from developing and emerging countries amounted to US$991.2 billion mainly stemming from crime, corruption, tax evasion, and other illicit activity. This amount was greater than the combined total of Foreign Direct Investment (FDI), US$789 billion net inward, and net Official Development Assistance (ODA), US$90 billion net inward, received by these countries that same year (Global Financial Integrity, 2014a).

During the period 2003-2012, Sub-Saharan Africa suffered the biggest loss due to illicit capital. Illicit outflows from the region averaged 5.5% of GDP per year compared to an average of 3.9% of GDP

4 *The ranking of Illicit financial outflows from the top 10 developing countries from 2003-2012 is as follows:* **Asia** *accounted for 40.3% of cumulative IFFs from the developing world during 2003-2012 (China No 1, India No 4, Malaysia No 5, Indonesia No 7, and Thailand No 8);* **Developing Europe**, *21.0% (Russia No 2);* **MENA**, *10.8% (no countries in the top 10, omitting Saudi Arabia);* **Western Hemisphere**, *19.9% (Mexico No 3 and Brazil No 6);* **Sub-Saharan Africa**, *8.0% (Nigeria No 9 and South Africa No 10) (Global Financial Integrity, 2014a).*

annually in all developing countries. The countries the most affected in the region during this period were Nigeria (US$7,922 million in 2012) and South Africa (US$29,134 million in 2012). Both countries were among the top 10 illicit financial outflows from developing countries during the 10-year period which on average accounted for 67% of the global total by volume (Global Financial Integrity, 2014a).

In addition, it is estimated that Africa lost over US$1.4 trillion in illicit financial outflows in the last three decades, which amounts to approximately US$50 billion to US$80 billion annually (AU/ECA, 2015). In a joint 2013 report, the African Development Bank (AfDB) and the Global Financial Integrity found that illicit financial flows from Africa were estimated at US$1.2 to 1.3 trillion (on an inflation-adjusted basis) between 1980 and 2009. Over this period, illicit outflows in real terms from three African regions accounted for 95% of total cumulative illicit outflows from Africa with: West and Central Africa at US$494.0 billion (37%), North Africa at US$415.6 billion (31%), and Southern Africa at US$370.0 billion (27%). In West and Central Africa, outflows were largely driven by Nigeria, the Republic of Congo, and Cote d'Ivoire while they were dominated by Egypt, Algeria, and Libya respectively in North Africa. Outflows from Southern Africa were mainly driven by South Africa, Mauritius, and Angola (AfDB and GFI, 2013).

At the sectorial level, between 2000 and 2009, more than half (i.e. 56%) of the IFFs from the African continent were concentrated in a few sectors, notably the extractive and mining industries, mainly arising from oil; precious metals and minerals; ores; iron and steel; and copper. Sectors such as edible fruit and nuts; electrical machinery and equipment; fish and crustaceans; apparel; and cacao, accounted for (each of them) between 3% and 4% of the total IFFs from the continent (AU/ECA, 2014).

Overall, the main destinations of IFF from African countries are developed countries (especially, the United States, Europe, Canada, Japan and Korea) and emerging economies (such as China, India) (AU/ECA, 2014). For instance, in 2008 76.4% of the IFFs in oil from Nigeria benefited only the United States, Spain, France, Japan and Germany. In addition, the IFFs from Africa measured through trade mispricing show high concentration in a few countries and few sectors (AU/ECA, 2015).
As a result of resources and tax revenues being drained, the affected countries are less able to finance productive infrastructure development and provide essential services such as healthcare and education, thus stifling economic growth and undermining poverty reduction (Tax Justice Network Africa & Christian Aid, 2014). Africa is estimated to need an additional US$30–US$50 billion annually to fund infrastructure projects and thus tackle the serious infrastructure constraints and the low levels of savings and investment rates that impede growth in the continent. For example, in 2012 gross capital

5 "Tackling Illicit Financial Flows and Inequality in Africa", World Economic Forum (WEF) on Africa, Abuja, Nigeria (7-9 May 2014) (http://www.weforum.org/events), see http://leadership.ng/news/369960/multinationals-account-60-illicit-financial-outflows-africa-mbeki, accessed on 6 April 2015.

