

"Africa's Capital Losses: What Can Be Done?"

Edited by William Minter and Timothy Scarnecchia

Special Bulletin Editors: Léonce Ndikumana and James Boyce

Table of Contents

Page 1	<i>Introduction</i> William Minter and Timothy Scarnecchia
2-7	<i>Rich Presidents of Poor Nations: Capital Flight from Resource-Rich Countries in Africa</i> Léonce Ndikumana and James K. Boyce
8-14	<i>Macroeconomic Impact of Capital Flows in Sub-Saharan African Countries, 1980-2008</i> John Weeks
15-21	<i>Illicit Financial Flows: A Constraint on Poverty Reduction in Africa</i> Janvier D. Nkurunziza
22-28	<i>The Paradox of Capital Flight from a Capital-Starved Continent</i> Elizabeth Asiedu, John Nana Francois, and Akwasi Nti-Addae
29-35	<i>Stolen Asset Recovery: The Need for a Global Effort</i> Hippolyte Fofack
36-41	<i>Debt Audits and the Repudiation of Odious Debts</i> James K. Boyce and Léonce Ndikumana
42-47	<i>The Benefits of Country-by-Country Reporting</i> Richard Murphy
48-53	<i>Africa's Lost Tax Revenue</i> John Christensen
54-58	<i>Tax Havens: An Emerging Challenge to Africa's Development Financing</i> Nicholas Shaxson
59-62	<i>Plundering a Continent</i> Raymond Baker
63-64	<i>Information Resources on Capital Losses and Related Issues</i> William Minter

Editors' Introduction

William Minter and Tim Scarnecchia

William Minter is editor of AfricaFocus Bulletin and a member of the ACAS Advisory Council. Tim Scarnecchia is associate professor of history at Kent State University and co-editor of the ACAS Bulletin.

When presidential candidate Mitt Romney released his 2011 tax return in September 2012, Huffington Post journalist Zach Carter calculated that 267 of the 379 pages of the return were devoted to investments in foreign companies and partnerships. Of the 34 offshore companies involved, 30 were located in countries considered to be offshore tax havens by the U.S. Government Accountability Office.

But Romney is far from an exception among the rich in the United States and around the world. According to a Tax Justice Network report released in July, the global super-rich hold at least \$21 trillion in offshore accounts protected by secrecy, both in well-known tax havens such as the Cayman Islands and in a shadow financial system involving the world's largest banks and related financial industry institutions. That minimum estimate is equivalent to the size of the U.S. and Japanese economies combined.

In their 2011 pathbreaking book, *Africa's Odious Debts: How Foreign Loans and Capital Flight Bled a Continent*, Léonce Ndikumana and James Boyce demonstrate the systematic draining from Africa of resources by this global system, in which rich individuals and large companies hide income and assets from public scrutiny and from taxation by transferring them across borders. Africa's situation is aggravated by its vulnerability in the world economy, by the weaknesses of African states, and by the misguided assumption that this pattern stems only from the personal corruption of African

leaders. In fact, despite the many differences between the rich countries of the West and developing countries in Africa, the same structural realities and the same institutions are implicated in the "fiscal crises" of Europe and North America and in the failure of African states to capture and channel sufficient resources to development.

We asked Ndikumana and Boyce to put together this special issue of ACAS Bulletin, titled "Africa's Capital Losses: What Can Be Done?" The goal of this Bulletin is to provide a better understanding of the ways capital is lost and the measures that can be taken in Africa and in rich countries to stem this hemorrhaging of resources.

The issue of illicit financial flows is moving higher on the agenda of Western countries and the international community more generally. Notably, mechanisms that have been developed for tracking flows associated with drug smuggling or support for terrorism turn out to be precisely the same mechanisms needed to track resources sent across national borders to evade the tax authorities of both rich and poor countries. This is creating new opportunities to address illicit financial flows of all kinds.

The contributors to this issue are among the leading authorities in the field. They have been asked to cover specific aspects of the topic in accessible language and to suggest further resources for those seeking to explore the topics in more depth. We are delighted with the result, and we hope this issue will be widely used to draw greater attention to the topic of illicit financial flows, which is of fundamental importance for Africa and for countries around the world. The capacity of the 1% to evade their responsibilities and undermine the public good depends on a deeply entrenched network of financial secrecy that spans national boundaries. Exposing this web of institutions to public view and recapturing public resources for public goods requires joint action by scholars, policymakers, and activists that also crosses national and institutional boundaries.

Rich Presidents of Poor Nations: Capital Flight from Resource-Rich Countries in Africa

Léonce Ndikumana and James K. Boyce¹

Department of Economics and Political Economy
Research Institute (PERI), University of
Massachusetts Amherst

Léonce Ndikumana and James K. Boyce are co-authors of Africa's Odious Debts: How Foreign Loans and Capital Flight Bled a Continent (2011) and teach economics at the University of Massachusetts, Amherst. Léonce Ndikumana is Director of the African Policy Program at PERI. James K. Boyce is Director of PERI's Development, Peacebuilding and Environment Program.

Recently some African presidents have featured in media headlines not for their heroic accomplishments as leaders but for robbing their nations and siphoning their ill-gotten gains to safe havens. Since 2010, French judges have been investigating illicit wealth accumulation by the presidents of the Republic of Congo, Gabon, and Equatorial Guinea, all of whom are accused of embezzlement of public funds, money laundering, and plundering national wealth (Gurrey 2012).² In July 2012, Judge Roger Le Loire issued an arrest warrant against Teodoro Ngema Obiang, nicknamed Teodorin, the son of the president of Equatorial Guinea, on the basis of evidence of illicit wealth accumulation through embezzlement of public resources. The stylish president's son has amassed a portfolio that includes multi-million-dollar real estate in France, luxury cars, designer watches, and art objects. His personal financial transactions are

handled through his forestry company, Somagui Forestal, and bank accounts in offshore centers.

Equatorial Guinea, Gabon, and the Republic of Congo are among the richest countries in Africa with per capita incomes of \$8,649 (second), \$4,176 (5th), and \$1,253 (15th), respectively. They have massive oil reserves, ranking 7th (Gabon), 8th (Congo), and 10th (Equatorial Guinea) in the continent. While their presidents and other members of the political elite are amassing fortunes abroad, the majority of their fellow citizens live in abject poverty, lacking access to basic social services such as decent sanitation, clean drinking water, elementary school, and health care. Despite Equatorial Guinea's large oil revenues, a baby born there has less chance of living to his or her fifth birthday than the average sub-Saharan African infant. Gabon and Equatorial Guinea rank second and third to last in their rate of immunization against measles, at 55% and 51%, respectively.

The stories of opulence and extravagant lifestyles of leaders of resource-rich African countries illustrate critical leadership failures, where national leaders rob their nations instead of helping to develop them. These pathologies are perpetuated by complicit foreign special interests and a shadow international financial system that enables the perpetrators of financial crime to walk free thanks to banking secrecy. They are also facilitated by the willful blindness of Western financial institutions and governments that have tolerated this illicit accumulation of wealth over the years.

This article tells a story of poverty in the midst of plenty, a story of elite capture of resources and expropriation of the people by those entrusted to advance national interests. It is a story of endemic grand corruption, well beyond mere bribe taking and opaque management of natural resources. It reflects systematic dysfunction of the judicial system and the regulatory framework, which have been hijacked by the political elite and powerful special economic interests.

¹ The authors are grateful to Theresa Owusu-Danso for excellent research assistance.

² In October 2011, the United States also sought to seize \$70 million in assets from Teodoro Nguema Obiang (<http://www.bbc.co.uk/news/world-africa-15464988>).

The story features both domestic and foreign actors who collude in the capture of rents from natural resources and in the transfer of the proceeds to safe havens. This means that finding a solution to the problem requires looking beyond the natural resource sector and addressing dysfunctions in the entire economic and political system. It requires looking beyond the individual African countries and addressing the complicity of foreign parties, especially resource-exploitation companies that connive with corrupt leaders to embezzle wealth, banks that facilitate the illicit transfer of illicitly acquired funds, and regulators in advanced countries who turn a blind eye on illicit transactions involving African political and economic elites.

The oil bonanza

In the decades before the global financial crisis, resource-rich African countries enjoyed an explosion in their export revenue due to hikes in commodity prices, especially oil. Oil prices have resumed their ascent after the crisis. The oil boom has led to a rapid increase in oil rents collected by the governments of these countries. In 2010, the Republic of Congo collected over 61 percent of GDP in oil rents. In the same year, the oil rent/GDP ratio exceeded 40 percent in Equatorial Guinea (47%), Gabon (46%), Angola (46%) and Libya (42%). Between 2000 and 2010, oil rents more than doubled in many African oil producing countries (see Table 1). They tripled in Algeria, and went up fivefold in Angola and sixfold in Equatorial Guinea and Sudan.

As a result of the boom, oil-rich countries posted high economic growth rates over the past decade. Per capita GDP grew annually by 13.5% in Equatorial Guinea and by 7.6% in Angola. The oil bonanza vaulted these countries to middle-income status.³ Ghana has also recently joined the ranks of

³ With the exception of the Democratic Republic of Congo, all the major oil exporting countries listed in Table 1 belong to the middle-income category.

oil producers, and expected oil discoveries around the continent may further expand the club in the coming years.⁴ At least at face value, this is good news for Africa.

Underperformers in development: behind aggregate indicators

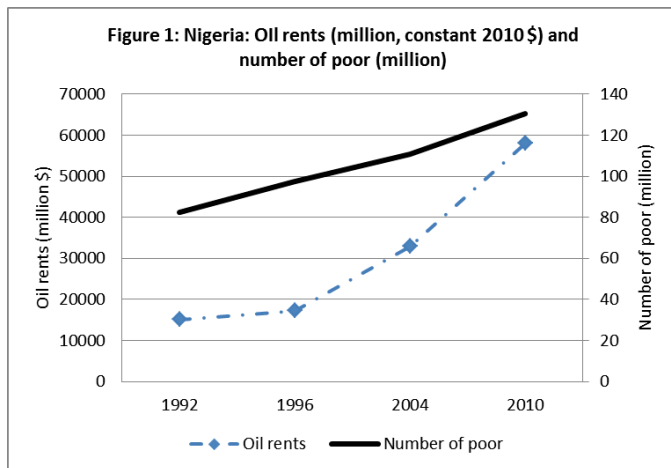
Indicators of aggregate economic performance in resource-rich African countries, however, say little about the conditions of ordinary citizens. Average national incomes are much higher in these countries than in many other African countries, but citizens with average incomes are few and far between. While some individuals are indeed extremely rich in these countries, lifting the arithmetic average, the majority of the people have received little from the resource bonanza. Their high poverty rates exceed the sub-Saharan average.⁵ In Nigeria, more than two-thirds of the population live below the national poverty line, meaning that they do not have enough income to meet basic daily needs (see Table 1). In the Democratic Republic of Congo, a country plagued by both institutional decay and civil strife, more than seven out of ten citizens are classified as poor.

The oil boom has done little to ameliorate the living conditions of the poor. In Nigeria, the number of poor has risen even as oil rents were increasing (see Figure 1). From 1992 to 2010, the number of poor Nigerians (based on a daily-purchasing-power-adjusted income threshold of \$2 per day) increased

⁴ Uganda has recently discovered oil. Substantial reserves may have also been discovered in Kenya by Tulow Oil PLC, the same company that undertook the successful oil exploration in Uganda.

⁵ Unless otherwise stated, the statistics cited in this section are from the World Bank online databases for World Development Indicators (<http://data.worldbank.org/indicator>) and Poverty and Inequality Data (<http://povertydata.worldbank.org/poverty/home/>).

from 80 million to 130 million, even as oil rents nearly quadrupled from \$15 billion to \$58 billion (in constant 2010 dollars).



Along with high levels of poverty, resource-rich countries exhibit high levels of inequality. Poverty headcounts are much higher in rural areas than in urban areas, reflecting the preference for cities in public investments and allocation of infrastructure and services. In Cameroon, 55 percent of the rural population is poor compared to 12 percent of urban dwellers. In Sudan, the poverty rate in the countryside is more than twice that in urban areas.

Inequality in access to social services exacerbates the consequences of income inequality and further retards human development. In Gabon and the Republic of Congo, while 95% of the urban population have access to improved water sources, according to official figures, the majority of rural people lack access to clean drinking water (59% in Gabon and 68% in Congo).

An important reason for the inadequate provision of public services is substandard performance in public revenue mobilization. Oil-rich countries collect relatively less taxes than their resource-scarce counterparts (AfDB, OECD, and UNECA 2010; Ndikumana and Abderrahim 2010). It is remarkable that a resource-rich country like Nigeria collects less revenue in relation to its size (9% of GDP in 2008) than a resource-scarce country like

Burundi (16.6% of GDP in 2008). The poor performance in tax mobilization is a result of, among other things, corruption in the oil industry, tax evasion, and capital flight.

Capital flight and elite capture of national resources

Natural resource-rich African countries suffered a severe financial hemorrhage through capital flight over the past decades. Recent estimates suggest that the leakages increased during the resource boom. From 1970 to 2008, Nigeria lost a staggering \$296 billion to capital flight. About \$71 billion went 'missing' from Angola between 1985 and 2008 (Ndikumana and Boyce 2011). Other oil-exporting countries also suffered substantial capital flight in the last four decades: Côte d'Ivoire (\$45 billion), the DRC (\$31 billion), Cameroon (\$24 billion), the Republic of Congo (\$24 billion), and Sudan (\$18 billion).

A key source of capital flight is the natural resource sector. The two main mechanisms are outright embezzlement of export revenues by government officials entrusted with the management of public resource exploitation and commercialization, and the under-invoicing of oil exports. In 2002, for example, the IMF reported that as much as \$4 billion of Angolan oil sale proceeds had not been accounted for over a period of four years (BBC 2002). This missing money finances private wealth accumulation by the political elite and their associates.

A critical issue in natural resource-rich countries is the lack of transparency in the management of resource revenue, and with it the lack of separation between politicians' personal assets and public assets. The stories of stolen wealth by government officials repeatedly come back to the same fact: the plunder of public resources in the context of endemic corruption. In Nigeria, some state governors have taken advantage of their autonomy in the federal system to erect financial empires.

Former governor James Ibori of Delta State became famous for embezzlement of state funds, money laundering, and bribery. His accomplishments included the diversion of \$25 million from state coffers for the purchase of a jet for personal use. Joshua Dariye, Governor of Plateau State, and Diepreye Alamieyeseigha, Governor of Bayelsa State, similarly embezzled public funds and deposited them in bank accounts abroad. Swiss and Cameroonian authorities are still pursuing the assets of Yves Michel Fotso, the former director of Cameroon Airlines, including \$31 million initially appropriated for the purchase of a government jet that subsequently disappeared. Apart from top political leaders and senior officials, their family members are often also involved in illicit financial flows, often using disguised identities, as in the case of Inge “Collins” Bongo, the first lady of Congo.⁶ The list goes on and on, and these are only the cases that are reported in the media. The plundering goes much deeper.

The plunder of national resources is not new in African autocracies. During his three-decade reign, Mobutu of Zaire (now the DRC) built what was referred to as a “kleptocracy to end all kleptocracies” (Richburg 1991).⁷ It appears that he has had many studious disciples across the continent. Mobutu was able to ride on support from Western governments that regarded him as a strategic ally in the fight against communism during the cold war. But the cold war has ended, and African kleptocrats and their accomplices are still with us.

What can be done?

The culprits in African capital flight include not only corrupt leaders but many others who gain from illicit financial flows. These include natural

⁶ Cases cited in this paragraph are documented at <http://star.worldbank.org/corruption-cases/>

⁷ For a detailed study on capital flight from the Congo under Mobutu see also Ndikumana and Boyce (1998)

resource exploitation companies, trading partners who facilitate misinvoicing, banks in safe havens, and middlemen and “deal makers” who facilitate transactions. Thus addressing the problem of capital flight and the plunder of natural resources requires a multipronged strategy, involving systemic changes aimed at establishing a culture of transparency in the management of national resources and ending the impunity traditionally enjoyed by politicians and their private associates.

African countries need to pursue strategies to encourage domestic investment and reduce the incentives of private wealth holders to smuggle their assets abroad. These economic measures will reduce the outflow of honestly acquired capital, but they will not address the endemic problems of corruption, embezzlement, and elite capture of national wealth described above, nor are they likely to entice the voluntary repatriation of stolen funds stashed in safe havens. We cannot expect the same politicians who robbed their countries to metamorphose into champions of good governance and accountability.

