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**FINAL REPORT OF THE HIGH LEVEL PANEL ON ILLICIT  
FINANCIAL FLOWS (IFF)**

# Illicit financial flows

Issues paper



United Nations  
Economic Commission for Africa





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## Introduction

1. Financing developmental efforts in Africa has proved to be costly in the past, compelling the continent to rely on external sources known as overseas development assistance. This type of assistance is often unevenly distributed, unsustainable, and in some cases, damaging to the national economies in the long run. Lessons learned from the Millennium Development Goals have prompted a fresh wave of thinking towards a post-2015 transformative developmental framework designed to ensure self-reliance for Africa. However, a structural transformation agenda will require an adequate, predictable, sustainable and integrated financing mechanism geared towards financing developmental goals (Abugre and Ndomo, 2014). Also, the continent must embark on reforms to capture currently unexplored or poorly managed resources. This includes curtailing illicit financial flows and rather transforming those funds into a powerful tool for enhancing domestic resource mobilization, as a way of furthering the continent's development.

2. Illicit financial flows are unrecorded capital flows derived from: (a) proceeds of theft, bribery and other forms of corruption by Government officials; (b) proceeds of criminal activities, including drug trading, racketeering, counterfeiting, contraband and terrorist financing; and (c) proceeds of tax evasion and laundered commercial transactions. Estimates from various recent studies including "Financing Africa's post-2015 development agenda" reveal that, from 1970 to 2008, Africa lost \$854 billion to \$1.8 trillion in illicit financial flows. The latest progress report of the High-level Panel on Illicit Financial Flows from Africa revealed that the annual average was between \$50 billion and \$148 billion a year (ECA, 2013). Commercial money (tax evasion and trade and services mispricing) through multinational companies constitute the largest component of illicit financial flows, followed by proceeds from criminal activities and corruption. The loss of funds through illicit financial flows undermines revenue generation and reduces the benefits from economic activities, particularly in the extractive sector (ECA, 2013). It also undermines Africa's ability to mobilize resources generated by such sectors to fund developmental goals. This has had an adverse welfare and distributional effect on the poor, whose income prospects for employment have dwindled (Kar and Cartwright-Smith, 2010).

## Objective

3. The present issues paper aims to:

- Identify, examine and raise awareness about the development challenges that illicit financial flows pose to Africa's transformation
- Identify important mechanisms, the dynamics and the main challenges to curtailing and redirecting illicit financial flows and their implications for Africa's economic transformation
- Establish knowledge for anchoring policy change to control and curb illicit financial flows from the continent, as part of structural transformation
- Establish appropriate policy modalities, including the mobilization support for practices that reverse such illicit financial outflows at national, regional and global levels
- Propose policies which promote a better global understanding of the scale of the problem for African economies and encourage the adoption of relevant national, regional and international guidelines and instruments, including safeguards and agreements to redress the situation

- Draw on country experiences and case studies to examine the nature of illicit financial flows and their effect on development, and tackle the challenges to efforts being made to curb their magnitude and impact.

## The broader issues

4. The issue of illicit financial flows is complex and technical in terms of factors relating to origin, destination, scale, modalities, drivers, actors and regulatory responses. The concept of illicit financial flows must be defined clearly, using the right terminology. Indeed, it has often been used interchangeably with capital flight. Capital flight has a legal component, which is registered in the books of the institution making the outward transfer, and an illegal one which is not recorded anywhere. These hidden resources merit the term illicit as they may include unrecorded capital flows that derive from criminal, corrupt (bribery and theft by Government officials) and commercial activities.

5. Money laundering, drug trafficking, racketeering, counterfeiting, dealing in contraband goods and terrorist financing account for 35 per cent of illicit financial flows globally (ECA, 2014). Money laundering was estimated at \$1.6 trillion, the illicit drug trade \$320 billion and counterfeiting \$250 billion. Also, commercial transactions by multinationals, tax evasion, laundered commercial transactions, aggressive tax avoidance through harmful tax holidays, duty waivers and mis-invoicing account for 60 per cent of global illicit financial flows. The remaining 5 per cent of these flows is driven by corruption (theft, bribery and other forms); although the figure could be much higher. This is because corruption is cross-cutting and relates to other illicit financial flows components such as organized crime, drug trafficking, money laundering, tax evasion, trade mis-invoicing, lobbying and transfer pricing by private sector businesses, which are often overlooked. Total annual illicit financial flows, according to the Economic Commission for Africa and others, is estimated at \$50 billion. This amount exceeds Africa's official development assistance. This estimate may well fall short of the actual figure, as accurate data are lacking for all transactions and for all African countries (ECA, 2012).