6 See Economic Report on Africa 2014, http://www.uneca.org/publications/serie/Economic-Report-on-Africa, accessed on 6 April 2015.

formation rates in Nigeria and South Africa were 13% and 19% respectively, as compared to a rate of 49% in China and 35% in India. Consequently, Africa cannot afford to lose U$50 billion a in IFFs. They must be stopped in order to maximize tax revenues, keep investible resources within countries, prevent state capture, and curb criminal and corrupting activities; thus releasing desperately needed funds to finance social services, infrastructure and investment in the continent (Global Financial Integrity, 2014a; Global Financial Integrity, 2014a).

Illicit financial flows out of Africa have also a negative impact on the continent's governance agenda and political economy. Indeed IFFs undermine the ability of governments to implement economic policies that run against the powerful interest groups that oppose these policies. This is the result of financial globalization that has provided a conducive environment for capital as a class to go on 'capital strike' against undesired taxation or regulatory policies (Epstein, 2005).

The largest component of IFFs from developing countries during the period 2003-2012 was the fraudulent misinvoicing of trade transactions. It accounted for 77.8% of all illicit flows. Consequently, curtailing illicit financial flows would require addressing trade misinvoicing. The other source of IFFs is due to leakages in the balance of payments, also known as illicit hot money narrow outflows (Global Financial Integrity, 2014a).

The table below illustrates an overview of the issue of IFFS in developing and emerging countries from 2003 to 2012.

Table 1: Illicit Financial Flows from Developing Countries, 2003-2012

	Illicit Financial Flows from Developing Countries 2003-2012, Cumulative (in billions of nominal U.S. dollars)	**Illicit Financial Flows to GDP, 2003-2012** (in percent)	**Trade Mis-invoicing Outflows, 2003-2012, Cumulative** (in billions of U.S. dollars, nominal)	**Trade Mis-invoicing Outflows to IFFs, 2003-2012** (in percent)	**Illicit Hot Money Outflows, 2003-2012, Cumulative** (in billions of U.S. dollars, nominal)	**Illicit Hot Money Outflows to IFFs, 2003-2012** (in percent)	**IFFs to Total Trade, 2003-2012**	**IFFs to ODA, 2003-2012**	**IFFs to FDI, 2003-2012**
Sub-Saharan Africa	528.9	5.5	364	68.8	165	31.2	10.20%	151.90%	186.20%
Asia	2,655.6	3.7	2,251	84.8	404	15.2	6.80%	1375.50%	110.70%
Developing Europe	1,386.4	4.4	1,181	85.2	206	14.8	7.50%	1763.80%	106.00%
MENA (Middle East and North Africa)	727.4	3.7	176	24.3	551	75.7	5.10%	607.30%	126.40%
Western Hemisphere	1,288.8	3.3	1,129	87.6	160	12.4	8.80%	1869.30%	114.40%
All Developing Countries	**6,587.1**	**3.9**	**5,101**	**77.8**	**1,486**	**22.2**	**7.20%**	**814.70%**	**115.70%**

Source: Author's calculations, Global Financial Integrity (2014a).

IV. TRADE MISINVOICING IN DEVELOPING COUNTRIES

Trade misinvoicing is the falsification of the price, quality, quantity values or composition of traded goods on customs declaration forms and invoices. This is often done with the purpose of evading customs duties and domestic levies, laundering money, or exporting foreign exchange abroad, and so forth (Global Financial Integrity, 2014b; AU/ECA, 2015). Trade misinvoicing consists of four categories: import under-invoicing, import over-invoicing, export under-invoicing, and export over-invoicing. These activities often require the knowledge and approval of both the seller and the buyer in the transaction and the settled amounts are deposited into another bank account (Global Financial Integrity, 2014b).

