Symposium on IFFs: Perpetual Financial Drain: Assessing the Effect of Abusive Corporate Tax Practices in Exacerbating Africa's Illicit Financial Flows, Debt Burden, and Under-development

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As of 2021, the total external public debt in Africa is over US$726.55bn. The total public debt volume owed by African governments has risen to over US$1 trillion as of 2023 which is low compared to countries like the United States of America with a debt volume of over US$30bn as of 2023. However, the urgent peculiarity of Africa's ballooning debt volume lies in its cause, debt ownership composition and the uneven impacts of the debt burden on Africa's burgeoning development. Unsustainable public debt levels have increased following the outfall of back-to-back global crises of the COVID-19 economic downturn and the Russian-Ukraine conflict. A significant cause of Africa's debt alongside debt servicing costs is perpetual resource drainage via Illicit Financial flows (IFFs). According to the United Nations Conference on Trade and Development (UNCTAD), Africa loses over US$88.6 billion annually in illicit financial flows. Africa’s IFFs and the IFFs in other regions generally arise from trade misinvoicing, tax abuse, cross-border corruption, and transnational financial crime.

There is no universally acceptable definition of IFF. However, IFFs may be identified from certain salient characteristics and descriptions. A broad description of IFF from a development lens covers cross-border transfers of money or assets associated with illegal activities or legal transactions. IFF thus may arise from corruption proceeds, conduit tax schemes and transfers, and legitimate or illegitimate funds purposed for illegal objectives like terrorism financing. IFF may also arise from criminal activities, commercial activities like tax avoidance, trade misinvoicing, and corrupt proceeds. An existing source of polarity in IFF policy discussions addresses the fine line between legally acceptable forms of financial flows like recognized tax avoidance mechanisms and illegal commercial practices like tax evasion. Equally, the description of IFF presently does not explicitly incorporate elements of development or the harmful development impact of IFFs, especially from a revenue generation perspective through taxes. A glaring absence of the developmental impact of IFF in its descriptive scope may obscure its destructive effects in real-time and downplay the urgency in stemming IFFs, especially as Africa’s unsustainable debt levels continue to rise. IFFs should extend beyond their source and forms to include their revenue draining impacts because these impacts are most noticeable in countries- developing economies of Africa that require sufficient and low-cost financing to meet their SDG goals. Revenue mobilization for development is severely affected by aggressive tax practices like international tax evasion and tax avoidance, especially from corporate sources.

Taxation remains an important source of revenue for many African countries, especially corporate taxes. Statistical estimates indicate that the volume of revenue losses from aggressive tax avoidance in Africa alone amounts to over US$ 50 billion annually. The opportunity for tax avoidance of this magnitude is traceable to the international tax system and its foundational rules and principles that influence the actions of MNEs in a bid to maximise profit at the expense of development. The rules of residence and source taxing rights, permanent establishment rules, and other rules have contributed to the creation of Base Erosion and Profit Shifting (BEPS) strategies in facilitating tax avoidance using abusive transfer pricing, thin capitalization tools through the tax treaties and related agreements like advanced transfer pricing agreements (APAs). APAs may potentially be misused as state aid and for granting multinational enterprises (MNEs) preferential tax treatment.

Tax treaties are the primary instruments through which international tax rules especially for corporate profits are executed between countries. Tax treaties aim to eliminate double taxation, whereby different countries can tax the same cross-border income from the operation of taxing rights rules or principles. Although most rules in tax treaties may decrease the uncertainties of international movement of finance for commercial or other purposes, the burning question remains who benefits more from the removal of these uncertainties at the expense of development? Tax treaties in their current state bring several adverse effects on the revenue mobilisation interest of African countries, thereby providing an opportunity for IFFs. Tax treaties allow the classification of income for taxation between source and residence countries, and in some situations, exempt source taxing rights over certain incomes earned in a source jurisdiction. Tax treaties also limit withholding tax rates of source jurisdictions owing to their status as capital importers (source jurisdictions are mostly developing or emerging economies). For business income, tax treaties limit the taxing rights of source jurisdictions through the burdensome permanent establishment rules. The permanent establishment rule sets a relatively high business presence and activity threshold that must occur in a source taxation of profits can occur. The permanent establishment rule impliedly ties source taxing rights on business income to the permanent establishments. As a result of these rules and provisions present in tax treaties, multinational businesses may exploit favourable provisions in tax treaties through tax arbitrage and aggressively sophisticated tax planning.