6. These illicit financial flows have huge repercussions in Africa and pose multiple threats. First, they drain resources and tax revenues by eroding the much-needed tax base for domestic resource mobilization. They also curb domestic savings needed to reduce the continent's annual \$31 billion infrastructure financing gap and tackle climate change and youth employment. Secondly, illicit financial flows lead to governance issues such as resource distribution, which are fraught with rent seeking rather than productivity maximization. This practice can be damaging to the State as it undermines institutions such as banks, financial intelligence units and other legal mechanisms for detecting and prosecuting perpetrators of illicit financial flows. Thirdly, these flows perpetuate Africa's economic dependence on external aid. This is reflected by the level of official development assistance in Government budget. Indeed, the official development assistance for some countries amounts to 70 per cent of total Government revenue. Lastly, the lack of political will and leadership have helped illicit financial flows to thrive in Africa. The greatest victims are the poor and the vulnerable, as resources which could have been used on poverty reduction and economic growth measures are diverted elsewhere.

## Specific issues

### Illicit financial flows and natural resources

7. In the area of natural resources, illicit financial flows occur mainly through corruption, illegal resource exploitation and tax evasion. Acts of corruption include bribes paid by companies and money embezzled from tax collection and budgetary allocations. Illegal resource exploitation has to do with undeclared corporate revenues from illegal resource exploitation and tax evasion (including smuggling and transfer pricing). These forms of illicit financial flows have dire consequences for the revenue streams of the extractive industry. Payment of bonuses, for instance, is hindered by bribes and payments outside central budget accounts. Royalties are affected by volume underreporting, value underestimation, price discount benchmarking or indexation, extortion and avoidance of fee payment. Also, corporate income taxes are declining because of transfer mispricing or over-invoicing, undue tax exemptions or rebates and company misreporting on volume or quality, inflating of operational costs and embezzlement. This situation affects development, as most countries are unable to maximize their gains from natural resource wealth, with corrupt Government officials and companies benefiting at the expense of the wider population (Le Billon, 2011).

### Illicit financial flows and governance

8. Illicit financial flows and governance are strongly interrelated, with linkages at the domestic and international levels. For instance, governance challenges caused by kleptocratic regimes, political instability, weak tax administration, unfavourable exchange rates and the absence of the rule of law are opportunities for illicit financial flows to thrive (Abugre and Ndomo, 2014). These outflows are facilitated by the establishment of shadow financial systems such as tax havens, secrecy jurisdictions, disguised corporations, anonymous trust accounts, fake foundations, trade mispricing and money laundering techniques, which enrich developed countries and other developing regions. At the national level, illicit financial flows are undermining the dynamics of macroeconomic components such as domestic savings, hard currency reserves and tax collection in African countries. This has crippled their economies and reduced them to a cycle of external borrowing and debt service payments. It has also perpetuated their dependence on external aid. In 2011, for instance, total official development assistance inflows to Africa amounted to \$50 billion, compared to \$17.4 billion in 2002. Indeed, illicit financial flows are a catalyst for increased external borrowing, creating more scope for further debt, thereby limiting public expenditure (NEPAD, 2013). They also threaten stability and security, as criminal activities such as trafficking of people, weapons and drugs take place within and across borders (ECA, 2014).

### Illicit financial flows and the private sector

9. Illicit financial flows affect the private sector in two ways. First, 60 per cent of such flows occur through mispricing or invoice manipulation by multinational and private companies to channel money abroad or launder money by bribing regulators or inspectors. These companies have a strong global presence and influence and are therefore able to do transfer pricing and evade tax through corrupt practices such as buying off national authorities. They even go as far as lobbying for the introduction of low taxes or laxer regulations during contract negotiations. The inability of African Governments to check and control such illicit acts has given free rein to multinationals to engage in mispricing of exports and imports, under-declaration of the quantities of natural



resources extracted and generous tax holidays, sold out just before the expiry period of the concessions, which actually re-emerge as an entirely different company. Secondly, illicit financial flows undermine the private sector by stifling business and entrepreneurship, and significantly reducing structural transformation and economic diversification (ECA, 2012).

## **Redirecting illicit financial flows to increase domestic resource mobilization**

10. Increasing domestic revenue mobilization is a challenge for many Governments, particularly in low-income countries.

11. According to several studies, illicit financial flows are a potential source of domestic resource mobilization for the continent.

12. They undermine Africa's fiscal policy space and deny its financial systems and Governments the opportunity to use domestic resource mobilization schemes. Tax evasion is a significant component of illicit financial flows. For example, double taxation treaties usually reduce or eliminate tax avoidance (tax payable where the business takes place) and withholding taxes (tax payable as the money crosses borders), allowing the financial transaction to go ahead unchecked. Multinational companies take advantage of different double taxation treaties to shift profits from country to country, exploiting the treaties with the lowest withholding tax rates.