A key element of the solution to capital flight must therefore be the establishment and consolidation of democratic governance. To be sure, democracy is not a panacea: it can be hijacked by strong interest groups. But it offers a better framework for giving the African people a voice in the management of public resources. To support the democratic process and public oversight on management of the national economy, it is important to promote open and transparent budgeting processes, especially open disclosure of the sources and utilization of public funds including resource revenues, borrowed funds, and external aid.

It is considered best practice in the business sector to undertake thorough annual audits of companies’ finances and operations. A similar practice needs to be instituted in the management of public finance. In particular, public external debts should be subjected to independent audit to establish their legitimacy and their contribution to national

development. On the basis of these audits, external loans that fail the legitimacy test could be classified as odious and unilaterally repudiated. African countries could learn valuable lessons from the case of Ecuador, which has successfully implemented a systematic debt audit. The country saw a drastic reduction in its debt burden due to unilateral repudiation of debts that were found to be odious.⁸ Promoting transparency and accountability would benefit not only African countries but also their donors and lenders, as external resources would be more likely to be used for genuine development purposes, increasing aid effectiveness and reducing the risk of default on debt.

An important element of the strategy against capital flight is a vibrant civil society, especially an independent media. A common feature of most cases of kleptocracy described above is the lack of a free press, which helps shield financial crimes from public scrutiny.

Reforms are also needed at the international level with respect to three key players: banks, multinational corporations (MNCs) engaged in natural resource exploitation and trade, and the host governments of these banks and MNCs. Banks in global financial centers must be obliged to assist in the detection and tracking of illicit financial flows. They must be required to disclose all suspicious bank transactions, especially those involving “politically exposed persons.”⁹ This cooperation by banks is critical for the sharing of information among governments, an essential tool in the fight against corruption and capital flight. Multinational corporations must be held accountable by anti-corruption laws, such as recent legislation in the United States and the United Kingdom that

⁸ See Boyce and Ndikumana in this issue.

⁹ In 1996, the United States established the Suspicious Activity Report (SAR), a discretionary report filed to the Financial Crime Enforcement Network (FinCEN) every time a bank encounters an activity that it considers to be “suspicious.” The enforcement of the provision is hampered by the lack of a clear definition of what is ‘suspicious’ and the fact that it is discretionary.

encompasses crimes committed abroad.¹⁰ Other foreign governments should follow suit to establish a clean and level playing field in the corporate sector. They should also assist African governments in enforcing these laws on the African soil.¹¹

In the long run, a stable global financial system founded on transparency and accountability will benefit not only Africa but also the world as a whole.

¹⁰ Key recent legislation includes the U.S. Foreign Corrupt Practices Act (FCPA) (<http://www.justice.gov/criminal/fraud/fcpa/>) and the UK Bribery Act (http://www.legislation.gov.uk/ukpga/2010/23/pdfs/ukpga_2010023_en.pdf).

¹¹ For further discussion of how international reforms can assist in the battle against illicit financial flows in extractive resource sectors, see LeBillon (2011).

Table 1: Oil rents and poverty in major African oil exporters

	Oil rents			GDP per capita in 2010	GDP per capita growth (constant 2000 \$)		Poverty				
	% GDP 2010	Total amount, 2010 (million \$)	Absolute % change 2000-10		Absolute % change 2000-10	Compound annual % change 2000-10	Head count (% of population)			# of poor (million)	year
							National	Rural	Urban		
Algeria	17.6	28510	202.7	4567	24.4	2.2	n.a.	n.a.	n.a.	n.a.	n.a.
Angola	46.1	38005	425.4	4322	108.9	7.6	55.9	62.3		10.7	2000
Cameroon	7.1	1598	25.1	1147	11.1	1.1	39.9	55.0	12.2	7.9	2007
Congo, DR	3.9	512	98.6	199	21.6	2.0	71.3	75.7	61.5	54.6	2006
Congo, Rep.	61.6	7392	153.2	2970	22.1	2.0	50.1	57.7		2.6	2005
Cote d'Ivoire	4.3	976	1114.4	1161	-6.4	-0.7	15.3	20.3	9.5	8.8	2008
Egypt	5.9	12859	80.4	2698	33.9	3.0	22.0	30.0	10.6	12.1	2008
Eq. Guinea	47.3	6852	586.5	20703	254.4	13.5	n.a.	n.a.	n.a.	n.a.	n.a.
Gabon	46.4	6122	100.9	8770	2.7	0.3	32.7	44.6	29.8	0.3	2005
Libya**	42.3	26675	86.2	9957	21.7	2.2	n.a.	n.a.	n.a.	n.a.	n.a.
Nigeria	29.5	57986	140.9	1242	45.3	3.8	67.9	n.a.	n.a.	130.5	2010
Sudan	18.5	12425	535.2	1538	44.9	3.8	46.5	57.6	26.5	18.7	2009

Source: World Bank, World Development Indicators; Poverty and Inequality Data.

Note: * For Libya, oil rents and real per capita data are not available for 2010; the data refer to 2000-2009.

Macroeconomic Impact of Capital Flows in Sub-Saharan African Countries, 1980-2008

John Weeks, SOAS, University of London

John Weeks is professor emeritus of economics of the University of London, School of Oriental and African Studies. He is author of many scholarly articles and books on sub-Saharan Africa. His recent policy work includes advising the government of Sierra Leone on macroeconomic policy and the Central Bank of Kenya on its short-term forecasting model.

The financial crisis of the late 2000s generated the deepest global recession since the end of the Second World War. The recession resulted in declines in international private capital flows, including those from developed to underdeveloped countries. The fiscal stress in developed countries provoked by the recession gave rise to speculation that the fall in private flows might be followed by reductions in official development assistance. The recession-generated changes in the tempo and pattern of capital flows have major implications for the national economies in the sub-Saharan African region. Prominent among these is the need for capital account management, that is, "capital controls".

In mainstream ("neoclassical") economic analysis, an international regime of unregulated currency movements facilitates capital inflow, which can contribute to funding investment and faster growth. Even if one accepts this analytical generalization, however, one should carefully distinguish between stable and unstable components of flows, in specific between direct foreign investment and "portfolio" capital. In practice the absence of regulation allows for outflows of foreign exchange which is not

matched by inflows. In some countries "portfolio" flows are no more than an euphemism for capital flight. The focus of this article is the probable impact of the most important components of capital flows, including capital flight, on the macroeconomic performance of sub-Saharan African countries over several decades leading up to the global financial crisis.

The empirical evidence used to make my case is for 31 countries included in the Ndikumana and Boyce (2011) database. Inspection of the statistics strongly suggests that in the absence of effective regulation of the external account, as is the case in most of the sub-Saharan African countries, capital flight is quite substantial, both absolutely and compared to other types of resource flows. In many countries, capital flight plus official debt service outweigh positive flows from development assistance and direct foreign investment. The comparison of inflows and outflows leads to the conclusion that the impact of capital inflows on sub-Saharan African countries has been exaggerated.

The evidence suggests that loss of foreign exchange through debt service and capital flight may in part explain the relatively weak growth of the countries of sub-Saharan Africa. In the 2000s, outflows from debt service declined for most countries as a consequence of long-delayed debt relief, which contributed to improved growth performances in the years before the global financial crisis. National measures to limit capital flight would result in further improvement in economic performance.

Capital Flow, Growth and Instability

Categorizing Countries

To empirically assess the likely impact of capital flows I divide the 31 countries into three groups, exporters of petroleum, conflict-affected, and "others." The categories are exclusive. A consensus exists that conflict and an export sector dominated by petroleum affect macroeconomic performance. Difficulty arises in assigning

countries to these categories in an exclusive and non-arbitrary manner. For the petroleum-exporting group arbitrariness arises if a country qualifies for only a part of the time period, either because of recent discovery or substantial decline in production. But this is not a major problem for the 31 countries in the data set. Another objection to the classification might be that some mineral producers, such as Botswana, have macroeconomic characteristics similar to petroleum exporters. I take a "minimalist" approach, adhering strictly to the petroleum category and including only those whose exports have been oil-dominated for over a decade: Angola, Cameroon, Chad, Republic of Congo, Gabon, Nigeria, and Sudan.

The "conflict-affected" category presents analytical and practical difficulties. Because few countries of the world are completely free from conflict, distinctions must be made on the basis of degree. For the 31 countries over the years 1980-2008, few would object to the inclusion of Burundi, Democratic Republic of Congo, Mozambique, Rwanda, and Sierra Leone. I also include Ethiopia, whose internal conflict lasted throughout the 1980s, formally ending with Eritrean independence and a new government in Addis Ababa in 1991. In subsequent years the ebb and flow of tensions between the two countries resulted in armed hostilities during 1998-2000. In addition I include Zimbabwe, due to the severity of its internal strife, despite the absence of some formal characteristics of civil war.

A more serious categorical objection is that at least two of the petroleum-exporting countries also clearly qualify as conflict-affected, Angola and Sudan. For this analysis of capital flows, petroleum-exporting status here takes priority over conflict status. Arguments could be made to include at least three other countries: Côte d'Ivoire (civil war during 2002-2007, rekindled in 2011), South Africa (anti-apartheid conflict until the early 1990s), and Uganda (civil war until about 1985, conflict in the north since the late 1980s). I omit Côte d'Ivoire because its conflict affects less than a

third of the years covered by the statistics. The economic effects of the conflict in South Africa were not sufficiently substantial for inclusion, though the human cost of apartheid was enormous beyond measurement. Uganda is omitted for the same reason as Côte d'Ivoire. The substantial economic impact of its conflict lasted less than a third of the time period under review.

Growth and Investment

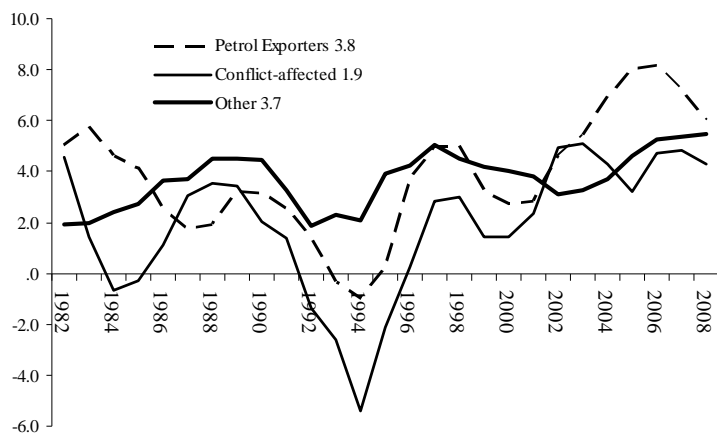
As one would expect, the group of conflict-affected countries had the lowest rate of economic growth in every decade since 1980, with twenty years of declining per capita income overall followed by weak recovery slightly above population increase. The growth rates for the petroleum exporters and the group of other countries were very close on average for the three decades as a whole, but growth among the petroleum-exporting countries was considerably more variable over time. Much of the greater variation resulted from the swings in world petroleum prices.

Also as should be expected, the share of gross investment in GDP is greatest for the petroleum-exporting countries and least for the conflict-affected group. The most important characteristic of the investment statistics for all three groups is how low they are. If the typical aggregate net capital-output ratio for sub-Saharan African countries is about four, the gross would be close to five, implying a quite modest potential growth rate of slightly above four percent for petroleum exporters and slightly below that for the group of other countries. These rates, close to the actual ones for the three decades, mean extremely modest per capita growth, requiring roughly fifty years for income per person to double.

The three-year moving average growth rates for the three groups are shown in Figure 1. This highlights the greater variability among the petroleum-exporting countries. The chart also shows especially poor growth performance in the first half of the 1990s. My working hypothesis,

demonstrated elsewhere for these countries (Weeks 2012), is that the share of investment is the major driver of the potential rate of growth in the region. This hypothesis becomes relevant below, when I link the investment rate to capital flows.

Figure 1. GDP Growth Rates, 31 sub-Saharan countries, 1980-2008 (3 year moving average)



Overview of Capital Flows

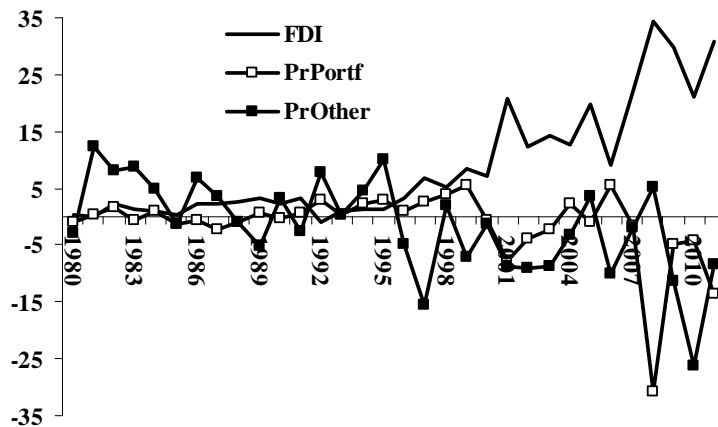
Sub-Saharan African countries receive substantially less private capital inflow than other developing regions. This is the case for portfolio flows because no country except South Africa has a developed capital market. South Africa also has the only substantial domestic market, implying limited opportunities in the other countries for direct investment except for resource extraction (which is also important in South Africa).

Figure 2 provides IMF statistics on private capital flows to all countries of the region, divided among direct investment, portfolio, and other flows. In contrast to direct investment, portfolio and other flows show extreme volatility. In addition, these two types of flows were severely affected by the global recession. During the 1990s, the aggregate non-FDI inflow to the region was US\$19 billion at prices of 2008,¹ which fell to a negative US\$49

¹ This base year is chosen because it corresponds to that used by Ndikumana and Boyce.

billion for 2000-2007. The negative flow almost doubled to US\$94 billion for the next four years, 2008-2011. Direct investment was a positive US\$118 billion during 2000-2007, and hardly changed over the next four years (US\$116 billion). The volatility of non-FDI flows compared to FDI is not difficult to explain. The former is itself not linked to any productive activity. If governments allow it, non-FDI flows generate severe balance of payments instability. The dramatic difference in behavior between FDI and non-FDI flows makes a strong circumstantial argument for regulation of short-term capital flows.

Figure 2: Net private capital flows to all sub-Saharan countries, 1980-2011 (billions of constant US dollars of 2008)



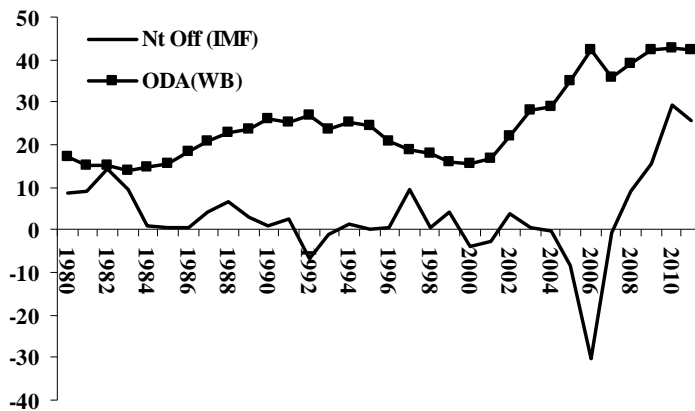
Notes: FDI is direct foreign investment, PrPortf is private portfolio flows, and PrOther is other private flows. The deflator is the US GDP price index.

Source: IMF, *World Economic Outlook 2012*, data tables.

The pattern is quite different for official development assistance and net official flows (Figure 3). The former, taken from the World Bank (*World Development Indicators*) and using the OECD definition of official assistance, increased continuously in constant prices from its low point in 2000 (US\$ 15 billion in prices of 2008, lowest total since 1984). The movement of net official flows, which includes debt servicing, was a negative US\$ 42 billion over the eight years 2000-2007. The cancelling of most sub-Saharan African official debt, especially that to the IMF and World Bank,

led to a dramatic shift to a positive net flow of US\$ 80 billion during 2008-2011.

Figure 3. Official flows to all sub-Saharan countries, 1980-2011 (billions of constant US dollars of 2008)



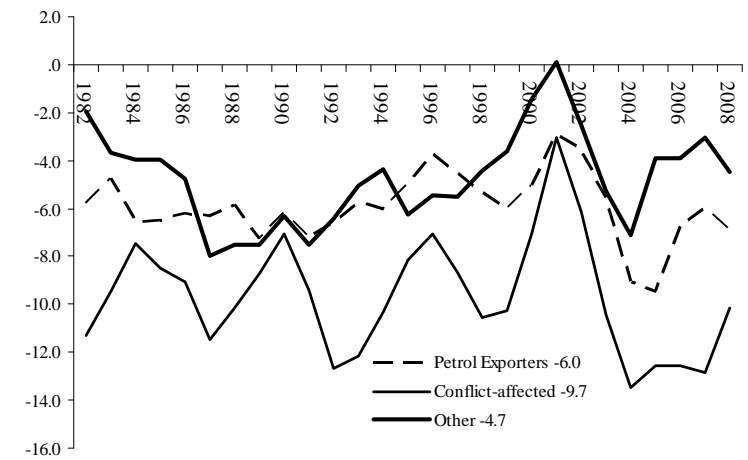
Notes: Nt Off(IMF) is net official flows, and ODA(WB) is official development assistance.