Tax and trade mispricing may aid IFFs from the extreme tweaking of cross-border transaction prices between related parties through transfer pricing strategies. Transfer pricing serves as a viable tool to shift profit through artificial arrangements. These arrangements may occur through re-characterisation of income, intra-group debt and interest shifting. Intra-group financing may occur where in a group of companies under a parent company, one company operating in a high-tax jurisdiction borrows from a sister company in a low-tax jurisdiction and eventually high interest rate to reduce its tax liability. Tax mispricing may occur through the creation of a business entity operating in a preferential tax jurisdiction to hold the intangible assets of the whole company or a part of it. The tax minimization impact of these practices contributes to IFFs and underdevelopment by transferring much-needed development funds to jurisdictions where they remain generally dormant.

Preferential tax jurisdictions also known as tax havens are notorious for applying a system of unique tax benefits that perpetuate abusive tax practices that aid IFFs. Many of these jurisdictions offer low or zero taxation, secrecy of income flows, and privacy of taxpayer identity. Although several African countries have designed beneficial ownership laws, many African states still do not have or have porous beneficial ownership disclosure laws that contribute to secrecy on ownership registration and transparency that obscure the flow of income that can easily be operated through offshore shell companies. Curbing tax-related IFF can improve domestic revenue mobilisation from disclosing beneficial owners in legal business structure may deter harmful tax practices and assist in providing necessary information for tax exchange of information between tax authorities. Having strong beneficial ownership disclosure and transparency laws can help to tackle rampant illicit financial flows out of Africa in the face of rising unstainable debt levels.

Failing to give urgency to the IFF in Africa, especially from aggressive tax practices may bring intended and unintended consequences. One of the first consequences is that IFF increases global financial and economic inequality and continues the trend of concentrating wealth in a few hands. In turn, these funds may be rechannelled to African countries as debt, attracting high interest rates and debt service costs, continuing the cycle of unsustainable debt. Statistical findings illustrate that in 2021, about 40.4% of Africa’s public external debt was owed to the private sector, with 28 % held by bondholders. Also, a large chunk of public revenues mobilized between 2019 and 2021 in 25 African countries were used for interest payments and debt servicing. IFFs made through aggressive tax practices affect the consistency and stability of funds available to the African government for development. In addition to the sale of mineral resources (which is susceptible to fluctuating market prices), taxes remain the most stable source of revenue to expend on infrastructure and development projects without much dependence on loans and official development assistance (ODA). IFFs equally reduce tax revenue available to sponsor poverty-reducing initiatives and programmes as a tool for tackling underdevelopment. IFFs from aggressive tax practices may drive poverty by placing unnecessary pressure on the middle-class and domestic Small and Medium Enterprises (SMEs). This pressure comes from unevenly shifting the costs of public services and continuously increasing tax types and rates to cover the financing shortfall from MNEs' tax evasion and avoidance strategies. IFFs may also thumb down domestic and regional financing efforts channelled towards mitigating climate risks, which remains a development impediment to African countries.

African countries may take several steps to gradually limit IFFs and re-route funds towards development. Designing sound tax policies to guide the review of existing tax treaties and the negotiation of subsequent tax treaties is one of many steps. Effective tax policies may help countries to avoid signing tax treaties that limit taxing rights. In the same vein, bilateral tax treaties should also contain anti-abuse and limitation of-benefit clauses to restrict aggressive tax planning. Achieving these at the domestic and continental levels may reduce the vulnerability of African countries to substantial revenue losses from IFFs. African countries may also take necessary steps to domestically and regionally expand the scope of IFFs to include aggressive legal tax practices and their development impacts of IFFs. Likewise, there is a need for African countries to enact and fortify beneficial ownership disclosure laws. Beneficial ownership disclosure and transparency standards should be incorporated into existing corporate and existing tax laws and as anti-abuse provisions in tax agreements. African countries can also cooperate with other jurisdictions by committing to existing exchange of information on request standards and design strategies for the efficient use of exchange of information standards for tax audits.

Focusing on limiting IFF is a much better option for providing African countries with the necessary funds towards achieving Agenda 2063 and the United Nations Sustainable Development Goals. Realizing tax revenue from reducing IFFs may also reduce dependence on foreign aid. As African countries take the required steps to curb IFF, it is relevant to note that no single country can independently curb Illicit financial flows, especially from aggressive tax planning. Increasing financial transparency through consistent domestic policy implementation and international cooperation remains one of the most efficient channels to halt IFFs out of Africa.

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