The under-invoicing of exports occurs when the amount of exports leaving a country is under–reported in order to evade or avoid taxes on corporate profits in the country of export. It is common practice in Africa especially in the extractive industry sector. On the other hand, the overinvoicing of exports involves over-stating the amount of exports leaving a country with the intention on the part of the seller to gain extra export subsidies or tax credits or to disguise inflows of capital, so as to avoid capital controls or anti-money laundering scrutiny.

On the imports side, the under-invoicing of imports occurs when traders often under-report the amount of imports in a transaction with the objective of avoiding applicable import tariffs and value added taxes (VAT); whereas over-invoicing of import occurs when imports are over-reported in order to disguise the movement of capital out of a country, thus bypassing capital controls. It also artificially increases the importing company's input costs and thus reduces its corporate taxes paid to the government (Global Financial Integrity, 2014b; AU/ECA, 2015).

In Africa, it has been found that small and medium enterprises (SMEs) are also involved in illicit financial outflows, mostly through the misinvoicing of imports and exports, mainly to reduce customs duties (through imports under-invoicing) and benefit from export incentives (through exports overinvoicing) (AU/ECA, 2015).

---

7 *The term trade "mispricing" is often used interchangeably; however it is less accurate since it does not include manipulations to the quantity or composition of goods (Global Financial Integrity, 2014b).*

8 *Definitions: Export under-invoicing occurs when the seller secretly channels the difference between the true value of the transaction and the misinvoiced value to a foreign account. Export over-invoicing occurs when for example the parties are trying to collect excess export credits via a transaction that is actually worth less than the official invoice. Import under-invoicing occurs when the buyer or the seller falsifies the value of the trade to be less than its actual market value in order to reduce the amount of customs duties and VAT due the government. Import over-invoicing refers to hidden outflows of capital often leading to lower year-end corporate taxes due to the government in the importing country (Global Financial Integrity, 2014b).*

Trade misinvoicing accounts for a substantial portion of illicit flows of capital through developing countries which amounts to approximately US$542 billion per year on average (over a 10-year period). Trade misinvoicing represents close to 80% of this amount or US$424 billion (Global Financial Integrity, 2014b). As aforementioned, capital flight not only drains domestic resources much needed to fund African countries' development agenda, but it also exacerbates inequality and facilitates crime and corruption. A study produced by the Global Financial Integrity (GFI) analysed the issue of trade misinvoicing using case studies of Ghana, Kenya, Mozambique, Tanzania, and Uganda. The study found that trade misinvoicing is a significant source of illicit outflows and inflows of capital in each country, resulting in billions of dollars of lost investment and hundreds of millions of dollars in unrealized domestic resource mobilization as illustrated in table 2.

Table 2: Annual average trade misinvoicing figures from five African countries, 2002–2011 (1/, 2/) (in millions of U.S. Dollars)

	Export Misinvoicing		Import Misinvoicing				
Country	**Under-Invoicing**	**Over-Invoicing**	**Under-Invoicing**	**Over-Invoicing**	**Illicit Outflows**	**Illicit Inflows**	**Gross Illicit Flows**
Ghana	568	-270	-464	221	732	707	1 439
Kenya	1 029	0	-438	42	1 071	438	1 508
Mozambique	140	-79	-247	119	259	326	585
Tanzania	0	-1 034	-11	828	828	1 044	**1 873**
Uganda	26	-46	0	813	839	46	884

Source: Global Financial Integrity (2014b).
1/ Data for 2011 for Kenya, Mozambique, and Tanzania was not available at the time of writing.
2/ A negative sign indicates an inflow; a positive sign indicates an outflow.

V. MEASURES TO CURTAIL IFFS AND TRADE MISINVOICING IN AFRICA

1. Implementing corporate transparency measures

It has been argued that illicit financial flows, exacerbated by anonymous companies and tax haven secrecy undermine economic growth and tax revenues in all countries. In particular, according to past President of South Africa, Thambo Mbeki, multinational corporations operating in Africa account for about 60% of the illicit financial outflows which drain the continent's domestic reserves and deprive it of crucial investment funds.