Sources: Net official flows is from IMF, *World Economic Outlook 2012*, data tables; and ODA is from World Bank, *World Development Indicators*.

The rest of this paper seeks to disaggregate the private flows at the national level for the 31 sub-Saharan African countries. As noted already, the financial structure in most countries of the region is underdeveloped and in some cases non-existent. As a result, non-FDI flows fall overwhelmingly into the category of capital flight, in the sense that they are unrelated to any domestic financial asset at any stage of their life cycle.

The Ndikumana and Boyce data allow a closer look at capital flight for these countries. Figure 4 presents those statistics, again applying a three-year moving average. Measured capital flight is negative (indicating net outflows) for each group and every year except one (the "other" country category for 2001 is marginally positive at 0.1). From the end of the 1980s to 2000-2001, capital flight shows a diminishing trend for the seventeen "other" countries, and also for the petroleum exporters, though for the latter group the tendency is weaker. This trend was sharply reversed after the early 2000s for each group, a reversal that pre-dated the Global Financial Crisis by at least five years.

Figure 4: Capital Flight as share of GDP, 31 sub-Saharan African Countries, 1980-2008 (3 year moving average)



Notes: See annex for country groups. Numbers in legend are the averages for the entire period.

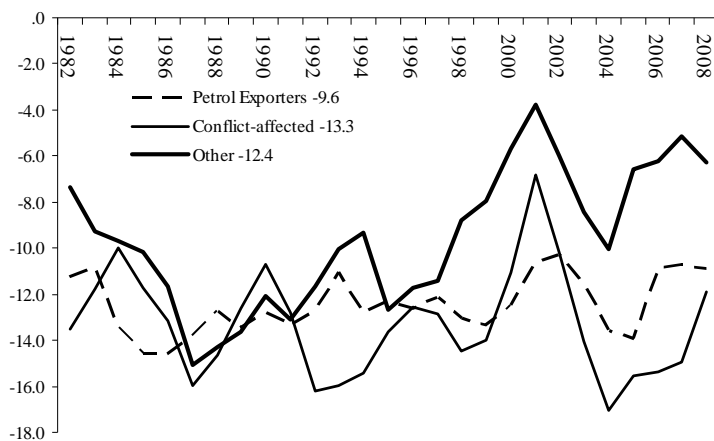
Source: Ndikumana and Boyce data base on capital flight.

The reversal is all the more striking when one inspects the data for the conflict-affected group. The conflicts in five of the seven countries in the group had ended or became less intense as the 2000s proceeded (Burundi, Ethiopia, Mozambique, Rwanda, and Sierra Leone) and in a fifth was no worse (Democratic Republic of Congo). Despite this, capital flight in the mid-to-late 2000s, averaged across the seven countries, was the greatest for the three decades both absolutely and as a portion of GDP (this was also the case for the petroleum exporters).

The other major non-trade element of external outflow in sub-Saharan African has been debt service. The absolute and relative burden of debt service increased into the early 1990s, then began to ease. When the two major outflows, capital flight and debt service, are combined (Figure 5), there appears to be an improvement for the 2000s in total outflow for the 17 "other" countries. No improvement occurs for the conflict-affected countries compared to the level of the early 1980s, though an upward (less negative) trend can be seen since the mid-2000s. The overall impression is of a similarity of the patterns for the three country

groups. This similarity may reflect underlying forces common to the three groups, with the intra-group characteristics determining levels rather than patterns of movement.

Figure 5: Capital Flight plus Debt Service as share of GDP, 31 sub-Saharan African Countries, 1980-2008 (3 year moving average)



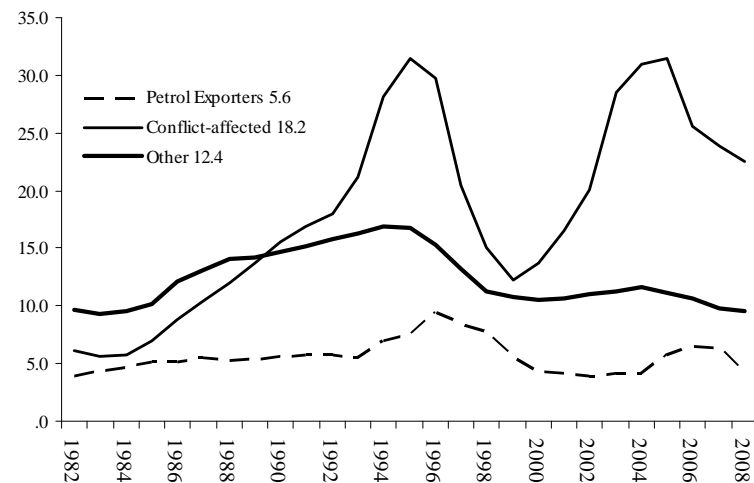
Notes: Numbers in legend are the averages for the entire period.
Source: Ndikumana and Boyce data base on capital flight.

The statistics on direct investment indicate a positive trend since the 1980s in all three groups of countries (see Figure 2), although the petroleum exporters, recipients of the largest amounts, suffered a sharp decline in the second half of the 2000s. Nevertheless, direct investment is far less than capital flight for all three groups. This is especially the case for petroleum exporters, which received the largest inflows and the largest outflows (plus 3.4 percent of GDP for FDI and minus 6.0 percent for capital flight). It is not possible to assess what part of direct investment was accounted for by mergers and acquisitions as opposed to new investment.

The upward trend in direct investment contrasts with the results for official development assistance (Figure 6). For the average share in GDP across all 31 countries for three decades, there is no significant trend. If one arbitrarily splits the time series at the mid-point (1995), for the group of 17 other countries the mean is slightly lower in the second period, and slightly higher for the petroleum exporters, but neither difference is statistically

significant. The pattern for the conflict-affected countries is one of extreme fluctuations, reflecting the large inflows that come with the end of hostilities.

Figure 6: Official Development Assistance as share of GDP, 31 sub-Saharan African Countries, 1980-2008 (3 year moving average)

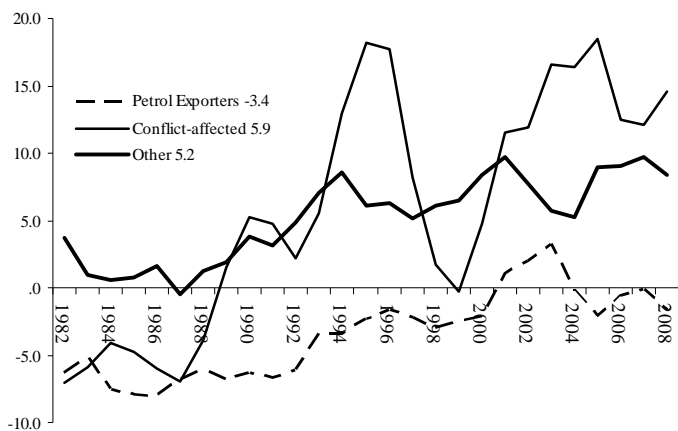


Notes: See Figure 3.

Numbers in legend are the averages for the entire period.

The last time series chart, Figure 7, combines inflow and outflow to obtain net flow. The sum of direct investment, development assistance, debt service, and capital flight produces positive values for all years but one for the group of seventeen "other" countries. From that negative value for 1987, one finds an almost continuously upward movement. However, the statistically significant positive trend occurs only during 1987-1995. From 1995 onward the pattern appears cyclical. The pattern for conflict-affected countries also appears cyclical. The petroleum exporters show a relatively long upward tendency for 1982-2004, followed by a sharp decline.

Figure 7: Net Capital Flow as share of GDP, 31 sub-Saharan African Countries, 1980-2008 (3 year moving average)



Notes: See Figure 3.

Numbers in legend are the averages for the entire period.

In assessing the net capital flow statistics, it must be stressed that only part of development assistance enters the recipient country. Leakage occurs not only due to the recycling of ODA into debt service (here netted out), but also due to payments directly to donor country suppliers that involve no material inputs, such as consultancy fees. If over the three decades in these 31 countries leakages averaged a modest twenty-five percent of gross aid, the net capital flow as portion of GDP for the 31 countries in Figure 7 would be zero. While it is not justified to draw conclusions from information we do not have, it is probable that net flows were considerably less than estimated in this study.

This review of the major flows of funds produces the following conclusions for the 29 years 1980-2008:

1. Capital flight appears strongly cyclical for all three country groups, with a striking reduction in the early 2000s that was reversed during the following years.
2. Debt service declined continuously from the mid-1990s, although prior to debt relief in the 2000s the measured decline may overstate the actual because of recycling of development assistance.
3. Direct foreign investment shows an upward trend for all three country groups, though for all it is substantially less than capital flight.

4. Official development assistance shows much the same pattern for the petroleum exporters and the group of 17 countries: upward movement until the mid-1990s, then stagnation or decline. For the conflict-affected group, development assistance has extreme peaks and troughs.

In summary, on average across all 31 countries, official development assistance was the largest of the four flows, but it was barely large enough to equal the sum of debt service and capital outflow. Direct investment was relatively small, contributing only a bit over two percent of GDP as a positive element in external flows.

Policy Measures

Reduction of capital flight is essential to increase the resources available in sub-Saharan Africa for both consumption and for public and private investment. With development assistance likely to decline as a proportion of recipient national income, stemming capital flight may be the most important growth-generating policy available to governments of sub-Saharan African countries.

Part of the responsibility for reducing capital flight lies with the governments of developed countries (Ndikumana and Boyce 2011, Chapter 5).

Governments in sub-Saharan Africa can hope for but not rely on the implementation of effective measures by developed country governments. Even if several major countries introduced effective measures, there would for the foreseeable future remain other "offshore" money centers beyond the reach of regulation.

Therefore, while pressing for effective action by external actors, sub-Saharan African governments should individually and collectively pursue their own solutions. The minimum first step would be for governments to require all foreign exchange transactions to be registered with the central bank in order to be legal. A second and broader step would be to require all businesses, donors, and non-governmental organizations to channel their foreign

exchange through the central bank. While this measure need not in itself involve currency controls, it lays the basis for such controls if necessary. Thirdly, governments could legally require their citizens to provide details of foreign bank accounts they hold.

Finally, governments in sub-Saharan Africa could consider a measure implemented in Argentina in recent years with great effectiveness. In Argentina, any person, company or institution wishing to send abroad funds exceeding a specified minimum must provide the central bank with proof that the appropriate taxes have been paid on the income generating the funds to be remitted. In addition to its other virtues, this policy conforms to the global fight against the laundering of drug money.

Capital flight is a blight that has seriously undermined growth and development in sub-Saharan Africa. Although it might not be possible to eliminate it, it should be possible to substantially reduce it. While African governments should encourage the uncertain process of reform in the developed world, there are effective measures they can take themselves to reassert control over their external capital flows.

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Illicit Financial Flows: A Constraint on Poverty Reduction in Africa

Janvier D. Nkurunziza, Officer-in-charge, Africa Section, ALDCs Division of UNCTAD, Geneva

Janvier Désiré Nkurunziza is in charge of the Africa Section, Division for Africa, Least Developed Countries and Special Programs at UNCTAD. He has also worked for UNECA, UNDP, Harvard University, University of Yaoundé, and University of Burundi. His recent research has focused on the effect of capital flight on poverty, horizontal inequality, financial systems in Africa, economics of civil wars, and applied industrial organization. He holds a doctorate in Economics from the University of Oxford, UK.

The amount of illicit financial flows out of Africa is staggering. According to estimates by Global Financial Integrity (GFI), these flows amounted to between USD 854 billion and \$1.8 trillion over the period 1970-2008 (GFI 2010). Another study found that the cumulated amount of capital flight out of Sub-Saharan Africa over the same period is in excess of \$700 billion (Ndikumana and Boyce 2011). It is ironic that out of the six countries with the highest average capital flight over the period 2000 to 2008, namely Angola, the Democratic Republic of Congo, Côte d'Ivoire, Nigeria, South Africa, and Zimbabwe, four had poverty rates above the African average in 2008. Moreover, five out of eight countries with the highest capital flight in Africa are classified as low human development countries (UNDP 2011).

Assessing the negative effect of illicit financial flows on poverty is not easy. The effect is partly through direct channels such as foregone investment in poverty-reducing programs (health, education, job creation, etc.) or indirect channels such as low investment and its resulting effect on income. This

article focuses on the latter channel, the income channel, given the direct relationship between changes in income per capita and poverty reduction. We are not aware of any study that has attempted to estimate the effect of illicit financial flows from Africa and the level of poverty in the continent, with the exception of the *African Economic Outlook 2012* (AfDB et al. 2012). The discussion in this paper partly draws from the background work the author was involved in when preparing UNDP Regional Bureau for Africa's input to this document. Before analyzing the relationship between illicit financial flows and poverty in Africa, it is useful to briefly discuss the contrasting trajectories of the two variables.

Illicit financial flows and Africa's slow poverty reduction

Some analysts argue that Africans involved in illicit financial flows are motivated by portfolio considerations as they seek abroad for higher returns on their assets. Even though this justification makes sense from a theoretical standpoint, it is hard to convincingly justify Africa's illicit financial flows on the basis of the portfolio argument only. The average investor in the continent has limited capacity to access the knowledge, information, and technology required to engage in financial market operations across continents. In contrast, given the history of weak governance characterizing many African countries, a more plausible reason behind Africa's high illicit outflows is the illicit appropriation of resources in the form of theft, corruption, mismanagement of public resources, and trade mispricing. For example, ongoing investigations in France and USA into fraudulent acquisition of assets by some African political elites have revealed that they have embezzled large sums of money used to buy mansions costing hundreds of millions of dollars apiece, luxury goods such as expensive cars, jewelry, paintings, memorabilia,

private jets, yachts, etc., mostly in Western countries.¹

Illicit financial flows increase risk and uncertainty in the domestic economy, discouraging investment and its potential positive effect on poverty reduction. Moreover, in countries where corruption allows the elites to unlawfully appropriate resources and transfer them abroad, the incentive to put in place economic and social measures that reduce poverty is weakened. Illicit financial flows allow the elites to easily access foreign services such as healthcare and education, leaving the poor to fend for themselves.

Illicit financial flows from Africa have been increasing over the last years. The highest growth rates of illicit financial outflows from Sub-Saharan Africa over the last 30 years were recorded during the period from 2000 to 2008, a period of accelerated economic growth in the continent. It is noted that this increase was partly due to trade mis-invoicing during a period of increasing trade volumes. From an average of \$17.8 billion per year in the 1990s, illicit financial flows shot to \$50.3 billion per year on average during the period from 2000 to 2008 (GFI 2010).

It is striking that Africa suffers from high levels of poverty, defined as the number of people living on less than \$1.25 per day using 2005 purchasing power parities, when so much of its resources are leaving the continent. Although sub-Saharan Africa recorded its best performance in terms of poverty reduction in the 2000s, the level of poverty was still the highest in the developing world. In 2008, the latest year for which comparable data is available, 47.5% of Africa's population were poor. This proportion is more than twice the average poverty level of all developing regions combined, which stood at 22.4% of the population. Africa's poverty

ratio was more than three times the figure in the East Asia and Pacific region where poor people represented 14.3% of the population in 2008. In absolute numbers, Africa had the second highest number of poor people with 386 million against 571 million in South Asia in 2008. In terms of poverty dynamics, Africa shows a remarkable difference relative to other developing regions. Between 1999 and 2008, the rate of poverty in Africa declined by 18%, a poor performance in comparison with East Asia and Pacific as well as Latin America and Caribbean regions where the ratio of poverty declined by 60% and 45%, respectively (World Bank 2012a).²

Several factors help explain why Africa has not been able to reduce its level of poverty as fast as other developing regions. Among the key factors is high population growth that reduces the growth of income per capita. Between 2003 and 2008, GDP per capita in Africa increased by about 2.7% per year even though the average rate of real GDP growth was 5.9% per year (AfDB et al. 2012). Second is high inequality. While economic growth strongly affects poverty elsewhere, it has a weak effect on poverty in Africa as it disproportionately benefits the wealthy more than the poor. The third factor relates to high volatility of Africa's growth. Erratic growth rates could not sustain gains in employment and poverty reduction, partly explaining the weakness of the poverty-growth relationship. Fourthly, Africa's rate of economic growth has remained low relative to the level needed to induce a meaningful effect of growth on poverty reduction. Africa's income growth elasticity of poverty is about -1.5, the lowest in the developing world. Hence, for a given rate of poverty reduction, Africa needs much higher rates of economic growth than, say, Latin America and the Caribbean region where the elasticity is -3.1 (Fosu 2011). It has been estimated that Africa needed a growth rate of 7% per year on average

1 See for example, "France Seizes Equatorial Guinea's Family Mansion" in *The Wall Street Journal*, 3 August 2012. <http://blogs.wsj.com/corruption-currents/2012/08/03/france-seizes-equatorial-guineas-family-mansion/>.

