Symposium on IFF: Illicit Financial Flows: An Impediment to Africa’s Sustainable Development Introduction

By:

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Introduction

There is no gainsaying the fact that Illicit Financial Flows (IFFs) constitute a major impediment to Africa’s sustainable development. In fact, IFFs have a direct impact on a country’s ability to raise, retain and mobilise its own resources to finance sustainable development. Its negative impact further includes draining a country’s foreign exchange reserves, reducing domestic resource mobilization, preventing the flow of benefits of foreign direct investment, and worsening insecurity, poverty and economic inequality. Patrick Olomo stated during the 2023 African Parliamentary Network on Illicit Financial Flows and Taxation Conference that part of the reason for Africa's financing deficits is the pervasive issue of illicit financial flows to jurisdictions outside the continent. This essay is focused on IFFs in taxation and illegal commercial practices within the context of the international investment regime in Africa.

Currently, it is generally agreed that IFFs constitute a drain on the resources required for Africa's development, particularly given the domestic resource requirements for actualizing Africa's Agenda 2030 and its Agenda 2063. Therefore, it is no longer news that IFFs are of increasing concern to governments, policymakers, civil society, regional and international bodies, and there is a growing global movement towards the elimination of IFFs in the various forms in which they occur.

Presently, there is no universally agreed definition for the term "illicit financial flows". Current defini¬tions of IFFs are not only diverse but are for the most part informed by the context. According to the African Union High Level on Illicit Financial Flows from Africa (HLP), which was established by the Economic Commission for Africa (ECA) in February 2012, IFFs refers to "money that is illegally earned, transferred, or utilized. Broadly defined, they are funds acquired and transferred by taking advantage of the loopholes in the law or some other artificial arrangements aimed at circumventing the spirit of the law.

Recently, UNCTAD estimated the incidence of IFFs in Africa at $86.6 billion per year. It is necessary to note that given the hidden nature of IFFs, these are only conservative estimates. It is highly prob¬able that Africa loses far more revenue than this to IFFs annually. IFFs include money from tax evasion and other criminal activities (corruption, money laundering etc.) which undermine Africa's development and governance agenda. This loss represents about 3.7% of the continent's total Gross Domestic Product (GDP). The size of IFFs also far outstrips the amount of Official Development Assistance (ODA) and Foreign Direct Investment (FDI) to Africa per year which stands at $48 billion and $54 billion respectively. Aptly put, the main impact of IFFS is a reduction in public funds because revenue is reduced or misappropriated.

In line with its mandate to facilitate discussions and promote cooperation on critical issues regarding Africa, and to contribute to the discussions aimed at the elim¬ination of IFFs in Africa, the UN Office of the Special Advisor on Africa (OSAA) commissioned three studies in 2021 on the impact of IFFs on Africa. The studies were in relation to IFFs in the context of:

1. taxation and illegal commercial practices.

2. corruption and money laundering; and

3. terrorism and conflict.

According to the 2015 High Level Panel (HLP) Report, commercial practices constitute the largest source and are responsible for at least 65% of all IFFs in Africa. The Central Bank of Nigeria's Financial Stability Report (2014) estimated oil bunkering to be responsible for 35% of illicit financial flows in Nigeria. Another 60 % of illicit financial flows emanate from tax evasion, money laundering, aggressive tax avoidance and misinvoicing mainly by multinational corporations. This report supports the claim that commercial activities giving rise to IFFs in the case of Africa mainly take the form of aggressive tax avoidance which occurs in the form of abusive transfer pricing, trade mispricing, misinvoicing of services and intangibles and using inequitable contracts/treaties, all for purposes of tax evasion, aggressive tax avoidance and illegal export of foreign exchange. Treaty abuse or treaty shopping can also be used for tax avoidance practices. Lastly, inequitable resource con¬tracts form another channel for IFFs.

For its part, UNCTAD has defined tax and commerce-related IFFs in Africa to include "tax-avoid¬ance practices, including transfer mispricing, debt shifting, relocation of intellectual property, tax treaty shopping, tax deferral, changes in corporate structure or economic residence, and other profit-shifting schemes." The other forms of tax and commerce-related IFFs listed include "tax evasion, tariff, duty and revenue offenses, competition offenses, import/export offenses, acts against trade regulations, restrictions or embargoes and investment or stock/shares offenses." All these activities constitute IFFs when they contribute to flows across borders.

In the international investment regime, IFFs are the outcome of the inequitable treaties signed by the African host countries with the developed countries and the major drivers/enablers are the activities of powerful profit driven Multinational Enterprises (MNEs). These MNEs have taken advantage of their power and influence to execute IFFs to their benefit and the detriment of the African host countries. They have also taken advantage of the governance gaps, weak and often inadequate financial sector regulation, general institutional incapacity by governments in Africa.

Other drivers of IFFs include information asymmetries which make it difficult for governments to detect tax schemes and other commercial practices specifically designed to place the income and profits of multinational enterprises out of reach of governments. Information asymmetries are very common in the extractive industries, and this is the reason why IFFs emanating from that sector are currently among the highest.