In this context, the following recommendations can be made in the context of Africa: implementing corporate transparency measures for example through the creation of public registries of beneficial ownership information aimed at curbing the abuse of anonymous companies and the requirement that all multinational corporation publicly report their sales, profits, and taxes-paid on a country-by-country basis. In a context where anonymous companies are estimated to be the primary means for laundering the proceeds of crime, corruption, and tax evasion, governments should be able to determine which company is doing business with whom. Additionally, country-by-country reporting, through a public disclosure of revenues, profits made, losses, taxes paid, subsidiaries, and staff levels on a country-by-country basis, is essential to detect and deter tax dodging by multinational corporations, especially in the extractive industry (Rowe, Bolger, Payne, & Shubert, 2014; Global Financial Integrity, 2014b; Tax Justice Network Africa & Christian Aid, 2014).
Furthermore, a greater transparency is importan
t to put in place effective polices to address illicit financial flows out of developing countries. Governments need to be able to see where, how, and at what value trade flows are moving across their country's borders in order to effectively detect, deter, and prosecute any illegal transactions (Global Financial Integrity, 2014b).

2. Taxing Africa's vast income and assets held offshore

The buoyant growth rates in Africa over the past decade have led to some poverty reduction and some progress in sectors such as health and education. However, high levels of income inequality in sub-Saharan Africa are holding back progress and headway in human development has been limited. This is partly explained by the fact that Africa's high growth period has been accompanied with a significant increase of illicit financial flows. In effect, income inequality in Africa is considerably exacerbated by the inability of governments to tax the proceeds of growth because a substantial part of the continent's income and wealth has escaped offshore. This is fuelled by what has been called Africa's "perfect storm." It refers to a variety of factors such as relatively undiversified economies and overreliance on the natural resource sector which increase the likelihood of the continent's wealth being diverted by elites via opaque tax haven structures (Tax Justice Network Africa & Christian Aid, 2014).

In order to effectively tax Africa's vast income and assets held offshore, African countries must move beyond national initiatives and endeavour to be correctly included in, and benefit from systemic projects and reforms in international taxation, financial secrecy and tax havens (Tax Justice Network Africa & Christian Aid, 2014).

3. Changing the international tax consensus that has influenced Africa's tax systems

Led by the International Monetary Fund (IMF) and supported by other multilateral institutions, bilateral donors and tax professionals, the tax consensus over the past decades has focused on reducing corporate and, to a lesser extent, personal income tax (PIT) rates while expanding the base for consumption taxes and value added tax (VAT) in particular. This has resulted in a heavy reliance on indirect taxation at the expense of more progressive income and wealth taxes. Furthermore, the introduction of new taxes on income, wealth and property in many African countries has often been met with strong resistance by the private sector. For instance, the reintroduction of a capital gains tax on the sale of property and shares in Kenya; the introduction of windfall taxes on mineral production in Ghana and Zambia; and moreover the removal of ill-granted tax incentives that dominate tax systems in sub-Saharan Africa, especially in the extractive industry, leading to huge revenue losses. Overall, the tax consensus in Africa must not neglect direct taxation in spite of the many associated difficulties and must strive to tax income and wealth correctly, thus reducing the probability of shifting the tax burden onto the poor via an increase reliance on indirect taxation (Tax Justice Network Africa & Christian Aid, 2014).

---

9 *"Tackling Illicit Financial Flows and Inequality in Africa", World Economic Forum (WEF) on Africa, Abuja, Nigeria (7-9 May 2014) (http://www.weforum.org/events), see http://leadership.ng/news/369960/multinationals-account-60-illicit-financial-outflows-africa-mbeki, accessed on 6 April 2015.*

10 *Creation of public registries of company ownership information and country-by-country reporting for multinational corporations, see http://www.gfintegrity.org/press-release/gfi-urges-g20-action-anonymous-companies-country-country-reporting-brisbane-summit, accessed on 6 April 2015.*

4. Exchange of Information (EoI)

Co-operation between tax administrations in Africa is critical in the fight against tax evasion and tax avoidance and a key aspect of that co-operation is exchange of information (EoI). EoI is a critical tool for fighting cross-border tax evasion in developing countries. Over the last few years, a series of global initiatives to strengthen EoI have been implemented. The main driver of this campaign has been the OECD Global Forum on Transparency and Exchange of Information. The international standards on exchange of information must continue to be implemented at the international level; in addition international EoI agreements must be expanded to include developing countries and efforts must be increased to build their capacity to exchange information (OECD, 2014; Rowe, Bolger, Payne, & Shubert, 2014; Tax Justice Network Africa & Christian Aid, 2014; AU/ECA, 2015).