2 From a poverty ratio of 51.5% of the population in 1981 to 56.5% of the population in 1990, poverty increased to 57.9% of the population in 1999 before falling to 47.4% of the population in 2008 (World Bank 2012a).

between 2000 and 2015 in order to reach the first Millennium Development Goal (MDG) of halving the 1990 level of poverty by 2015.

Africa has been unable to reach the growth rate required to meet the first Millennium Development Goal partly as a result of low investment in economic and social sectors that have direct and indirect effects on poverty reduction. From 1980 to 2009, the decadal average ratio of gross fixed capital formation over GDP in sub-Saharan Africa was 20.1%, 17.1%, and 18.5% for the three respective decades. In the East Asia and Pacific region where poverty reduction was fastest, investment rates over GDP were 33.3%, 36.2%, and 36.3% for the same decades (World Bank, 2012b). This shows that fast poverty reduction in the East Asia and Pacific region was accompanied by high investments in economic and social infrastructure. Hence, according to some estimates, for sub-Saharan Africa to reach the economic growth needed to halve the 1990 level of poverty by 2015, the region would need \$72 billion to \$89 billion of additional annual investments (Atisophon et al. 2011). Another estimate finds that Africa needs \$40 billion annually for several years to bridge its infrastructure gap and another \$40 billion each year to maintain the existing one (Gijon 2008).

Had Africa had not lost so much resources in the form of illicit financial transfers, it is likely that poverty would have been less acute. The logic is that keeping these resources in Africa would have produced higher rates of investment, allowing African countries to invest in productivity enhancing sectors such as infrastructure, creating jobs, and raising incomes, resulting in lower levels of poverty. In contrast, the leaders of the countries with high illicit financial outflows care less about poverty reduction as the people engaged in this process are primarily the country's elites who value more their foreign assets than building domestic socioeconomic structures that would benefit the poor. Given that African elites are able to send their family members abroad for education and healthcare, they are less affected by poor domestic

service delivery.³ The majority of the population, however, has no access to foreign services. Illicit financial transfers by African elites are also a signal that African elites do not have confidence in their own economies, so they discourage investment and its potential effect on job creation and poverty reduction.

Illicit financial outflows, considered to be "dis-saving," have been found to have a strong and negative effect on the rate of investment, particularly private investment. This effect is stronger in Africa where savings and investments are strongly correlated (Nkurunziza 2010) and traditional sources of investment provide limited funding. Therefore, for Africa to win its battle against poverty, it needs to identify non-traditional sources of finance to close its large investment gap.⁴ Preferably, non-debt creating sources of investment should be sought in order to avoid accumulating unsustainable levels of public external debts whose servicing absorbs important resources that could be invested in poverty-reduction programs. Reversing the flow of illicit financial transfers and finding ways to repatriate these resources could potentially generate important resources for investment and contribute to the fight against poverty.

3 In recent years, three African presidents from countries highly affected by illicit financial transfers have died in foreign countries' clinics due to the lack of reliable health infrastructure in their own countries. In recent years, another African president has regularly traveled to Singapore and Malaysia for medical treatments.

4 Traditional sources include Official Development Assistance (ODA), Foreign Direct Investment (FDI), remittances, and domestic tax revenue. Even though many African countries have benefited from ODA, it is known to be too volatile, subject to conditionality, and tends to create dependency on external resources. For example, many donor countries have drastically reduced their ODA to Africa as a result of the economic crisis that has weakened their economies over the last four years. FDI and remittances are also volatile and too dependent on the business cycles in developed economies.

Potential effect of capital flight on poverty

Two simulations were performed to determine the potential effect of capital flight on poverty in Africa. The first was based on the incremental capital-output ratio (ICOR) approach which determines how many units of investment are needed to produce one unit of output. In other words, the simulation determines the additional units of income per capita would be generated if all flight capital had been invested in the originating country during the year it fled. The simulated effect of capital flight on poverty is derived using pre-determined income-growth elasticities of poverty.

The second simulation used capital stock instead of investment as the variable capturing capital flight. The idea is that investing capital flight in a given year has an effect on income not only during the same year but also in subsequent years. Capital stock is computed on the basis of the perpetual inventory method which derives the current stock of capital by adding current investment to the past stock of capital, net of capital depreciation. Each stock of capital generates a certain level of income, so the additional income per capita due to capital flight is determined using the ratio of capital to GDP. The effect on poverty is obtained by multiplying the income-growth elasticity of poverty and growth of GDP per capita that would result from investing flight capital. Country data on capital flight covers 33 countries over the period from 1970 to 2008, although data coverage is unequal across countries (Ndikumana and Boyce 2011).

These simulations suggest that over the period 2000 to 2008, assuming that all flight capital had been invested in Africa with at least the same productivity as actual investment, poverty would have been remarkably lower in the region than it currently is. The average rate of poverty reduction would have been 4 to 6 percentage points higher per year, on average. There are differences between oil-rich and non-resource-rich groups of countries. Using the ICOR methodology, poverty reduction

would be highest in the group of non-resource-rich countries whereas the capital stock-based method returns a better performance in the case of oil-rich countries. Discussing the reasons of these differences is beyond the scope of this article.

Considering the most recent average annual rate of poverty reduction of -2.87% per year, the results of the simulation suggest that stemming capital flight would indeed have a very significant impact on poverty reduction. Adding 4 to 6 percentage points to the current rate of poverty reduction would allow most African countries to reach the MDG1 of halving poverty by 2015, a goal that only a handful of them will reach if the most recent trend in poverty reduction is maintained. The stimulation results show that stemming capital flight would have an even stronger impact on poverty in oil-rich economies, which have the highest incidence of capital flight. Oil-rich countries as a group would comfortably meet MDG1 if their illicit financial transfers had been invested domestically.

Conclusion and some policy suggestions

The analysis and the simulations presented above make it clear that if Africa is to successfully fight against its high level of poverty, it will need to mobilize more resources to invest in poverty-reducing programs. Poverty in Africa is so widespread that traditional sources of investment such as ODA, FDI, and tax revenue have shown their limit in addressing the problem. New additional sources of finance are needed. Mobilizing the resources that leave the continent in the form of illicit financial flows could provide such needed resources. If these resources had been invested with the same efficiency as current investment, they would have added 4 to 6 percentage points to the most recent estimate of the annual rate of poverty reduction in Africa. This would allow African countries as a group to reach the Millennium Development Goal of halving the 1990 level of poverty by 2015. Hence, the fight against illicit financial transfers from Africa should be considered as a fight against poverty.

Tapping illicit financial flows for poverty reduction purposes will not be possible without strong political will from African leaders. Indeed, unless they are fully on board, they may frustrate the process given that some of them are part of the problem. Provided there is political will, action will be needed on two major fronts: first, countries will have to put in place structures that prevent new resources from illicitly leaving Africa; second, given the size of accumulated resources that have left the continent over the years, it will be important to find ways of attracting them back to the region in order to use them as investment into poverty-reducing activities.

A number of measures could be taken to minimize illicit financial outflows from Africa. First, considering that a large part of such flows result from trade mispricing, import and export operations should specifically integrate shipment inspections by specialized agencies. Their role would be to check the conformity of the physical quantities of the goods traded and their value, quality and quantity on export or import documents. International agencies, such as the *Société Générale de Surveillance* (SGS), have established an international reputation in doing just this. Second, African governments should be encouraged to ensure transparency and disclose information relating to financial inflows and outflows. Breaking the secrecy surrounding financial flows to and from Africa is crucial in the fight against illicit financial flows. For example, requiring that each country publishes information on how much it receives in debt, FDI, and ODA and showing how these resources are used would go a long way in addressing the problem of illicit financial flows. Fourth, improving the general level of economic and political governance would not only lead to the adoption of policies that are more inclusive of the poor but also minimize the corrupt practices that fuel illicit financial flows.

The second front for action could center on the repatriation of the resources which are currently

held abroad and not benefiting the continent. For example, if only a quarter of the stock of flight capital was repatriated to Africa, the ratio of the continent's domestic investment to GDP would increase from about 19% to 35% (Fofack and Ndikumana 2010), giving Africa investment ratios comparable to those in the regions that have been most successful at reducing poverty. African countries could use the Stolen Asset Recovery Initiative, a joint initiative of the World Bank and the UN Office on Drugs and Crime (UNODC), to make their case at the international level. Given the asymmetric interests between African countries that need these resources to fight against poverty and the countries and institutions hosting these assets which would like to keep them, this strategy will be successful only if the international community is united behind it.

Describing illicit financial flows as a cause of poverty in Africa could help, to some extent, if naming and shaming those holding these assets is deemed appropriate, as seen in some countries that have threatened to name and shame the biggest tax avoiders.⁵ In addition, it is important that African countries demonstrate that these resources would be used for poverty reduction and other development purposes and not be embezzled by people in power. Finally, following the example of successful experiences in capital flight repatriation, African countries could grant time-bound amnesties to anyone willing to bring back illicit assets without any risk of prosecution. Although this measure is controversial, it has allowed countries such as Italy to repatriate tens of billion of dollars. Otherwise, countries should reserve the right to prosecute any of their citizens suspected of holding abroad assets transferred illicitly from their countries of origin.

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⁵ See, for example, "Taxes and the Rich: Britain May Name and Shame Biggest Tax Avoiders" at <http://www.theworld.org/2012/07/tax-evasion-britain/>.

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Table 1: Effect of Capital Flight on GDP per Capita and Poverty (Annual, 2000-08)

	Oil-Rich	Resource-Rich	Non-Resource-Rich	Full Sample
Actual GDP per capita (a)	1101	993	399	604
Income-growth elasticity of poverty (b)	-1.35	-1.37	-1.4	-1.37
Simulations with ICOR methodology				
GDP per capita (c)	1156	1018	423	621
Annual % growth of GDP per capita (d)	5.00	2.52	6.02	2.81
Effect on poverty [(b) * (d)]	-6.74	-3.45	-8.42	-3.86
Simulations with capital stock				
GDP per capita (e)	2174	1518	582	858
Annual % growth of GDP per capita (f)	8.88	5.45	4.83	4.49
Effect on poverty [(b) * (f)]	-11.98	-7.46	-6.76	-6.15

Source: AfDB et al. (2012).

The Paradox of Capital Flight from a Capital-Starved Continent

Elizabeth Asiedu, Department of Economics, University of Kansas, asiedu@ku.edu ; **John Nana Francois**, Department of Economics, University of Kansas, jfrancois@ku.edu ; and **Akwasi Nti-Addae**, Department of Economics, University of Kansas, ntiaddak@ku.edu

Elizabeth Asiedu is Professor of Economics at the University of Kansas. She is also the President and founder of the Association for the Advancement of African Women Economists (AAWE). John Nana Francois and Akwasi Nti-Addae are doctoral candidates in economics at the University of Kansas.

Introduction

There is general consensus in the growth literature that investment is an important determinant of economic growth. The effect of investment on growth is robust (Levine and Renelt 1992; Sali-i-Martin 1997)—and the results hold for sub-Saharan African (SSA) countries (Hoefler 2002; Cinyabuguma and Putterman 2010).¹ Thus one of the explanations often cited for Africa's underdevelopment is that the region lacks the capital needed for investment. The argument is as follows: (i) Africa has a resource gap—i.e., the capital available for investment is less than the capital required to invest in order to ensure sustainable growth; (ii) Africa has to fill the

1 There is an extensive literature on the “African dummy variable” which investigates whether the factors that determine growth for SSA countries may be different from the determinants of growth in other regions. See Cinyabuguma and Putterman (2010) for a review of the literature.

resource gap in order to achieve long-term development; and (iii) Africa will have to depend on external capital to fill the resource gap. Consequently, many African policymakers have called for an increase in foreign aid. In addition, several African countries have increased their efforts to attract foreign direct investment (FDI), albeit unsuccessfully (Asiedu 2004).²

The importance of external capital as a solution to Africa's development problems is also stressed in the Millennium Declaration Goal (MDGs) document and the NEPAD framework papers of the New Partnership for Africa's Development (NEPAD).³ Specifically, page 37 of the NEPAD framework document states that:

To achieve the estimated 7 per cent annual growth rate needed to meet the International Development Goals (IDG), particularly, the goal of reducing by half the proportion of Africans living in poverty by the year 2015, Africa needs to fill an annual resource gap of 12 per cent of its GDP, or US \$64 billion. This will require increased domestic savings, as well as improvements in the public revenue collection systems. However, the bulk of the needed resources will have to be obtained from outside the continent. [emphasis by authors]

Indeed, one of the key pillars of the NEPAD strategic plan is the Capital Flows Initiative (CFI). The CFI emphasizes the importance of increasing foreign aid and international private investments, in particular, foreign direct investment (FDI) as a strategy to fill the resource gap and also reduce

2 We note that FDI to SSA has increased substantially since 2005 (see Figure 1 on page 27). However the investments are concentrated in a few countries. For example, from 2005-2010, about 63% of FDI to the region went to 5 countries: Nigeria, South Africa, Republic of Congo, Ghana and Sudan (WDI 2011).

3 NEPAD is a development plan put together by African leaders to eradicate poverty and promote growth in the region. For more on this issue, see Owusu (2003).

poverty in the region.⁴ For example, the CFI notes “NEPAD seeks to increase private capital flows to Africa, as an essential component of a sustainable long-term approach to filling the resource gap” (NEPAD 2001, 39) and “Additional Official Development Assistance is required to enable least developed countries to achieve the international development goals (IDGs)” (NEPAD 2001, 40).

The CFI also notes that capital flight exacerbates the resource gap problem—and that “this situation can only be reversed if African economies become attractive locations for residents to hold their wealth.” It is important to note that there are two types of capital flight: *illicit* and *licit* capital flights. The capital flight referenced in the NEPAD document pertains to licit financial transactions. This paper asserts that in addressing Africa’s resource gap problem, more attention should be paid to illicit capital flight. As shown in Ndikumana and Boyce (2011), illicit financial outflows are common in African countries. Furthermore, the magnitude of illicit capital flight is quite substantial, both in absolute monetary terms and relative to GDP. Illicit capital outflows widen the resource gap and therefore increase the need for foreign capital.

This paper analyzes the links between illicit capital flight, foreign aid, and FDI to Africa. We argue that Africa’s resource gap could be narrowed and even completely filled if *illicit* capital flows from the continent were curtailed. Specifically, we show that over the period 1970-2008, illicit capital flight was much larger than foreign aid as well as FDI, and comparable to the sum of FDI and aid. Thus our analysis reveals a paradox: Africa is *supposed* to be a capital-starved region—yet it is a capital exporter. We also advance reasons why relying on external resources to finance Africa’s development may be problematic.

⁴ We note that foreign direct investment has other benefits, such as technology transfer and employment creation. This paper focuses on using FDI to finance the resource gap.

Illicit capital flight, FDI, and foreign aid to sub-Saharan Africa

Table 1 (p. 26) and Figure 1 (p. 27) show trends in illicit capital outflows (ICF), FDI and foreign aid to 33 countries in SSA for which data on capital flight are available.⁵ The data are in constant 2008 dollars and cover the years 1970-2008. To facilitate the discussion, we report the average annual financial flows per country from 1980-2008 as well as the average annual flows per country for 4 sub-periods: 1970-1979; 1980-1989; 1990-1999 and 2000-2008.⁶ In order to facilitate comparison between ICF and external flows, we also report the ratio of ICF to FDI, aid and the sum of FDI and aid.

There are several notable points. First, ICF have increased substantially over time. On the average, ICF in 2000-08 were about three times ICF in 1970-1979, and increased by about 90 percent over the periods 1990-1999 to 2000-2008. This clearly suggests that illicit capital flight still remains a problem and that the situation has gotten worse over time.