Inequitable Contracts/ Investment Treaties

Inequitable investment treaties signed by African governments constitute another source of IFFs. They include bilateral and multilateral investment agreements that seek to restrict the power of developing countries to tax (such as the DTAs and resource contracts) and to collect other forms of revenues from multinational enterprises and individuals from countries with which they are signed.

There is no gainsaying the fact that the international investment regime evolved out of the need to provide legal protection against the abuse of power and egregious behaviour of governments. In fact, when entering into Bilateral Investment Treaties (BIT) arrangements, host states recognised that concessions had to be made for the sake of economic development. The problem lies in the fact the investment treaties signed overtly protected foreign investments to the detriment of the developing host states and their people. It can be argued that Foreign Direct Investment (FDI) boomed after the Second World War with the intention of developed countries to maximize profit on investment in developing countries. Most MNEs' main objective is to pay less tax, make extensive profits and transfer the proceeds to their country of origin. This subsequently gave rise to illicit financial flows in Africa where the continent is losing billions of dollars.

Most developing countries are party to at least one BIT due to competitive pressures to attract foreign investment to boost their economies. For instance, many developing countries waived some taxes and duties in order to provide incentives to large and powerful MNEs and to attract more foreign investment. During the BIT negotiation, there was not much concern for the needs of poorer States which was why Sornorajah, described it as a sad episode because “greed” and not “need” influenced international investment law. Unfortunately, this created an unequal bargaining power for the parties to the BITs with the developing countries at a disadvantage during the negotiation process. Consequently, so far, it is debatable whether the developing countries have been able to receive or enjoy the potential benefit of the foreign investment. Furthermore, these powerful MNEs rely on these treaties to escape paying taxes while domestic Small and Medium Enterprises (SMEs) and individual taxpayers bear the biggest burden of taxes and other forms of payments to the state. Also, these agreements deny African governments a critical opportunity to collect any form of revenue from large multinational enter¬prises even when such enterprises utilize public infrastructure to generate income, which in this case is remitted to their home states.

There are also allegations that these MNEs bribe public officials in the host countries in exchange for favourable terms including provisions for payment of less revenues than ought to be paid. For all these reasons, foreign investors, enjoy a high leverage in the negotiation and signing of investment treaties with African countries. The result is that most of these investment treaties are inequitable and favor MNEs in various ways. The revenue payments saved by relying on inequitable treaties as well as bribes paid to public officials in return for favors also constitute a major source of IFFs.

Therefore, there is no doubt that Africa’s revenue could increase significantly, if appropriate mechanisms of monitoring the flows were in place. To support this claim, Raymond Nazar called for improved tax collection systems supported by trade and investment to shield Africa from the vulnerabilities to external shocks and dependency. In his words, “Estimates show that enacting legislation to protect tax bases from losses due to tax incentives could result in an additional revenue of around $220 billion while cross-border transactions and e-commerce have the potential to generate approximately $40 billion in revenue for the African industry by 2023”.

Furthermore, there is need for policy makers in Africa to harmonize policies at regional and continental level to curb and disrupt the practice of IFFs in the continent. Since IFFs are the main causes related to the inability of Africa to achieve the Millenium Development Goals, it has now become necessary that, African governments adopt a set of strategies that should strongly discourage the activities of these IFFs. Regional Economic Communities (RECs) should adopt common policies related to punishable measures on money laundering by foreign investors. RECs should also have a common position on reporting by MNEs that should be requested to disclose a number of information for transparency sake. For instance, Africa should strengthen their anti-money laundering regimes, enforce greater transparency over company ownership, support efforts to trace, freeze and recover stolen assets, develop automatic exchanges of information systems, and tackle tax evasion.

African governments need to utilize the opportunities provided by African Continental Free Trade Area (AfCFTA)'s protocol on Investment to combat IFFs. This provides a foundation for harmonization of investment laws and practices, information exchange, enhancement of institutional capacities and transparency of ownership and control of corporations, and accountability in the public and private realms, all of which are critical for eradicating IFFs. The opportunity is provided in Article 40 of the Investment Protocol which provides that:

1. "1. Investors and their investments shall:

a. ensure that all transactions with related or affiliated companies are arms length transactions at fair market price in accordance with the domestic regulations of the Host State and relevant international best practices;

b. conduct their operations in a manner that fully complies with all applicable domestic tax laws and international rules and principles relating to base erosion and profit shifting practices; and

c. provide all information required by the Host State to ensure compliance with the applicable laws relating to taxation.

2. . State Parties shall, in accordance with the applicable international legal instruments, cooperate in the detection and prevention of transfer pricing manipulation by investors, including in the provision of information necessary to identify and prevent such practices and providing opportunities for Joint Audits within the framework of mutual administrative assistance in tax matters."

Conclusion

Illicit Financial Flows remain a critical global challenge with devastating impact on the socioeconomic development of the global community particularly Africa, therefore, curbing or eradicating it totally will accelerate efforts to achieve inclusive growth and sustainable development.

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