In the wake of increased focus on the problem of illicit financial flows, the Africa Initiative was launched. It is a 3-year project (2015-2017) aimed at raising awareness and building the tools to foster effective EoI by increasing the capacity of tax administrations on EoI. The Africa Initiative is led by ATAF (African Tax Administration Forum), CREDAF (Centre de rencontre des administrations fiscales), the Global Forum, the OECD, the World Bank, and individual African members of the Global Forum.

The exchange of information upon request and automatic exchange of information (AEoI) requirements would have tremendous implications on African countries. Consequently, the need to build capacity in the region to allow countries to fully benefit from the ongoing improvements in international tax transparency is crucial, especially when considering the challenges they face which include:

- expensive (i.e. membership fees) and resource- and skill- intensive
- gaps on legal instruments for EoI/AEoI in place in African countries
- inadequate legislation and regulatory framework to ensure availability of and access to information for exchange of information purposes
- gaps on domestic legislation in place, especially Financial Institutions reporting requirements and account opening requirements

---

11 Through the Global Forum on Transparency and Exchange of Information for Tax Purposes, with currently 126 members, the automatic information exchange will be expanded to a global scale by 2017 or by end 2018. 17 African countries are members of the Global Forum which is the premier international body for ensuring the implementation of the internationally agreed standards of transparency and exchange of information in the tax area through an in-depth peer review process; see http://www.oecd.org/tax/transparency/, accessed on 6 April 2015.

12 See http://www.oecd.org/tax/transparency/gf-african-initiative.pdf, accessed on 6 April 2015.

- issues and gaps around confidentiality and data protection rules and practices
- information Technology (IT), including information in existing data warehouses, data mining techniques, and data matching capability
- major changes needed at significant financial cost
- in many low income countries, IT systems are extremely rudimentary, so very low starting point
- lack of alignment between tax policy and tax administration
- inadequate number of Competent Authorities
- lack of capacity and capability in some tax administrations to deal with requests for exchange of information, and
- Lack of communication as to who are the designated Competent Authorities in some countries as this is the only point of contact for requests for exchange of information between countries.

Given the associated costs and considering there are few indications that AEoI can actually deliver increased revenues, the question then arises as to whether AEoI is a realistic goal for African countries.

It is important to note that the **ATAF Agreement on Mutual Assistance in Tax Matters (AMATM)**, the first of its kind in Africa, allows signatories to exchange information, with limitations, either on request, spontaneously or automatically. It also has the added advantage to allow them to share expertise and conduct joint audits and investigations. The AMATM specifically applies to all direct taxes on income or on capital as well as taxes on goods and services imposed by or on behalf of the Contracting Parties. Customs duties are excluded as these forms of assistance are already dealt with under the World Customs Organisation (WCO) conventions, regional agreements and bilateral treaties. In pursuit of the development of common values, systems and institutions as well as the promotion of self-sustaining development on the basis of collective self-reliance and the interdependence of ATAF members states, the benefits of signing up to this Agreement are vast and signatories thereto will be able to assist each other in the exchange of information, the carrying out of joint examinations and the collection of taxes.

Additionally, ATAF developed the **ATAF Practical Guide on Exchange of Information for Developing Countries**, assisted by the OECD Global Forum on Transparency and Exchange of Information and the OECD Task Force on Tax and Development. The purpose of the Guide is to:

- Assist developing countries and in particular ATAF members to improve the effective use of exchange of information in order to counteract tax evasion and avoidance
- Ensure efficient implementation of EoI while ensuring taxpayer confidentiality
- Raise the awareness on the legal instruments available for EoI; and
- Help developing countries benefit from the international cooperative environment.