The second noticeable point is that ICF outpaced FDI and foreign aid. This is clearly evident from Figure 1, where the ICF graph lies above the graphs of FDI and aid. Table 1 also shows that the ratio of ICF to FDI exceeds one in all the periods (ranges from 2.5 to 22.9), suggesting that ICF dwarfs FDI flows. The ICF-aid ratios are much lower than the ICF-FDI and they range from 0.94 to 1.6. For example from 1970-2008, ICF was about 3 times FDI flows but only 1.3 times aid flows. This result

⁵ Data series prepared for Ndikumana and Boyce 2011, available at http://www.peri.umass.edu/fileadmin/pdf/ADP/Capital_flight_series_1970-2008.pdf.

⁶ We report average flows instead of cumulative flows because the data on illicit capital flows are not available for some countries in the 1970s. As a consequence, a comparison based on cumulative flows will underestimate the magnitude of illicit capital flows. The country and per-country averages are calculated excluding missing years in some country series.

is interesting because it implies that overall countries relied on foreign aid to fill the resource gap.

Our discussion so far is based on aggregated data for the 33 countries. Such an analysis is useful in that it provides a good overview of ICF in comparison to other external flows for the countries. The disadvantage is that it obscures the variation in financial flows between countries. In addition, the data on financial flows may reflect the situation in only a few countries. For example, two countries, South Africa and Nigeria accounted for about 46 percent of FDI flows from 1970-2008. Accordingly, the conclusions based on the aggregate data for the countries may be misleading. We therefore also report the annual flows for ICF, FDI, and aid as well as the ICF-FDI and ICF-aid ratios for each of the 33 countries.

As shown in Table 2 (p. 29), there is a wide variation among countries in the magnitudes of ICF, FDI, and the ICF-external flow ratios. We group the countries into two sets based on how the countries finance their resource gap. Aid-dependent countries are those countries for which the ICF-aid ratio is greater than the ICF-FDI ratio, and FDI-dependent countries refer to countries for which the ICF-aid ratio is less than the ICF-FDI ratio. Thus, aid-dependent countries rely on foreign aid to fill the resource gap and FDI-dependent countries rely on FDI to fill the gap. The data for the aid-dependent countries and FDI-dependent countries are shown in Panel A and Panel B, respectively.

One noteworthy point is that 27 out of the 33 countries (about 80 percent) are aid-dependent. Also note that for several countries the ICF-FDI ratio is quite high, suggesting that ICF dwarfs FDI. This is interesting because as pointed out earlier, several countries in the region have been aggressive in their efforts to attract private foreign capital, in particular, FDI, albeit unsuccessfully.⁷ For many of

these countries, there will be less need for FDI to fill the resource gap if ICF are curtailed.

Conclusion

Relying on external capital to fill Africa's resource gap and also to address poverty in the region may be problematic for three reasons.

First, both FDI and aid are volatile, and volatility has an adverse effect on the economy (Desai and Kharas 2010).⁸ For example, FDI to SSA increased in real terms from \$15 billion in 2006 to about \$38 billion in 2008, which is an increase of about 146 percent, but decreased to \$26 billion in 2010, a decline of about 30 percent from 2008 to 2010 (WDI 2012). With regards to foreign aid, net aid increased substantially after the adoption of the MDG goals in 2001, and declined after the 2007 world financial crisis. Net aid to SSA tripled in real terms from about \$10 billion 2001 to about \$36 billion in 2006, but it declined to \$30 billion at the end of 2007, a decrease of about 14 percent.

Second, the extensive aid-growth literature suggests that the effect of foreign aid on economic growth is ambiguous (Charnning, Jones, and Tarp 2010).

Third, the region has generally been unsuccessful in attracting FDI, and this trend is unlikely to change. As a consequence, relying on FDI to fill the finance gap is unrealistic, both in the short and medium term.

We therefore recommend that sub-Saharan African countries need to establish effective strategies to curtail illicit capital flight as part of the broader agenda of mobilizing resources for economic development.

⁷ We note that FDI has other advantages, such as technology transfer and employment creation.

⁸ See Desai and Kharas (2010) for a review of the literature on the effects of aid volatility.

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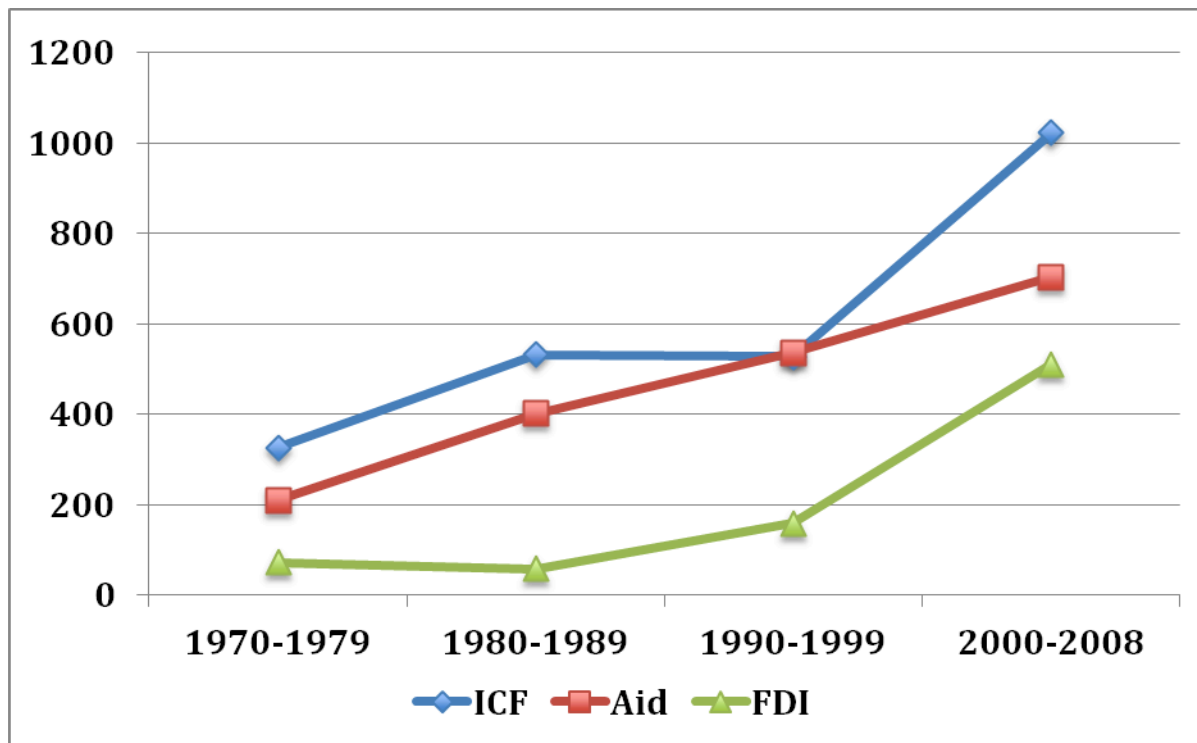
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Table 1: Illicit Capital Flight, Foreign Aid, and FDI: Annual Flows per Country, 1970-2008 (million, constant 2008 dollars)

Description	1970-79	1980-89	1990-99	2000-08	1970-2008
Illicit Capital Flight (ICF)	326.58	531.80	527.67	1023.04	604.19
Foreign Aid (Aid)	209.44	402.12	536.68	704.07	200.82
Foreign Direct Investment (FDI)	71.86	57.56	159.05	510.64	461.19
(Aid+FDI)	281.30	459.68	695.73	1214.71	662.01
ICF/FDI	5.61	22.91	6.95	2.51	3.01
ICF/Aid	1.55	1.33	0.94	1.48	1.31
ICF/(Aid+FDI)	1.14	1.17	0.77	0.84	0.91

Notes for Tables 1 and 2: The data on capital flight, aid and FDI are flows per year in constant 2008 million dollars. The data are for 33 countries in Sub-Saharan Africa: Angola, Botswana, Burkina Faso, Burundi, Cameroon, Cape Verde, Central African Republic, Chad, Congo, Dem. Rep., Congo, Rep., Cote d'Ivoire, Ethiopia, Gabon, Ghana, Guinea, Kenya, Lesotho, Madagascar, Malawi, Mauritania, Mozambique, Nigeria, Rwanda, Sao Tome and Principe, Seychelles, Sierra Leone, South Africa, Sudan, Swaziland, Tanzania, Uganda, Zambia, and Zimbabwe. The data on capital flight are from http://www.peri.umass.edu/fileadmin/pdf/ADP/Capital_flight_series_1970-2008.pdf, a data series used for Ndikumana and Boyce (2011) and the data on FDI and foreign aid are calculated by the authors based on data from the World Development Indicators. Note that there are missing years in the data series for a number of countries. The country and per-country averages are calculated excluding missing years.

Figure 1: Illicit Capital Flight (ICF), Foreign Aid, and Foreign Direct Investment (FDI): Average Annual per Country Flows, 1970-2008 (million, constant 2008 \$)



Notes: The data are for 33 countries in Sub-Saharan Africa: Angola, Botswana, Burkina Faso, Burundi, Cameroon, Cape Verde, Central African Republic, Chad, Congo, Dem. Rep., Congo, Rep., Cote d'Ivoire, Ethiopia, Gabon, Ghana, Guinea, Kenya, Lesotho, Madagascar, Malawi, Mauritania, Mozambique, Nigeria, Rwanda, Sao Tome and Principe, Seychelles, Sierra Leone, South Africa, Sudan, Swaziland, Tanzania, Uganda, Zambia and Zimbabwe. The data on capital flight are from http://www.peri.umass.edu/fileadmin/pdf/ADP/Capital_flight_series_1970-2008.pdf, a data series used for Ndikumana and Boyce (2011) and the data on FDI and foreign aid are calculated by the authors based on data from the World Development Indicators. Note that there are missing years in the data series for a number of countries.. The country and per-country averages are calculated excluding the missing years.

Table 2: Illicit Capital Flight (ICF), Foreign Aid and Foreign Direct Investment (FDI), 1970-2008

Panel A: Aid Dependent Countries							
Average annual flows 1970-2008 constant \$ (million)					Ratios		
Country	ICF	FDI	Aid	Aid+FDI	ICF/FDI	ICF/Aid	ICF/(Aid+FDI)
Burkina Faso	29.08	23.91	478.74	502.65	1.22	0.06	0.06
Burundi	186.02	0.98	253.96	254.94	189.75	0.73	0.73
Cameroon	616.46	112.47	596.96	709.43	5.48	1.03	0.87
Cape Verde	128.00	25.79	116.36	142.15	4.96	1.10	0.90
Central African Rep.	61.55	12.47	177.88	190.35	4.94	0.35	0.32
Chad	63.60	90.49	268.92	359.41	0.70	0.24	0.18
Congo, Dem. Rep.	787.82	177.19	933.11	1110.30	4.45	0.84	0.71
Cote d'Ivoire	1165.49	171.95	553.63	725.58	6.78	2.11	1.61
Ethiopia	515.96	105.31	1079.80	1185.11	4.90	0.48	0.44
Gabon	585.79	35.85	108.96	144.82	16.34	5.38	4.05
Ghana	272.02	193.67	681.13	874.80	1.40	0.40	0.31
Guinea	39.88	41.63	276.26	317.89	0.96	0.14	0.13
Kenya	182.59	88.34	807.88	896.22	2.07	0.23	0.20
Lesotho	20.76	61.44	128.75	190.19	0.34	0.16	0.11
Madagascar	240.38	81.12	495.68	576.80	2.96	0.48	0.42
Malawi	58.80	34.18	455.25	489.43	1.72	0.13	0.12
Mauritania	100.21	60.36	328.15	388.51	1.66	0.31	0.26
Mozambique	537.78	104.97	950.84	1055.81	5.12	0.57	0.51
Rwanda	113.28	17.93	415.20	433.12	6.32	0.27	0.26
Sao Tome	34.62	5.21	34.41	39.62	6.64	1.01	0.87
Sierra Leone	156.21	15.04	194.86	209.90	10.39	0.80	0.74
Sudan	480.50	459.04	998.74	1457.78	1.05	0.48	0.33
Swaziland	59.65	55.23	55.90	111.13	1.08	1.07	0.54
Tanzania	203.45	163.71	1305.28	1468.99	1.24	0.16	0.14
Uganda	356.06	128.00	673.70	801.71	2.78	0.53	0.44
Zambia	625.95	220.99	755.41	976.40	2.83	0.83	0.64
Zimbabwe	706.97	54.54	334.05	388.59	12.96	2.12	1.82
Panel B: FDI Dependent Countries							
Average annual flows 1970-2008 constant \$ (million)					Ratios		
Country	ICF	FDI	Aid	Aid+FDI	ICF/FDI	ICF/Aid	ICF/(Aid+FDI)
Angola	3109.26	524.11	291.01	815.12	5.93	10.68	3.81
Botswana	53.78	184.65	156.98	341.63	0.29	0.34	0.16
Congo, Rep.	628.94	269.03	223.09	492.12	2.34	2.82	1.28
Nigeria	7595.41	1745.23	793.56	2538.78	4.35	9.57	2.99
Seychelles	146.60	41.29	29.71	71.01	3.55	4.93	2.06
South Africa	951.61	1320.97	265.12	1586.09	0.72	3.59	0.60

Stolen Asset Recovery: The Need for a Global Effort

Hippolyte Fofack, The World Bank Group¹

Hippolyte Fofack is a professional and research economist with over 15 years of experience in academia and international development. He is currently responsible for the Macroeconomic and Growth Program at the World Bank Institute, the knowledge and research arm of the World Bank Group.

“As we increase the flow of capital to developing countries, we also need to prevent its illicit outflow. We will work with the World Bank’s Stolen Asset Recovery (StAR) Initiative to secure the return of stolen assets to developing countries, and support other efforts to stem illicit outflows.” - G-20 Leaders’ Statement, The Pittsburgh Summit, September 24-25, 2009.

Background and context

Although illicit financial outflows have been a permanent and growing phenomenon in Africa since the 1970s, the global development and research community turned its attention to the problem only recently (Ajayi and Khan 2001).² However, over the last decade, and thanks in a large measure to the work by Global Financial Integrity (Kar and Cartwright-Smith 2010) and by Boyce and Ndikumana (2001, 2003, 2008, 2011), more empirical evidence has emerged to shed light on the

1 I would like to thank James Boyce, Léonce Ndikumana, Bamidele Olugbuyi Sanya, and Xiao Ye for helpful comments and suggestions on an earlier version of this paper. The views and opinions expressed in this paper are those of the author and do not necessarily reflect the official policy or position of the World Bank.

2 In 2001, Ajayi and Khan edited one of the first monographs ever published on capital flight from African countries, specifically looking at the dynamics of capital flight and external debt.

scale, magnitude, and dynamics of illicit financial outflows in the region over most of the post-independence period. According to Global Financial Integrity, the cumulative amount of illicit financial flows from Africa between 1970 and 2008 was US\$854 billion (Kar and Cartwright-Smith 2010).³

Illicit financial outflows from Africa have consistently been on the rise, although there was a slight decrease during the HIPC debt relief implementation in the 1990s. This is in contrast with other developing regions, especially Asia, which has benefited from two positive concurrent effects: large inflows of capital in the form of FDI and significant reduction of illicit financial outflows. Over the period 1970-2010, the stock of capital flight from Africa increased from about US\$2.6 billion in 1970 to more than US\$1.7 trillion, an increase of over 650 times over the four decades (Ndikumana and Boyce 2012a, 2012b). This exceeds the region’s total external debt outstanding of about US\$293.8 billion (at end of December 2010).⁴

Economic and social costs of illicit financial outflows

Illicit financial flows undermine the ability of African countries to reach adequate levels of domestic investment needed to accelerate growth (Fofack and Ndikumana 2010). Compared to other regions of the developing world, sub-Saharan African countries recorded the lowest rates of investment over the pre-HIPC decades (Bayraktar and Fofack 2011). For instance, while the East Asian region enjoyed average public investment rates in excess of 30 percent of GDP over 1960-2000, sub-Saharan Africa’s average was 15 percent

3 These figures are consistent with estimates derived by Ndikumana and Boyce (2008).

4 This figure excludes Equatorial Guinea, Namibia, and Libya, for which no data are available (Ndikumana and Boyce 2012, Boyce and Ndikumana 2012).

of GDP at its peak in the late 1970s, and it declined after the 1970s to a record low of 7.5% of GDP after the second half of the 1980s (Artadi and Sala-i-Martin 2003). Although investment rates have increased in the post-HIPC period, the aggregate stock of capital remains relatively low, as reflected in extremely low energy intensity and road density (Foster and Briceño-Garmendia 2010).