13. Such staggering sums of illicit outflows have a significant economic impact on the ability of African countries to mobilize domestic resources. The proceeds of such flows undermine the continent's potential for economic transformation as they drain tax revenues and scarce foreign exchange resources, stifle growth and socioeconomic development and weaken governance. As a result, African countries become trapped in a cycle of external borrowing and debt repayment, thus limiting them to external aid dependency (NEPAD, 2013).

## **Curbing illicit financial flows to finance the adaptation costs of climate change**

14. Illicit financial flows are a major challenge to the development of Africa, which is the most vulnerable continent to the impact of climate change and the least able to cope with this change, due, in part, to its low level of economic development. Adaptation to the impact of climate change will cost African countries billions of dollars a year, increasing pressure on development budgets.

15. The continent is expected to experience increased drought and flood episodes, frequent extreme events such as hurricanes, cyclones and rising sea levels. These changes will have serious adverse consequences for many development sectors, and threaten the economies and livelihoods of many African countries. Recent research further highlights these risks and the urgency to seek solutions, considering that the current dynamic growth of the continent is mainly attributed to increased natural resource use and climate-sensitive rain-fed agriculture, vulnerable to seasonal variability and climate change (IPCC, 2013).

16. Given the potentially devastating implications of climate change on the lives and livelihoods of people, adaptation measures are being implemented throughout Africa at all levels. These, however, are not far-reaching, due to the limited budget. Adaptation costs for sub-Saharan Africa are projected to be between \$14 billion and \$15 billion per year and expected to reach

\$70 billion by 2045, if no additional mitigation action is taken (UNEP, Adaptation Gap Report). Innovative domestic climate finance opportunities such as resource savings from curbing illicit financial flows could help in financing climate change.

## **Understanding illicit financial flows and conflict in Africa**

17. According to the Inter-Governmental Action Group against Money Laundering in West Africa, extremists in the Sahel and insurgency in some African countries are obstacles to tackling the problem of illicit funds related to terrorism (Sahadath, 2014).

18. Many of the violent conflicts in the forest regions of Africa are tied to “lootable” commodities such as precious metals and rough diamonds that can be used to fuel conflict (CIFOR, 2010). Revenue from forestry is used by belligerents to purchase arms and other materials. Logging operators participate in the conflict by trafficking weapons and trading timber for arms. The sector facilitates money laundering and other financial crimes.

19. Illicit financial flows pose a threat to the stability and security of African countries, undermine institutions and democracy, and jeopardize sustainable development and the rule of law. Clearly, to deal with the problems of conflict in Africa, it is important to understand the nature and patterns of illicit financial flows.

## **Cross-cutting issues**

### **Corruption**

20. While corruption cuts across all categories of illicit financial flows, it is clear that the term is mostly associated with public sector corruption such as bribery and abuse of office (ECA, 2014). It has the potential to facilitate criminal activities such as drug trading, racketeering, counterfeiting, terrorism financing, tax evasion, trade in contraband goods and laundered commercial transactions. Private sector businesses also perpetuate these vices by bribing public officials and using their personal connections to influence administrative processes (ECA, 2013).

### **Tax havens and financial secrecy jurisdictions**

21. Tax havens and financial secrecy jurisdictions serve as destination points for illicit financial flows through tax evasion and money laundering. Their nature allows for secrecy and ease of registration, which is often taken advantage of by business owners who use fake corporations as fronts. By serving as a destination point for funds, these tax havens undermine efforts to stem illicit financial flows from Africa and may encourage some African countries to also become havens and financial secrecy jurisdictions (ECA, 2013).

### **Capacity issues**

22. Capacity constraints have made it difficult to tackle the issue of illicit financial flows. One clear example is the customs and revenue service, which is unable to deal with the issue of mispricing in the trade of goods, services and intangibles. Another area is the extractive sector, which lacks the capacity to negotiate contracts or ensure that Africa’s views are reflected in the

emerging global architecture to stem illicit financial flows. There is capacity imbalance between prosecuting authorities and multinationals, which are always able to hire the best legal and accounting experts to fight their case (ECA, 2014).

## Conclusion

23. It is imperative to curtail illicit financial flows and fight corruption and the institution of tax havens, so as to ensure the efficient and effective use of resources and domestic long-term financing. Illicit financial flows should be retained on the continent; they could be invested, saved or consumed. Much of this could be appropriately taxed to provide additional tax revenue to fund Government budget, which is often in deficit; it would also help boost domestic resource mobilization efforts. In line with this, Africa needs strong findings on mechanisms, strategies, and peer research to distinctly show the impacts of illicit financial flows on the different sectors of economic activity. Indeed, curtailing illicit financial flows could become a key delivery mechanism for sustainable development.

24. Tackling the issue of illicit financial flows requires concerted efforts by countries of origin and destination countries alike. The legal and financial approach must be transparent and the international asset recovery regime integrated, in an effort to curb these outflows and unlock the much-needed resources.

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