5. Increasing capacity building, training, and resources for institutions and regulatory agencies for work on IFFs

African countries could benefit from a holistic approach to fighting tax crimes and other illicit flows and should strengthen their ability to detect and pursue such crimes. For example, institutions and regulatory agencies must be put in place to bring forth information about IFFs and international legal best practices for the rapid tracing, freezing and return of stolen assets must be implemented (OECD, 2014; Rowe, Bolger, Payne, & Shubert, 2014).

In Africa, when these institutions exists, they often face problems such as inadequate capacity (e.g. in equipment and relevant skills); shortages of funding (requiring them to rely on unpredictable foreign assistance); and in some cases, inadequate support from the judicial system. In addition, the duplication of responsibilities among the numerous agencies dealing with IFFs, the ineffective coordination between them, and the insufficient expertise, exacerbate the IFF phenomenon in African countries (AU/ECA, 2015).

African countries should also tighten the oversight of and the increase the transparency in international banks and offshore financial centres. They must implement the Financial Action Task Force's (FATF) anti-money laundering recommendations and ensure that regulators and law enforcement authorities (police, financial intelligence units and anti-corruption agencies) strictly enforce the anti-money laundering regulations (Global Financial Integrity, 2014a).

6. Building capacity to negotiate economic contracts effectively

As aforementioned, in spite of the acknowledged benefits of Double taxation Agreements (DTAs), they often include provisions that encourage IFFs such as provisions to remove or lower withholding taxes on management fees and remove limitations on intracompany loans. Additionally, the bargaining power of African countries is often undermined by inherent weak capacities. African countries are therefore called to adopt the model treaty proposed by the African Tax Administration Forum (ATAF) (AU/ECA, 2015). The ATAF model Double Tax Agreement (DTA):

- creates a common approach for the Region which is helpful when negotiating with States which, for example, propose an OECD approach
- is based on the majority approach of Members in light of Agreements already negotiated

---

13 *See Financial Action Task Force (FATF) at http://www.fatf-gafi.org/pages/aboutus/, accessed 16 April 2015.*

- remains a Model, therefore not legally binding but puts forward a regional view which is designed to carry more weight in negotiations outside the Region
- allows for minority views if so desired; these can be included as reservations
- results in easier negotiations between Member States as the large majority of the text should be common to both parties and therefore already be agreed, and,
- negotiation will be far easier and quicker, particularly between Members, and will in reality mainly focus on the real issues such as rates of withholding taxes on passive income, limits for permanent establishments and services.

7. Building efficient and effective tax administrations and Customs

Customs authorities in Africa are confronted to insufficient data on trade, tax, and corporate transactions in their own country, but also by the lack of data on international trade, as well as limited processes for investigating mis-valued invoices. They must be capacitated to collect the data they need to understand the magnitude of illicit flows due to trade misinvoicing and the tax revenue and investment capital forgone as a result. Customs enforcement must be boosted by equipping and training officers to better detect intentional misinvoicing of trade transactions; they must be able to track the direction of trade flows, detect if the invoices are altered in different jurisdictions, and understand how the invoice values compare to the world market prices. In this regard, access to information on who ultimately controls companies that are trading across the country's borders is essential (Global Financial Integrity, 2014b; Rowe, Bolger, Payne, & Shubert, 2014).

Tax administrations also face the shortage of technical and human capacity to deal with financial crime perpetuated by sophisticated companies and individuals, and they are struggling to enforce tax compliance against companies and elites. The large gap in remuneration between the public and private sectors in many African countries has exacerbated the issue of skill retention in public service. For example, the staff of tax agencies is regularly poached by multinationals, sometimes during ongoing investigations into their tax affairs (AU/ECA, 2015). African governments must therefore significantly increase their tax authority capacity, invest in human resources and capacity building, and strengthen the cooperation and increase the level of coherent operations between customs, tax, and law enforcement officials (Rowe, Bolger, Payne, & Shubert, 2014).