In the medium and long term, delayed investments owing in part to depleting savings in a context of massive capital outflows have contributed to keeping the tax base narrow in the overwhelming majority of countries, leading to twin structural deficits (fiscal and current account). There has been continued recourse to external financing to bridge financing gaps, which have persisted even in the post-HIPC debt relief era.

Illicit financial outflows also have adverse welfare and distributional consequences for the poor. In particular, they deepen income inequality as they primarily benefit the political elites and a fraction of the urban population connected to the political establishment. Illicit financial outflows jeopardize prospects for inclusive growth through perpetuating high unemployment rates. Furthermore, sustained illicit financial outflows have adverse long-term consequences for individual behavior and for the society as whole. They undermine good governance and weaken government's accountability to citizens. Indeed, one of the most insidious costs of illicit financial flows often neglected is its adverse effects on public institutions and its long-term consequences for social capital.

The Stolen Asset Recovery Initiative

In response to sustained illicit financial outflows from developing countries, the World Bank and United Nations Office on Drugs and Crime (UNODC) established the Stolen Asset Recovery (StAR) initiative, which was launched in September 2007. The link between the StAR and illicit financial outflows is direct. In effect, to the extent that stolen assets are largely proceeds from

corruption, the initiative discretely covers a wide range of illicit financial outflows.⁵ The proposed initiative has four pillars: empowerment, innovation, advocacy, and partnerships. In practice, StAR works with developing countries and financial centers that offer a wide range of financial services, particularly to international and non-resident clients, to prevent the laundering of the proceeds of corruption and to facilitate more systematic and timely returns of stolen assets.

The work of the StAR has encountered numerous obstacles in its efforts to stem the outflows and return the proceeds of corruption to source countries. Its actions thus far have taken the form of analytical work, partnership, and capacity building. On the latter, a number of governments in the north are organizing in-country capacity building for law enforcement agencies in originating countries on formulating formal requests to recover stolen assets and lowering barriers to assets recovery. On the non-governmental side, the International Centre for Asset Recovery launched by the Basel Institute for Governance in 2008 is assisting developing countries to build capacity through training and information sharing to trace, confiscate, and repatriate the proceeds of corruption.

The legal obstacles to the return of stolen assets include the mismatch between national laws and international agreements. For instance, countries that have ratified the UN Convention against Transnational Organized Crime (UNTOC) are not required to pass laws to criminalize some offenses included in the UN Convention against Corruption (UNCAC). At the same time, the lack of strong institutional mechanisms to ensure state compliance and accountability has also been identified as an important obstacle. For instance, a recent report by

⁵ Stolen assets are not restricted to financial outflows, however. In addition to money, they also include properties, or other assets amassed through corrupt acts, mainly bribery, embezzlement, misappropriation of property or funds, trading in influence, and abuse of functions in the public sector.

Global Witness found that none of the 24 Financial Action Task Force (FATF) member states are fully compliant with their own recommendations, and in particular recommendation number six requiring banks to perform thorough due diligence on politically exposed persons.

Assessment of Progress under the StAR Initiative

One successful area of intervention has been capacity building. StAR has provided training to more than 500 officials in forty countries in a wide range of areas, including legislative reforms, asset tracing, and international legal cooperation. Through close collaboration and support from StAR, six of the thirty OECD countries have been able to freeze stolen assets between 2006 and 2009, of which four returned assets to foreign jurisdiction over the same period (OECD and World Bank 2011).⁶ However, relative to the scale of illicit outflows from the region, the total amount of stolen assets frozen is negligible (about US\$135 million) and they include funds from only two countries (Nigeria and South Africa).

However, for the purpose of this study it is important to focus on prevention and repatriation of illicit financial outflows, the two ultimate objectives and acid test of the StAR initiative. Progress on both dimensions can be measured against benchmarks and quantitative targets. The potential benefits of repatriation have been proven to be significant, especially from the standpoint of financing a “Big Push” development model.

In effect, in an empirical study hypothetically assessing the potential benefits of repatriation of capital flight, Fofack and Ndikumana (2010) demonstrate that the gains from repatriation can be

6 These countries are: Australia, France, Luxembourg, Switzerland, United Kingdom and United States of America (OECD and World Bank 2011).

significant and largely outweigh the expected benefits from other sources such as debt relief.⁷ According to that study, if only a quarter of the stock of capital flight was repatriated to source countries in Sub-Saharan Africa, the region would go from trailing to leading other developing regions in terms of domestic investments and growth.

Although a formal baseline for monitoring and assessing the impact of the StAR initiative over time was not established at inception, progress at preventing the outflows of illicit financial resources can be assessed using the end-December 2007 stock of illicit financial outflows as the baseline. A successful prevention campaign under the proposed initiative would have either completely stemmed the outflows of illicit financial resources or significantly reduced its magnitude in the years following the launch of that initiative. Under these conditions, the continued increase in the cumulative stock of the illicit financial outflows from Africa to international financial centers would have been simply due to compound interest payments, with little or no additional outflows.

However, year-to-year variations in the stock of illicit financial flows since the launch of the StAR have consistently exceeded the expected returns from interest payments. For instance, under the assumption of no repatriation and no additional outflows after end-December 2007, the total stock of illicit financial outflows from African countries, including compound interest payments, would have been about US\$1.565 trillion by end-December 2010.⁸ Yet, according to the most recent estimates, the stock of capital flight (end-December 2010) is

7 While relief under the HIPC initiative reduces the stock of debt and interest payments, it does not automatically translate into additionality of financing. The “Big Push” option does by instantaneously raising the level of resources available to governments.

8 The figures refer to 33 SSA countries covered in Ndikumana and Boyce’s series, updated to 2010, plus four North African countries (Algeria, Egypt, Morocco, and Tunisia).

US\$1.685 trillion, implying that new outflows beyond interest payments exceeded US\$120 billion over the same period.

At the very least, these figures suggest that illicit financial outflows from Africa have continued to grow unabated since the inception of the StAR initiative. In fact, the largest increase in the amount of illicit financial outflows occurred over the last decade (2000-10), with an annual average of US\$45.8 billion, compared to about US\$21.3 billion in the 1970s and about US\$23.2 billion in the 1990s (Figure 1). These figures point to an overall failure to stem the illicit financial outflows in the StAR era. To the contrary, it is estimated that over US\$120 billion have fled the continent as illicit financial outflows since the launch of the proposed initiative in 2007.

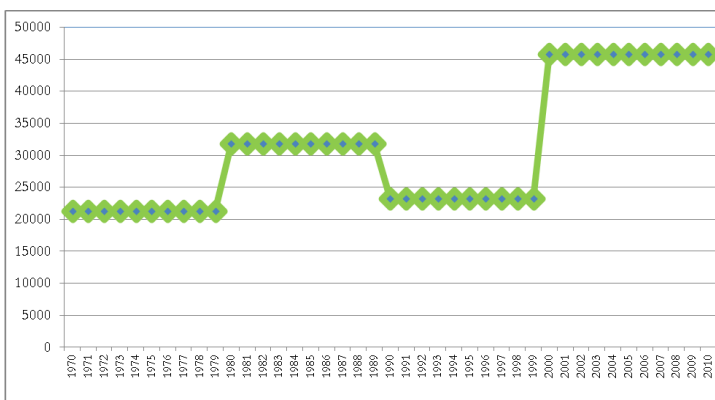


Figure 1: Decennial average annual illicit financial outflows from Africa, 1970-2010 (millions, constant 2010 US dollars)

The recovery of assets looted by President Sani Abacha of Nigeria is often singled out as a success in several reports, including those published by the StAR (Stephenson et al. 2011). That success refers to the recovery of US\$505 million from Swiss banks in 2006, representing less than 10% of total resources stolen by General Abacha estimated at about \$5 billion. For a country that has an estimated stock of capital flight in excess of US\$381 billion (end-December 2010), the amount of recovered assets are insignificant (approximately 0.1%).

Moreover the recovery cannot be attributed to the StAR as it occurred a year before the launch of the initiative.

This failure in ongoing efforts to recover stolen assets is not specific to Africa, however. The StAR estimates that at the global level only about US\$5 billion in stolen assets has been recovered and repatriated to source countries over the last 15 years (1995-2010), and most of it before the launch of the StAR (Stephenson et al. 2011). In a world where conservative estimates put the stock of illicit financial outflows at several trillion US dollars, this level of recovery rate is obviously disappointing.

The Need for a Global Effort and Renewed Push

A host of reasons have been put forth to explain the relatively poor performance of the StAR at stemming the continued financial hemorrhage and at recovering a significant amount of stolen assets. This is not the place to review these reasons. A report by the StAR outlines 29 different barriers to stolen asset recovery grouped under three different categories: institutional, legal, and operational (Stephenson et al. 2011).⁹ In summary, however, it is clear that the poor performance of the StAR is due to four primary factors: the lack of political will in both rich and poor countries, the collusion between the powerful bankers and countries in the north and politicians in the south, collusion between politicians and private sector operators, and absence of sanctions and punitive measures in the face of crime or violation of international conventions.

Unless the different protagonists are enticed or forced to cooperate, with dire consequences as the alternative for failure in compliance, the StAR initiative is unlikely to yield the expected results. Under the current international financial architecture and trading systems, the dominant stakeholders all have interests in preserving the

⁹ For further details on the different barriers to asset recovery, see Stephenson et al. (2011).

status quo. Politicians who are not exposed under the status quo will continue to accumulate personal wealth, albeit at the expenses of the state and majority of the population. Receiving countries, which benefit in terms of savings and long-term investments, have little incentives to facilitate the repatriation of these assets to source countries or to stem their inflows.¹⁰ Bankers in onshore financial centers and offshore safe havens benefit from large deposits. Even when the funds held in these financial centers are traced, declared illicit, and ultimately frozen, banks continue to benefit from the interest the capital provides as asset recovery procedures prove to be protracted.¹¹

One option for overcoming this impasse would be to adopt and institutionalize a system of ‘positive conditionality’ that would link future loans and balance of payments support to a prior repatriation of stolen assets. In the past such an approach worked rather well for a number of regions, and especially in Latin America where the solution to the debt crisis in the 1980s was inherently linked to the repatriation of capital flight under the Brady Plan (Pastor 1990). In contrast to that plan, the HIPC initiative, which granted debt relief to countries in Sub-Saharan Africa, was not bound by such a conditionality. This may partly explain the exponential growth in illicit capital outflows in the post-HIPC period over the last decade.

On the African side, success in recovering and repatriating stolen assets will require strong political will.¹² Strong political will to embark on a long and winding road to asset recovery by government officials in source countries is fundamental to

10 The Egyptian government recently criticized the UK’s failure to cooperate in efforts to freeze assets illicitly acquired by the Mubarak’s family.

11 The delay is due to the fact that most jurisdictions do not allow for the confiscation and return of assets on the basis of a criminal investigation.

12 Scher (2005) has attributed the inability of the Kenyan government to recover assets allegedly stolen by former President Moi to the lack of political will.

successful asset recovery. Indeed, the willingness and ability to introduce legislative reforms and prosecute corrupt officials (current and former) despite the power and influence they might wield would be unambiguous signals that the government is serious about recovery. Strong “political will” could also stem outflows through deterrence.

African countries and governments could learn from the successful model in effect in the United States and the United Kingdom, two countries which have singularly labeled illicit capital outflows as a *national security* issue. These countries have established specialized units targeting politically exposed persons who allegedly either hold assets obtained through corruption or have moved such assets through their country (Stephenson et al. 2011). The establishment of such units, along with “positive conditionalities” could send a strong signal to parties complicit in illicit financial transactions—politically exposed persons, private sector operators, and international bankers.

To support such national efforts, the global community needs to fully cooperate by lifting bank secrecy in international cases involving all UNCAC and UNTOC offenses and imposing stiff sanctions against receiving banks in receiving countries. In fact, political will in developed countries is just as important to the process of asset recovery, and will be strengthened if government officials in receiving countries see stolen asset recovery and repatriation as a development issue. Their commitment and cooperation will signal their determination in the fight against global corruption, while at the same time potentially raising development aid effectiveness through increased amount of funds effectively allocated to growth and poverty reduction programs in developing countries.

The recent settlement between the U.S. government and the Swiss-based UBS bank highlighted the impact when there is political will to break down the walls of banking secrecy. In a landmark settlement in 2009, UBS paid hundreds of millions of dollar for U.S. taxes it failed to withhold on the

accounts of US customers, and later provided client data and account details of thousands of US clients who were suspected of tax evasion.¹³

More recently, in August 2012, regulators in New York state imposed a US\$340 million penalty on Standard Chartered bank to settle allegations of illegal dealing with Iran. The prohibitive costs of such sanctions are a significant deterrent to other financial institutions that may be tempted to violate the sanctions imposed on Iran. In the case of illicit financial outflows from Africa, financial institutions in receiving countries have not faced any risks. This is a major reason for the poor record of the StAR initiative in inducing repatriation of Africa's stolen assets.

Another reason for the poor record of the StAR is overemphasis on 'big fish,' going only after leaders and heads of states. While such action may provide a strong signal and strengthen deterrence of corruption, real success for the StAR initiative will require casting the net wider to target a wider circle of government officials, private sector operators, and multinational corporations.

The evidence shows that those countries that have achieved greater success at recovering stolen assets have gone beyond focusing on the 'biggest fish' to target a much wider range of culprits. For instance, earlier this year, the U.S. government reported that the Internal Revenue Service recovered US\$5 billion in back taxes, interest, and penalties from 33,000 taxpayers who admitted holding offshore accounts to avoid taxes. Successfully casting such a wider net, however, requires strengthening specialized enforcement agencies in originating countries and building a critical mass of experts, including forensic accountants, lawyers, financial services analysts, and regulators.

Conclusion

The establishment of the StAR initiative in 2007 was a welcome development. It signaled a recognition that illicit financial outflows have adverse effects for economic growth and development aid effectiveness. These effects take on even greater significance in a time of shrinking development assistance resources and growing budget deficits in traditional donor countries.

But the actual progress achieved under the StAR initiative in prevention and recovery of stolen assets has to date been disappointing. Even as the international development community has turned its attention to the problem, the scale of illicit financial outflows has continued to increase. The StAR has made a contribution in capacity building in originating countries and in analysis of the obstacles to asset recovery. But it has not had a significant impact on the central objectives of slowing the outflows of illicit financial resources and recovering stolen assets.

The time is ripe for a renewed effort using StAR at the global level to accelerate stolen asset recovery. One promising potential action would be the use of positive conditionality in future allocation of development assistance to provide incentives for originating countries to act. Equally essential, however, is action in the receiving countries to adopt and enforce stiff sanctions against governments and financial institutions in receiving countries that are guilty of cooperating with illicit financial transactions.

¹³ For more details, see *Wall Street Journal* article titled "Switzerland, UBS settle US tax case" at the following link: <http://online.wsj.com/article/SB125007792394025747.html>.

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Debt Audits and the Repudiation of Odious Debts

James K. Boyce and Léonce Ndikumana,¹

Department of Economics and Political Economy
Research Institute (PERI), University of
Massachusetts Amherst

James Boyce and Léonce Ndikumana are co-authors of Africa's Odious Debts: How Foreign Loans and Capital Flight Bled a Continent (2011) and teach economics at the University of Massachusetts, Amherst. Léonce Ndikumana is Director of the African Policy Program at PERI. James K. Boyce is Director of PERI's Development, Peacebuilding and Environment Program.

African countries continue to rely on external borrowing to fill their resource gaps in financing development. By 2010, the total stock of external debt outstanding for the continent stood at \$297 billion and its annual debt service bill was \$22 billion. To the extent that debts are used for productive purposes, the direct and indirect returns for the debt-financed investments should enable the debtor countries to honor their debt obligations. In practice, however, foreign loans are often either squandered on ill-designed projects or even worse embezzled to finance private wealth accumulation in offshore centers.

When African governments borrow in the name of their countries and their people, they are expected to do so if, *ex ante*, the expected benefits from the loans outweigh the costs of loan repayment. They are supposed to act in good faith in the interest of the people they represent. The lenders, in turn, are expected to exercise due diligence so that they issue loans when they have sufficient evidence that the activities being funded will yield adequate returns

and that the borrower has established adequate institutional arrangements to ensure proper execution of the projects. Having issued the loan, the lender is expected to monitor the use of the proceeds and take corrective measures as needed. Due diligence and monitoring are key tools for minimizing default, which ultimately is in the interest of both the borrower and the lender.

