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African institutional architecture to address illicit financial flows

Tackling illicit financial flows has become a priority area to achieve sustainable development and build inclusive institutions and societies around the world. In both the 2030 Agenda for Sustainable Development and the Addis Ababa Action Agenda of the Third International Conference on Financing for Development, explicit targets were adopted to address illicit financial flows. This reflects a general agreement that illicit financial flows not only drain much-needed domestic resources for sustainable development, they also erode the trust in both social contracts and governance systems and increase inequalities within and between countries.

It is widely acknowledged that Africa has put the issue of illicit financial flows firmly on the international agenda with the issuance of the report by the High-level Panel on Illicit Financial Flows from Africa, chaired by Thabo Mbeki, former President of South Africa (African Union and Economic Commission for Africa (ECA), 2015). The present policy brief examines the types, channels and status of these flows on the continent and recommends initiatives to strengthen the prevailing institutional architecture created by African Governments for curbing them.[1] The definition of illicit financial flows used in the brief is in line with the definition used in the report of the High-level Panel: financial resources that are crossing borders and that are illegally or illegitimately earned, transferred or harboured abroad.[2] In the brief, the four main sources of illicit financial flows in Africa are addressed: tax fraud in the form of excessive tax avoidance and tax evasion, trade mis-invoicing, money laundering and corruption. Each of these flows contributes to and is influenced by weak institutions, poor governance and the rule of law.