The increased use of Information and Communication Technologies (ICT) to support the operations of tax administrations in Africa, accompanied with the interfacing of ICT systems between domestic taxes and customs as well as with other government agencies, was identified as a priority of reform in many African countries, not only to allow for more effective decision-making through integrated ICT, but also to broaden the tax base and reduce tax evasion and tax avoidance. The ICT must be developed, modernized, and accompanied with required human resource capacities and skills (e.g. basic ICT training for staff) (ATAF, 2012).

Finally, African policy makers must engage their governments and join forces to collectively improve African tax policy and administration and to support the work of ATAF. The organisation has been recognised globally as the premier African voice on tax matters, representing 38 tax administrations thus far. As a Regional Tax Organisation, it has become increasingly influential in and beyond the African continent. African countries have benefited immensely from their membership and participation in ATAF and continue to improve their revenue collection capabilities.

VI. CONCLUSIONS

The current global focus on international taxation offers a unique opportunity for African Leaders to embark on their own continental taxation renaissance that besides other issues would curb the illicit outflows from the continent and promote a sustainable domestic resource mobilization. This would require for example the creation of platform for dialogue at the level of the African Union that would foster a nexus between tax policy, tax legislation and tax administration at the continental level, seek ways to improve cross-border cooperation and thereby would optimise African revenue mobilisation so as to finance the Post-2015 Development Agenda. The continent is therefore presented with a great opportunity to invest on its own structures and processes and leverage on both continental and international expertise to prevent illicit financial outflows.

It is evident that through breaking IFFs into its three components identified (commercial and criminal activities, as well as corruption), several drivers and enablers that contribute for this appalling phenomenon are perceived. The most serious impact on Africa's development efforts and of profound consequences are the loss of investment capital and revenue that could have been used to finance development programmes, preventing the undermining of the State institutions and weakening the rule of law. Therefore it is necessary to strengthen national regulation and international cooperation as well as increase transparency in the international financial system to combat illicit financial outflows.
As the Report of the High Level Panel on IFFs argues, the study of illicit financial flows is ultimately a political matter, and it requires decisions at various levels of governance. However, it is evident that there is a relative lack of knowledge about the true nature of IFFs in government circles, and they also lack various requisite capacities in law and finance to tackle IFFs effectively, with unbalanced institutional capabilities.

It is also important to recognise that trade misinvoicing accounts for a substantial portion of illicit flows of capital out of developing countries and it represents close to 80% of the capital flight that not only drains domestic resources much needed to fund African countries' development agenda, but also exacerbates inequality and facilitates crime and corruption. Given that most measurable IFFs are trade based, actions for improving capacity and accountability to curtail trade-related IFFs should be given primacy.

This paper has also pointed out that there are important measures to be taken to curtail Illicit Financial Flows and Trade Misinvoicing in Africa. For example, governments need to be able to see where, how, and at what value trade flows are moving across their country's borders in order to effectively detect, deter, and prosecute any illegal transactions, as the High Level Panel Report well stated "Track it, Stop it, Get it!". Besides implementing corporate transparency measures and taxing the vast income held offshore, it is also important to change the international tax consensus that has influenced Africa's tax systems, since they maintain the tax rules that contribute to drain the continent's resources through illicit financial outflows. This change must also include the series of global initiatives to strengthen Exchange of Information. The international agreements must be expanded to include developing countries and efforts must be increased to build their capacity to exchange information. In this regard, the importance of the ATAF Agreement on Mutual Assistance in Tax Matters (AMATM) and the ATAF Practical Guide on Exchange of Information for Developing Countries is emphasised, both important tools on this endeavour. Finally, African governments must significantly increase their tax authority capacity, invest in human resources and capacity building, strengthen the cooperation and increase the level of coherent operations between customs, tax, and law enforcement officials, as well as adopting the ATAF model Double Tax Agreement (DTA), not only to combat IFFs but also improve the domestic resource mobilization in the continent.

VII. REFERENCES

AEO. (2010). Public Resource Mobilisation and Aid. AfricanEconomicOutlook.org, AfDB, OECD, UNDP, ECA. Retrieved from http://www.africaneconomicoutlook.org/en/in-depth/public-resource-mobilisation-and-aid/

AEO. (2014). African Economic Outlook 2014, Special Theme: Global Value Chains and Africa's Industrialisation. AfDB, OECD Development Centre, UNDP.