In practice, however, public debts often benefit less the people of the debtor countries than the government officials entrusted to manage them as well as their bankers. Some of the debts accumulated by African countries have financed genuine projects that have contributed to economic and social development. However, some of the debts did not. Analyzing the relationship between inflows of external borrowing and outflows of capital flight, we found that roughly fifty cents on each borrowed dollar exits the country in the same year – a finding that suggests substantial debt-fueled capital flight (Ndikumana and Boyce 2011a, 2011b).

Debts from which the people derived no benefit, and which were contracted without their consent, in situations where the creditors knew or should have known these circumstances, can be classified as 'odious' debts under international law. In current practice, however, all debts are shouldered by African populations until fully paid, whether they benefited from them or not.

Of course, sorting out which loans served legitimate development purposes and which were odious can be a monumental task. But a well-organized systematic audit of external debts can help shed light on the legitimacy of external debts and establish objective grounds for selective repudiation of odious debt. This paper discusses how this can be done and the potential benefits for Africa, its creditors, and the global financial system.

¹ The authors are grateful to Theresa Owusu-Danso for excellent research assistance.

Debt audit, its scope and purpose

International networks and organizations, including the Jubilee Movement, continue to press for an international system of fair and transparent arbitration for dealing with illegitimate debt and default. Debt audits would be an indispensable tool for making such a system effective.

A national debt audit involves a thorough examination of a country's external debts with the aim of establishing their legitimacy and identifying the benefits derived in terms of social and economic development as stated in the official initial justifications of the loans by the debtor government and its lenders. A debt audit focuses on three important sets of principles:

(1) *Legal principles*: This analysis scrutinizes the conditions of the debt contracts and assesses whether they conformed to the laws of the borrowing country, the laws and rules of the lending institutions and governments (e.g., provisions of the Securities and Exchange Commission in the case of the United States), and international law.

(2) *Equity and ethical principles*: A debt audit also investigates whether the loan procedures followed the principles of responsible lending, including due diligence and monitoring of the use of the loan proceeds, and whether appropriate measures were taken to protect the interests of both the borrowing nation and the lenders. It also investigates any evidence of undue coercion on the borrower and aims to establish whether external debts were contracted with the consent of the people, i.e., through appropriate authorization, such as parliamentary approval.

(3) *Developmental criteria*: Finally, a debt audit seeks to establish whether loans were utilized to serve the interest of the people, i.e., whether they financed *bona fide* development programs. The audit examines whether the loans were in line with the country's overall development strategy and the

lenders' stated developmental goals, and whether they ultimately benefited the people.

To be successful, debt audits must be implemented objectively, methodically, thoroughly, and transparently. Success requires strong political leadership in addition to popular support. Table 1 summarizes the key steps of the debt audit process, the material covered, and the areas and subjects to be investigated.

The most significant example of a systematic debt audit was that of Ecuador in 2007-2008. Following sustained campaigning by civil society organizations, in July 2007 Ecuadorian President Rafael Correa established the Internal Auditing Commission for Public Credit, an independent entity, to undertake a comprehensive audit of the country's foreign debts. In September 2008, the Commission submitted its report, which showed critical issues for some of the country's debts. The report found numerous irregularities, ranging from the use of two-thirds of borrowing to finance military expenditures by the dictatorship that ruled the country in the late 1970s to the negotiations over the subsequent restructuring of the debt as global bonds (Jubilee USA 2008).

The report concluded that creditors imposed unfair conditions on the country in connivance with corrupt national leaders: "*Multinational organisms, foreign banks and other lenders, with the participation of national authorities and officials, imposed their conditions on the country, forced it to accept a higher level of debt and successive 'restructuring' procedures that were not transparent and that generated the transfer of private debts to the State.*" (Ecuador, Internal Auditing Commission for Public Credit 2008, 132)

On the basis of the findings of this report, Ecuador unilaterally defaulted on more than \$3 billion in global bonds. In June 2009, the country reached an agreement with foreign creditors to buy back more than 90 percent of its defaulted debt at 35 percent of its face value (Economist 2009). President Correa

announced that this would save the government approximately \$300 million per year in interest payments. In 2010, Ecuador’s total external debt

service payments were less than half their average level in the previous four years.

Table 1: Key Components in National Debt Audits

<i>Component</i>	<i>Description</i>
General conditions	Evolution of the rules and regulations of the monetary authority; evolution of the debt stock; financial flows of resources and associated conditions; main creditors, intermediary agents, final borrowers.
Legal analysis	Approval procedures; general conditions of contracts; special conditions of contracts; clauses and conditions under the law and international principles.
Analysis of evidence	Volume and destination of resources; characteristics of funded projects; objectives; time of execution; rate of return; verification of necessity; criteria of prioritization of projects; beneficiary sectors.
Procedural aspects	Audit period; scope of the debt to be analyzed; Composition of the audit commission and technical expertise; information sources; reporting; publicity; transparency mechanisms.

The example of the Ecuadorian experience has not been lost on other indebted countries. In Latin America, the President of Paraguay has decided to initiate an exhaustive audit of his country’s external debts. Similarly, the Bolivian Parliament has passed a resolution to set up a commission to review Bolivia’s debts.

In Tunisia, following the fall of the Zine el-Abidine Ben Ali regime in 2011, the new government vowed to challenge the legitimacy of inherited debts (Madraud 2012). In June 2012, President Moncef Marzouki refused to endorse a proposal for an increase in Tunisia’s quota share in the IMF (by about \$370 million), pending passage of a bill to audit the debts incurred under the Ben Ali regime. The bill authorizes an investigation to determine whether the debts were used in the interest of the country or as an “instrument of dictatorship and repression,” the new President told the *Agence Tunis Afrique de Presse* (Ennouri 2012). If Tunisia follows through, this will set a historic precedent that other African countries may emulate.

On the donor and lender side, the Norwegian government has been in the forefront of efforts to address the issues of responsible lending and odious debt. In August 2012, it announced plans for an independent audit of all bilateral debt that nine developing countries have with Norway. The aim is to promote financial transparency and to test the Principles on Promoting Responsible Sovereign Lending and Borrowing, which were launched by the United Nations Conference on Trade and Development (UNCTAD) in April 2012.

Odious debt repudiation

Debt audits can help distinguish between debts which are legitimate and those that are not, on the basis of the legal, ethical, procedural and developmental criteria described above. They can thus establish a basis for declaring selected debts as odious and therefore fit to be considered for unilateral repudiation.

Historically the term ‘odious debts’ was first used in reference to ‘war debts’ or ‘hostile debts.’ Thus at the conclusion of the Spanish-American War, the United States Government, which had gained control over the colonies of Cuba, the Philippines, Puerto Rico, and Guam, rejected the Spanish claim that the new Cuban government should repay the debts inherited from the past regimes. The key argument advanced by the U.S. negotiators was that the debt “had been imposed on the people of Cuba without their consent and by force of arms” and that “the creditors, from the beginning, took the chances of the investment.” The United States prevailed, and the new Cuban government was relieved of the debt inheritance, while the creditors were left to attempt to recover their dues from the Spanish government (Wong 2012, 5).

More recent cases include the write-off of Iraq’s debts following the fall of Saddam Hussein. It was argued that it would be unethical to require the people and the new government of Iraq to bear the burden of repaying the loans incurred by a dictatorship that used borrowed funds to build its repressive apparatus. The debts were repudiated and the successor government was given a clean slate to begin mobilizing financing for development.

The legal doctrine of ‘odious debt’ was first codified by the scholar Alexander Nahum Sack (Sack 1927). In the most commonly used definition, a nation’s debt can be considered odious if (1) the debts were incurred without the consent of the people; (2) the loans were not used for the benefit of the people; and (3) the creditors were aware, or should have been aware, of the above two conditions.

Some debts are virtuous in the sense that the benefits to the people of the country exceed the costs. One would hope that is the case for the majority of loans that finance *bona fide* economic and social development programs. Other debts are onerous in the sense that the costs exceed the benefits. Onerous debts take two types. The first is imprudent loans, where the funds were used to

finance ill-designed projects or ‘white elephants,’ but the loans were actually used in the country for arguably legitimate purposes. The second type is odious debts, which include loans that financed the criminal accumulation of private wealth and loans used to finance a dictator’s repressive apparatus. Systematic debt audits can help to categorize past debts and provide an objective and transparent basis for repudiation of odious debts (Ndikumana and Boyce 2011a).

Arguments and counterarguments

Criticisms of debt audits and debt repudiation, whether well founded or not, have held back efforts to address the legacy of illegitimate debts and advance the agenda for responsible lending. As of today, there is no international body formally charged with debt arbitration. Debtor countries are left at the mercy of the powerful creditor clubs and vulnerable to exploitative transactions and claims.

One criticism is that debt audits may amount to a politically motivated ‘witch hunt’ used by current governments to settle scores against former rulers. Secondly, it is sometimes alleged that the audit process cannot be fair if audit commissions include representatives of anti-debt organizations with biased views against lenders. Thirdly, critics argue that it is not really in the best interest of debtor countries to engage in debt audits, let alone debt repudiation, because they would be penalized by financial markets and lose access to further loans. Finally, there are concerns that debt repudiation would encourage irresponsible borrowing by governments in the expectation that debts might not have to be repaid in the future.

Concerns about the objectivity of debt audits can be alleviated by ensuring representation of all key stakeholders from both the debtor country and the lending institutions and governments. The credibility of the process rests on transparency, independence, fair representation, and appropriate expertise.

The threat of credit rationing is in practice a paper tiger. Many severely indebted countries currently pay more to their creditors than they receive as new loans. The result is a negative net transfer. For these countries, a zero net transfer would be an improvement.

In addition, a well-executed debt audit can be a mark of strong and effective national leadership. By freeing resources from the servicing of odious debt, the government becomes better able to support productive investments that will improve its economic performance in subsequent years. Such positive effects were demonstrated in the case of Ecuador, which recorded higher growth in the post-repudiation period, despite condemnations from financiers who labeled President Correa a 'leftist' and Ecuador a member of the 'axis of evil' in Latin America' (Anderson and Watkins 2008). If economic conditions improve, lenders will in fact return to seek higher returns on their investments.

Finally, repudiation of odious debt, if properly implemented, is selective rather than indiscriminate. Creditors who lend in good faith for legitimate projects have no reason to fear a fair and transparent process, and no cause to withhold new lending. Indeed by freeing governments from the burden of servicing illegitimate debts and strengthening incentives for responsible lending, the strategy yields a better climate for legitimate borrowers and legitimate creditors alike.

But if debtor countries are likely to benefit from debt audits and selective debt repudiations, why have African governments not taken advantage of this opportunity? If the process is likely to lead to lower risks in international lending, a more stable global financial system, and increased gains from international development assistance, why have more lenders and donors not supported it?

These are good questions. The answer lies in large part with leadership. The gains from debt audit and selective repudiation will accrue mostly in the

medium to long term through improved fiscal governance and economic performance. Investing in these gains requires a future-oriented leadership that is committed to the interests of the people. If, in contrast, leaders are more concerned about meeting short-term financing needs—or worse, about profiting personally from more irresponsible borrowing at the people's expense—it may indeed make more sense to placate the lenders.

Lenders and donors, in addition to fearing the write-down of assets from debt repudiation, may be reluctant to set precedents even when they believe that some debts are indeed odious. But such fears that debtor governments may abuse the privilege of debt repudiation can be alleviated by establishing an independent international arbitration agency, as part of the international financial architecture. Such an agency, the creation of which is long overdue, can assist in the debt audit process and in the adjudication of contentious cases of debt repudiation.

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The Benefits of Country-by-Country Reporting

By Richard Murphy, Tax Research UK

Richard Murphy is a UK-based chartered accountant and political economist. Having had a career in practice and commerce for twenty years he began working on research and advocacy issues relating to tax reform and transparency in 2003. He co-founded the Tax Justice Network and is director of Tax Research UK. He blogs at <http://www.taxresearch.org.uk/Blog/>. He created the country-by-country reporting concept.

What is country-by-country reporting?

Country-by-country reporting is a new and innovative form of accounting.¹ The basic concept is to require the inclusion in annual audited financial statements of a profit and loss account for each jurisdiction in which a multinational corporation had operations during the year. These profit and loss accounts would include disclosure of both third party and intra-group transactions, which for these purposes are those trades that take place across national boundaries but between companies under common ownership or control. They would be required to be reconciled with the overall group results. In addition, limited cash flow and balance sheet data would also be required to be published.

Country-by-country reporting was first suggested in 2003. By 2012, it was on the agendas of the SEC, the International Accounting Standards Board, the Organisation for Economic Cooperation and

¹ For a much more detailed report on country-by-country reporting see “Country-by-Country Reporting: Accounting for Globalisation Locally” by Richard Murphy, published in 2012 and available at <http://www.taxresearch.org.uk/Documents/CBC2012.pdf>.

Development, and the European Union. It is likely to become law in the USA and European Union soon, at least for companies in the extractive industries. It is an idea whose time has come. This paper explains what country-by-country reporting is, why it is needed, what disclosures it would require, and what the resulting benefits would be to users of financial statements, including all potential stakeholders of the companies that publish them.

Problems in existing accounting that country-by-country reporting will address

The level of disclosure required of multinational corporations in their published annual audited financial statements is primarily governed by non-statutory self-regulated requirements laid down by bodies established by and largely run by the accounting and auditing professions (the International Accounting Standards Board in much of the world and the equivalent Federal Accounting Standards Board in the USA) and by the requirements of the stock exchanges on which the equity of such entities is traded.

The organizations calling for country-by-country reporting² have identified two key weaknesses in existing reports. The first is that they are published on a group-consolidated basis. Such an overall report is, of course, needed information for the equity holders in the corporation. And no one calling for country-by-country reporting is arguing for dispensing with such consolidated financial statements. However, they also have important weaknesses, including the following:

² Organizations involved include the Tax Justice Network <http://www.taxjustice.net/>, Christian Aid, <http://www.christianaid.org.uk/actnow/trace-the-tax/background.aspx>, Publish What You Pay, <http://www.publishwhatyoupay.org/country-by-country-reporting>, ActionAid http://www.actionaid.org.uk/102021/how_to_stop_tax_dodging.html, and many others.

1. They represent an accounting fiction. No entity actually exists that undertakes all the transactions that the accounts report. Those transactions are rather a selection from the full set of transactions undertaken by a large set of related but legally distinct entities located in different jurisdictions.
2. They ignore all intra-group trades which at a local level may be highly material and which are, for tax purposes, very often the most sensitive transactions undertaken by the companies in a group.
3. They do not locate transactions in a place because their reporting is not geographic.
4. They do not identify the assets and liabilities located in a place.
5. They do not reveal the structure of the trading group.
6. They do not supply many users—including many considered suppliers of capital by the International Accounting Standards Board, such as trade creditors and employees—with information about the particular entity with which they are engaged.³
7. They do not provide adequate information for determining tax responsibilities because tax is not paid on a group basis but at the level of the individual corporate entity.

It is readily apparent from the above weaknesses that such accounts cannot meet the needs of all suppliers of capital to a multinational corporation, let alone meet the needs of the many other users of financial statements who are not suppliers of capital.

³ For more information see the Tax Research Briefing on The Users of Accounts.
<http://www.taxresearch.org.uk/Documents/Accountusers.pdf>.

Although there do exist current reporting standards on “segment reporting,” they are too limited to address these deficiencies. The current standards are International Financial Reporting Standard 8 in countries where International Accounting Standards Board standards apply and Statement of Financial Accounting Standards (SFAS) No. 131 in the USA. For all practical purposes these standards are the same. They require that if the reporting entity is a multinational corporation it must differentiate trading geographically by reporting trade in its head office location separately from trade in all other locations, and then only if that split is material. No other geographic data need be supplied. Other segment data to be supplied to users of the financial statements must use the same break-down as is used for supplying data to senior management for their decision making purposes. This may or may not be geographic data. For example, the data may instead be broken down by business categories reflecting the different business sectors in which the multinational corporation is engaged.

This type of business sector analysis may well be useful for the multinational corporation itself and other stakeholders. But it is not sufficient for many users of accounting data who require geographic data, whether to assess risk, determine tax responsibilities, or otherwise analyze the impact of the corporation's actions in specific places.

The case for country-by-country reporting is that its absence leaves the following serious gaps:

1. The lack of mandatory geographic data destroys comparability in reporting.
2. The lack of specific jurisdiction data means that many local users of the financial statements of multinational corporations have no locally specific data on which to base their decisions, placing them at a competitive disadvantage.

3. Those wishing to hold corporations and governments to account for the management of the payment and spending of tax revenue do not have the information they need. Group consolidated financial statements of multinational corporations do not let them do this. Local subsidiary accounts cannot fill this gap because such subsidiaries are either unidentified or do not make their accounts available on public record.