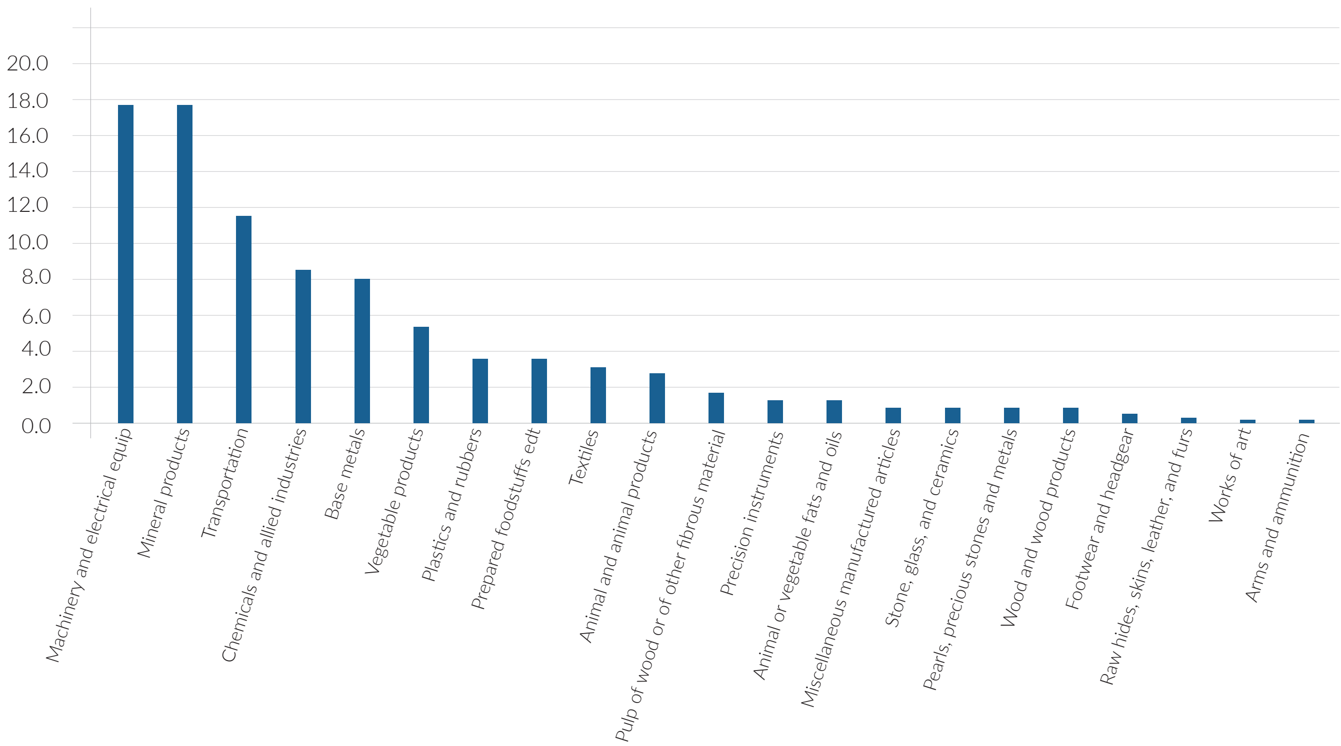
1. Types of illicit financial flows

There are four types of illicit financial flows siphoning resources off the continent. Tax avoidance is commonly perpetrated through base erosion and profit shifting. Manipulative transfer pricing is also used to exploit intragroup loans and to deliberately choose the beneficial allocation of profitable tangible or intangible assets to avoid taxes on the profits made in one jurisdiction by illicitly moving the profits across borders to jurisdictions of lower or no tax. Tax evasion stems from misdeeds that violate national tax laws to evade tax obligations. It includes trade misreporting and mis-invoicing, value added tax fraud, bribing tax officials, falsely claiming eligibility for tax incentives and failing to declare personal income or corporate profits to circumvent direct income taxation or tax obligations resulting from the sale of goods or services.

1 The present policy brief is based on the main findings from ECA (2021).

2 The definition is also in line with the definition used in United Nations Conference on Trade and Development and United Nations Office on Drugs and Crime (2020).

Average annual outflow by sector in Africa, 2000–2016 (Billions of United States dollars)



Source: United Nations, ECA (2019).

The volume of illicit financial flows that occurs through trade mis-invoicing is large and growing. According to ECA estimates, the value of these flows averaged $83 billion per year during the period 2000–2016 (United Nations, ECA, 2019), representing a total of $1.4 trillion, which is equivalent to 5.3 per cent of African gross domestic product, or 11.4 per cent of the continent's total trade for the period. An analysis of illicit outflows by economic sector reveals that the minerals sector and the machinery and electrical sector have the highest levels of mis-invoicing in Africa (see figure).

Money laundering is another crucial method of resource leakage in Africa. The value of laundered money is inversely related to the quality and efficiency of the anti-money laundering apparatus in the country concerned (United Nations, ECA, 2021). Money laundering is complex, involving multiple operations in several stages. Corruption is a cross-cutting issue influencing illicit financial flows through tax abuse, market or regulatory abuse, the abuse of political and administrative power and the laundering of the proceeds of crime. Corrupt practices are both the cause and effect of poor governance and weak institutions that are leading to the illicit transfer of substantial wealth from the continent.

2. Institutions and support from stakeholders

The quality of institutions influences illicit financial flows, as they can be both enablers and curtailers. Weak institutions harbour perverse incentives to allow illicit financial flows, which undermine governance and the enforcement of rules and order, and encourage a vicious cycle of weak institutions and illicit flows.

These flows can also weaken institutions by undermining their integrity or depriving a country of the resources needed to invest in effective rules and processes. As such, the relationship between illicit financial flows and institutions is bidirectional. Against this backdrop, the terrain of the institutional architecture to address illicit financial flows is complex, with intertwined roles and activities from various essential stakeholders (see table). A whole-of-government approach and buy-in from all relevant stakeholders from public, private and civil society is critical.

Institutional architecture for illicit financial flows

Legal and regulatory framework, culture and practices			
Roles	State bodies/agencies	Market	Civil society
Implementers	Revenue/tax authorities Trade and investment authorities Ministries of Finance and Justice	Financial institutions Private equity holders Stockbrokers Companies (international businesses) Importers/exporters	Trade unions Non-profit companies and trusts
Regulators/facilitators	Law enforcement Financial intelligence units Central bank Securities Regulation Company registers International rules	Auditing firms Law firms National and international law	Non-profit and trust laws Membership organizations
Oversight	Anti-corruption agencies Anti-money laundering agencies Prosecution agencies	Business and professional associations International compacts	Research and advocacy organizations