AfDB and GFI. (2013). Illicit Financial Flows and the Problem of Net Resource Transfers from Africa: 1980-2009. Joint Report by the African Development Bank and Global Financial Integrity, May 2013. Retrieved from http://www.gfintegrity.org/storage/gfip/documents/reports/AfricaNetResources/gfi_afdb_iffs_and_the_problem_of_net_resource_transfers_from_africa_1980-2009-highres.pdf

ATAF. (2012). ATAF Regional Studies on Reform Priorities of African Tax Administrations: Africa-Wide Report. Pretoria: AFrican Tax Administration Forum (ATAF) Secretariat.

AU/ECA. (2014). Economic Report on Africa 2014, Dynamic Industrial Policy in Africa Innovative Institutions, Effective Processes and Flexible Mechanisms. United Nations Economic Commission for Africa (UNECA) and the African Union, March 2014.

AU/ECA. (2015). Illicit Financial Flow, Report of the High Level Panel on Illicit Financial Flows from Africa. AU/ECA Conference of Ministers of Finance, Planning and Economic Development, February 1 2015 . Retrieved from http://www.uneca.org/sites/default/files/publications/iff_main_report_english.pdf

Epstein, G. (2005). Capital Flight and Capital Controls in Developing Countries: an Introduction. In G. Epstein (Ed.), Capital Flight And Capital Controls In Developing Countries (pp. 3-14). Amherst, MA: Political Economy Research Institute (PERI) Publications, University of Massachusetts, Amherst.

Global Financial Integrity. (2014). Hiding in Plain Sight: Trade Misinvoicing and the Impact of Revenue Loss in Ghana, Kenya, Mozambique, Tanzania, and Uganda: 2002-2011. Global Financial Integrity, May 2014. Global Financial Integrity. (2014a). Illicit Financial Flows from Developing Countries: 2003-2012. Global Financial Integrity, December 2014.

Global Financial Integrity. (2014b). Hiding in Plain Sight: Trade Misinvoicing and the Impact of Revenue Loss in Ghana, Kenya, Mozambique, Tanzania, and Uganda: 2002-2011. Global Financial Integrity, May 2014.

OECD. (2014). Illicit Financial Flows from Developing Countries: Measuring OECD Responses. OECD Strategy on Development. Retrieved from http://www.oecd.org/corruption/Illicit_Financial_Flows_from_Developing_Countries.pdf

OECD. (2014a). Part 1 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income

Countries, July 2014. OECD July 2014.

OECD. (2014b). Part 2 of a report to G20 Development Working Group on the impact of BEPS in low income countries. OECD August 2014.

Rowe, G., Bolger, F., Payne, R., & Shubert, E. (2014). Policy Options for Addressing Illicit Financial Flows: Results from a Delphi Study. Academics Stand Against Poverty (ASAP).

Tax Justice Network Africa & Christian Aid. (2014). Africa rising? Inequalities and the essential role of fair taxation. Tax Justice Network Africa and Christian Aid, February 2014. Retrieved from http://www.christianaid.org.uk/images/Africa-tax-and-inequality-report-Feb2014.pdf

TJN-A & ActionAid International. (2012). Tax competition in East Africa: A race to the bottom? Tax Justice Network and Action Aid International, April 2012.

UN Zero Draft. (2015). Zero Draft of the Outcome Document of the Third Financing for Development Conference. United Nations, 16 March 2015. Retrieved from http://www.un.org/esa/ffd/wp-content/uploads/2015/03/1ds-zero-draft-outcome.pdf

AFRICAN TAX ADMINISTRATION FORUM

FORUM SUR L'ADMINISTRATION FISCALE AFRICAINE

+27 (0) 12 451 8800

+27 (0) 12 432 9342

Block G, Hatfield Gardens,
Pretoria, South Africa

www.facebook.com/ataftax

www.twitter.com/ataftax