3. Institutional architecture

The landscape of institutional architecture in Africa is promising, but there are areas for improvement. A consortium of organizations tackling illicit financial flows was formed, incorporating the recommendations contained in the report of the High-level Panel, with the aim of coordinating African and international efforts to stop illicit financial flows and recover lost assets. For example, the following 14 institutional tools play a critical role in preventing excessive tax avoidance: policy organs, tax administration, large taxpayer unit, transfer pricing unit, supreme audit institutions, Global Forum on Transparency and Exchange of Information for Tax Purposes, automatic exchange of information, beneficial owners law, country-by-country reporting law, Convention on Mutual Administrative Assistance in Tax Matters, transfer pricing legislation, Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, Standard for Automatic Exchange of Financial Account Information in Tax Matters and multilateral competent authority agreements. Many of these tools are not in place for most of the African countries. As of January 2020, only 5 African countries had committed to their first automatic exchange of information, while 26 had yet to set a date. Following a commitment to implement an automatic exchange of information, Nigeria recovered $82.6 million through a voluntary assets and income disclosure scheme between July 2017 and September 2018, and it registered an additional 5 million new taxpayers. South Africa recovered $225 million in tax revenues from October 2016 to March 2017 through a special voluntary disclosure programme. Despite these potential gains, substantial gaps persist in the prevalence, effectiveness, efficiency and implementation of these institutional tools in the channels of trade, investment and financial systems.

The institutional framework helps to establish coordinated reporting and to harmonize the overlapping and competing mandates of the various entities in the illicit financial flows landscape. African countries have already established much of the institutional architecture and many practices for addressing such flows. For example, to address tax avoidance through transfer pricing, 31 countries have explicit legislation on transfer pricing and 8 have legislation mentioning tax avoidance that could address some aspects of transfer pricing. There are also 37 countries that have large taxpayer units responsible for the transfer pricing practices of major corporations, but there are gaps in transfer pricing legislation and in the competence of the taxpayer units to handle the specifics of tax avoidance and evasion in the natural resources sector, in particular the mineral subsector. Although many jurisdictions had adequate specific transfer pricing legislation in place, only a few enforced it, and transfer pricing audits were rarely carried out, including for mining companies. It is a priority of the existing institutions to effectively implement these institutional tools to address tax-motivated illicit financial flows. Effective implementation of institutional tools that are in place to address trade mis-invoicing, money laundering and corruption is also needed.

As such, areas for improvement in addressing illicit financial flows include effectiveness, inter-agency collaboration, coordinated reporting and the removal of duplicated and competing mandates, as well as consistent political support.

4. Whole-of-system approach

African Governments have the primary responsibility for combating illicit financial flows at the source. A whole-of-system approach comprising the strategies and measures listed below could be considered to address these flows.

National strategy: African countries should establish a comprehensive, unambiguous policy for combating illicit financial flows, with a medium- and long-term vision backed by legal and law enforcement systems. The strategy should include the establishment of an inter-agency task force to coordinate and oversee the activities of all the national agencies in the system that contribute to combating such flows. Moreover, greater awareness is needed among policymakers and oversight bodies about the significant impact of these flows in Africa.

Legislative measures: To address legal activities that country reporting and automatic exchange of information would also help to curb these flows.

Operational procedures: Prioritizing the establishment of specialized institutions and operational arrangements in the tax and trade management systems of African countries will facilitate the restriction of the massive outflows. Regular training for employees on selected topics to update their skills so that they are able to detect and address emerging offences, such as tax fraud and illegitimate profit shifting using digital platforms, would be necessary. Improving the salaries of those working for revenue authorities to make them sufficiently attractive to recruit capable staff and minimize the risk of corruption would be a key operational measure.

Special operational arrangements.: The establishment of an inter-agency task force on illicit financial flows is critical. It could include relevant implementing entities, such as tax administrations, customs authorities, financial intelligence units, anti-smuggling units, anti-corruption units, financial institutions and central banks, a special prosecutor's office and specialized courts for tax-motivated, illicit financial flow cases and international cooperation with the relevant authorities and strengthened anti-smuggling units of other tax jurisdictions.

Regional and international cooperation: Establishing institutional frameworks for a coordinated approach to address illicit financial flows at the regional and subregional levels will be instrumental in preventing these practices. Streamlined legal structures, harmonized tariff structures and robust legal mechanisms for data generation, exchange and protection require regional and international cooperation to fill gaps in information exchange, customs integrity and the oversight of commercial entities. African