Finally, those arguing for country-by-country reporting contend that it is necessary to supply significant macroeconomic data crucial for managing the international economy. International statistics are kept on a country-by-country basis. But the absence of country-to-country reporting means that much essential data is missing, leading to the skewing of information that is essential for policy decisions by governments. For example, what is left largely unknown includes:

data on the precise value of intra-group trading, although the OECD now appear to estimate that it amounts to 60% of total world trade; data on the location of worldwide profits; data on where multinational corporations declare and pay their tax; data on employment patterns within multinational corporations; data on where multinational corporations locate their assets and liabilities; and the location of financing flows within multinational corporations.

As noted below, country-by-country reporting can provide these data and more.

Information disclosure required by country-by-country reporting

Country-by-country reporting as currently proposed by the Tax Justice Network would require disclosure of the following information by each multinational corporation in its annual financial statements:

1. The name of each country or jurisdiction in which it operates;
2. The names of all its companies trading in each country or jurisdiction in which it operates;
3. What its financial performance is in every country or jurisdiction in which it operates, without exception, including:
 - Its sales, both third party and with other group companies;
 - Purchases, split between third parties and intra-group transactions;
 - Labor costs and employee numbers;
 - Financing costs split between those paid to third parties and to other group members;
 - Its pretax profit;
4. The tax charge included in its accounts for the country or jurisdiction in question, split as noted in more detail below;
5. Details of the cost and net book value of its physical fixed assets located in each country or jurisdiction;
6. Details of its gross and net assets in total for each country or jurisdiction in which operates.

Tax information would need to be analyzed by country or jurisdiction in more depth requiring disclosure of the following for each country or jurisdiction in which the corporation operates:

1. The tax charge for the year split between current and deferred tax;
2. Actual tax payments made to the government of the country or jurisdiction in the period;
3. The liabilities (and assets, if relevant) for tax and equivalent charges at the beginning and end of each accounting period;

4. Deferred taxation liabilities for the country or jurisdiction at the start and close of each accounting period.

Sales information may also require additional detail. If sales made from a jurisdiction differ by more than 10% from sales made to that jurisdiction, then data should be declared on both bases for that jurisdiction so that there is clear understanding of both the source and destination of the sales made by a multinational group. Otherwise sales could be artificially recorded as deriving, for example, from a tax haven when in fact they should be attributed to a major jurisdiction, thus understating the sales for that location.

For companies in extractive industries, country-by-country reporting would also imply a full breakdown of all those benefits paid to the government of each country in which a multinational corporation operates, using the reporting categories required by the Extractive Industries Transparency Initiative.⁴

Benefits that country-by-country reporting would provide

In broader terms, country-by-country reporting is important for the following reasons:

Transparency matters. In many countries a corporation does not have to put its accounts on public record. That means that what an MNC does in that country is not a matter of public record. That matters both for the country itself and at a global level. What MNCs do has enormous implications for the well-being of the world: country-by-country reporting overcomes this problem. It puts all MNC activity ‘on the record.’ Responsible investors, as well as the public, appreciate such transparency.

Corporate social responsibility (CSR) matters. CSR is about the relationship between a company

and its host community. This requires that the host community knows the company is there, and knows what it’s doing there. Country-by-country reporting provides that information.

Accountability matters. A company cannot be accountable unless it can be identified. This means that the names an MNC uses locally must be on public record. Too often they are not. Country-by-country reporting names local subsidiaries.

Trade matters. At least 60% (and maybe more) of world trade is intra-group. Current accounting reports from MNCs completely exclude such trade from public view. Country-by-country reporting shows it all. This is vital if trade relationships are to be understood and made fair.

People matter. MNC accounts include statements on the number of employees a company has and their aggregate remuneration. Country-by-country reporting would require this statement for every country in which an MNC operates. This would provide invaluable information on labor conditions.

Tax matters. MNCs have more opportunity than any other group in a society to plan their tax affairs. They can seek to shift their profits from country to country to find the lowest overall bill. Country-by-country reporting discloses the profits that companies record in each country in which they operate and the taxes that they pay on them. This means they can be held accountable for what they do and do not pay. It’s estimated that if this problem were tackled, enough tax could be collected to help meet the cost of achieving the Millennium Development Goals.

Corruption matters. The extractive industries are dominated by MNCs. The Extractive Industries Transparency Initiative seeks to hold those companies to account for the tax payments they make, and the governments that receive those payments to account for what they do with them. Many MNCs resist such disclosure because of competitive pressure, contractual obligations, and

⁴<http://eiti.org/files/document/EITI%20Business%20Guide.pdf>, page 31.

local political opposition. Country-by-country reporting would overcome these objections by requiring such reports from all companies, significantly enhancing transparency in this sector, and help cut corruption.

Development matters. Developing countries lack revenue to finance public goods and services. Aid helps alleviate this problem but has the potential to create dependency, reduce democratic accountability of developing country governments to their electorates, and itself contribute to corruption. Local declaration of economic activity by MNCs with the resulting accountability for taxes paid could help break this cycle and assist in creating fully independent, accountable governments capable of raising their own tax revenues.

Governance matters. Many of the major corporate scandals of recent times have involved extensive use of offshore subsidiary companies. These are becoming increasingly common in MNCs, and it is recognized that they pose serious governance issues for MNCs themselves. This results in increased risk for shareholders, employees, local communities, and even national governments that may depend on the MNC's operations.

Where you are matters. Some countries are politically unstable. If a company trades there, shareholders should know. Some are politically unacceptable. If an MNC trades there, civil society should know. Some countries are subject to sanctions, making trading there illegal. Where you are matters. Country-by-country reporting holds a company to account for where it is.

Country-by-country reporting would therefore provide multiple benefits for all users of the financial statements of multinational corporations.

How likely is it that we'll get country-by-country reporting?

In 2003 when I published my very first paper on country-by-country reporting⁵ the idea that it would ever really see the light of day was very far from even my mind. I simply put forward an idea that had interested me that arose out of a conversation with a friend. I honestly expected the total audience for the paper to be just two people.

In 2012 a limited form of country-by-country reporting for the extractive industries is now law in the USA and heading to be law in the European Union. It's far from the full version noted above, but in accounting terms, where change is usually glacial, the rate of progress has been phenomenal.

In that case the chance of full country-by-country reporting becoming law has to be considered. It is known that multinational corporations and their auditors oppose such a move, but they have also opposed the moves for its introduction in the extractive industries. That change in the extractive industries happened for two reasons. First, the groundwork had been laid, and second the opportunity arose. That opportunity was created by BP spilling millions of barrels of oil in to the Gulf of Mexico. The mood on regulation in the oil industry in the USA changed as a result.

For full country-by-country reporting the mood change creating political momentum for change is likely to have a different cause. The motivation for the governments involved will be, in this case threefold. The first will be an intense desire for increased tax revenue to close their deficits. The second will be a desire to tax what appear to be ever-rising cash mountains held by the world's multinational corporations (Apple is currently reported to be sitting on \$117 billion⁶). The third will be their frustration with those companies' attempts to hide that cash from view, aided by their

⁵ <http://visar.csustan.edu/aaba/ProposedAccstd.pdf>.

⁶ <http://www.zerohedge.com/news/2012-09-30/presenting-worlds-biggest-hedge-fund-you-have-never-heard>.

accountants. That frustration is already notable. Four major tax authorities have now said that country-by-country reporting would help them collect tax.⁷ The EU Parliament continues to demand the extension of country-by-country reporting beyond the extractive industries.⁸

We will not get country-by-country reporting overnight, but it is only ten years old now and we nearly have it for the extractive industries. In less than ten more years I suspect we will have it all for all multinational corporations.

⁷ <http://www.taxresearch.org.uk/Blog/2012/09/27/tax-authorities-back-country-by-country-reporting-to-prevent-transfer-pricing-abuse/>.

⁸ <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-%2f%2fEP%2f%2fNONSGML%2bIM-PRESS%2b20120917IPR51496%2b0%2bDOC%2bPDF%2bV0%2f%2fEN>.

Africa's Lost Tax Revenue, Lost Development Opportunities

John Christensen (john@taxjustice.net), Director,
Tax Justice Network

Since 1985 John Christensen has focused his research on the role played by tax havens in the global economy. He participates in the OECD's informal task force on tax and development and is a board member of New Rules for Global Finance. His work is sponsored by the Joseph Rowntree Charitable Trust.

Tax policy plays a major role in shaping development outcomes. While tax is not an end in itself, the role played by a suitably designed mix of tax policies in securing sustainable public finances, promoting equitable growth, dampening harmful social and ecological outcomes, and building democratic states, is well established (Kaldor 1980; Brautigam, Feldstad, and Moore 2008). However, the research that has been conducted on how tax policies shapes development outcomes often lacks sufficient detail on specific country cases (Bird 2010). Almost invariably, tax revenue provides the cheapest means of funding public investments in education, health, physical infrastructure, crime prevention, and public defense. Tax is also core to the social contract between citizens and state: citizens as taxpayers want assurance that everyone pays their fair share and that the revenue collected is being spent wisely on their behalf. Citizens are far more likely to pay taxes when they feel that politicians are honoring the social contract and that tax policies are legitimate and applied fairly.

Tax injustices are rife in many African countries, as they are in many (most!) countries around the world (http://www.taxjustice.net/cms/upload/pdf/tuiyc_africa_final.pdf). Tax evasion and tax avoidance are widespread among wealthy and corporate elites. In addition, a large proportion of the micro-businesses

that predominate in the majority of African countries operate outside the formal economies, reducing labor productivity and slowing growth. With this enormous scale of evasion and avoidance, tax departments fall far short of having sufficient staff and resourcing to tackle these endemic problems. Much African-origin wealth has been accumulated in secret offshore companies, trusts, and bank accounts (Henry 2012). But international efforts to curtail tax havens have been weak and largely ineffective. Unnecessary and typically harmful tax exemptions proliferate, not least for the ruling elites themselves. Tax regimes have become increasingly regressive in their impacts on poorer people, with indirect taxes being substituted for more progressive income, wealth, and property taxes. In many natural-resource-exporting countries, rulers have found it easier and more personally rewarding to make special tax deals with multinational companies than to go through the more arduous and time-consuming process of being accountable to their citizens.

The long-term outcomes in many countries have included low tax yields, requiring excessive reliance on external debt or foreign aid; under-investment in public goods such as health, education, training, and research; and widespread public disenchantment with the legitimacy of taxes and the state itself. These weaknesses have impacted the potential for sustainable growth and social and political stability, fueling a vicious circle of underdevelopment. This encourages the most harmful of all types of capital flight: the long-term exodus of Africa's brightest and most innovative people, whose departure leaves the continent bereft of the skills and flair required for sustainable development.

If poorer countries are to escape from aid dependency and the grip of external debt, and from poverty more broadly, it is essential that their revenue authorities have the capacity to collect taxes efficiently and in ways that are just and equitable. This requires measures both to enhance internal tax collection and also to reduce the barriers created by tax havens and international accounting

and tax rules that are quite simply not fit for their intended purposes. Clearly the time has come to put tax justice on the agenda.

Recent trends, and what they hide

At first glance tax revenue trends since 1990 in many African countries appear positive. Collected taxes have increased from 22 per cent of GDP in 1990 to 27 percent in 2007 (OECD 2010, 84). But these figures mask important factors that shape development prospects. Revenues from oil and mineral exports account for the majority of this increase. Revenue from other trade taxes has declined. Revenue from indirect taxes has likewise declined and the widespread adoption of Value Added Tax has generally had a regressive impact on poorer households. The overall trend in collection of direct taxes on personal incomes and corporate profits has been flat (OECD 2010, 90).

The big picture is therefore one which shows that mineral exporting countries such as Algeria, Angola, Chad, Gabon, and Libya have been successful in capturing economic rents during commodity boom times, while non-mineral exporters, particularly very low income countries such as Ethiopia, Guinea-Bissau, Mali, and Sudan, have been less successful in the arduous task of raising revenue from personal and corporate income taxes, and from taxes on wealth and property.

It is especially notable that yields from corporate income taxes have not increased in line with economic growth trends in recent years. Several factors might explain this. First, statutory tax rates have been reduced in many African countries, in parallel with a global race to the bottom in taxes on corporate incomes. Second, the past 30 years have seen a remarkable increase in the granting of corporate tax exemptions in a variety of different forms, including tax holidays, special rates, accelerated depreciation rates, and others. While there is no evidence that these exemptions are

essential to attracting inbound investment that contributes to long-term growth, there can be little doubt that they provide incentives to domestic investors to accumulate their capital in secret offshore structures, subsequently round tripping that capital to the country of origin dressed up as foreign direct investment. OECD and IMF officials have privately conceded to the author that this round tripping probably occurs on a significant scale, but they are unable to quantify that scale due to offshore secrecy. A third explanatory factor behind the flat-lining corporate tax yields is the increased sophistication of corporate tax avoidance, which is globally systemic.

Tax avoidance, particularly involving transfer pricing, undermines markets by distorting competition in favor of multinational companies (MNCs), which can and do use transfer pricing extensively to shift their profits to tax havens. This works to the disadvantage of the small and medium enterprises (SMEs) that typically provide the engines of innovation and job creation in most economies. This distorted playing field between MNCs and SMEs reduces price competition, lowers corporate tax yields, harms innovation, and favors capital-intensive over labor-intensive production technologies. These negative impacts are cumulatively harmful to development prospects, particularly for countries with high levels of under-employment.

Equally disturbing is the weak revenue growth from personal income taxes. Commodity booms and privatizations of monopoly sectors such as telecoms have contributed to the accumulation of extraordinary levels of personal wealth among African elites, who generally prefer to hold a large proportion of their wealth offshore. Several factors, not least personal security, shape this decision to hold wealth offshore. But the invariable outcome of illicit financial outflows to secrecy jurisdictions is that development prospects are undermined both by loss of investment capital and by endemic tax evasion (Christensen 2009a). Although hard to quantify, the real impacts on development are stark.

One estimate suggests that repatriation of just one quarter of the accumulated stock of illicit financial outflows from Africa would lead to a near doubling of the ratio of domestic investment to GDP (Fofack and Ndikumana 2010).

This in turn impacts the quality of governance in Africa. The majority of African people engaged in illicit financial flows to offshore secrecy jurisdictions come from the elite 1 percent. In many cases they have accumulated their wealth through corrupt activities, often embezzling public or private assets, which they subsequently transfer offshore. This elite has little or no interest in investing in their own domestic economies. They are protected from the social impacts of inequality and disorder by having overseas residences and access for themselves and their families to elite schools and hospitals in other countries. In short, they have every incentive to retain the status quo which enables looting and protects their ill-gotten gains, and to block progressive measures that might strengthen international cooperation and domestic governance. They are aided in this project by the global infrastructure of banks, accounting and legal firms, and secrecy jurisdictions which provide the supply-side infrastructure that enables and encourages their corrupt activities.¹

Barriers to progressive tax regimes in Africa

African tax policy makers face formidable barriers in the way of creating progressive, pro-poor tax regimes. Some barriers arise from domestic factors such as the scale of informal sectors, the power of political and wealthy elites to secure tax exemptions and special tax treatments while also resisting and evading progressive taxes on wealth and property, and the under-resourcing of national and regional tax departments. Domestic structural barriers are

compounded by external factors such as the protracted failure of the relevant international organizations to tackle transfer pricing abuses by multinational companies (Christensen 2009b) and the global scandal of tax havens and secrecy jurisdictions (Shaxson 2011, available at <http://treasureislands.org/the-book/>).

At the domestic level, seeking to bring the informal sector into the taxed formal sector offers opportunities not just for increased tax revenues, but also for higher levels of productivity, faster growth rates, and enhanced social inclusion. If, however, the costs of entering the sector are too high for small firms, and particularly for the micro-businesses that currently dominate most African informal economies, then most are likely to choose to remain outside the system (Jütting and de Laiglesia 2009). Addressing this issue requires changes in several factors, including the administrative capacity of the tax authorities, a cultural shift of attitudes to the legitimacy of state tax raising powers, and a tax mix that does not impose too much complexity or bureaucracy on small traders and micro-businesses.

African countries are hardly unique in suffering a proliferation of tax exemptions and preferential tax treatments, often targeting specific groups who normally fall into the elite category. These exemptions and special treatments seldom serve useful purposes and typically have negative outcomes, including the corrupting process of endless behind-the-scenes lobbying for yet more exemptions. While it is hard to quantify revenue losses from such exemptions, and recognizing that some exemptions may have an overall progressive impact on poorer households, one recent estimate suggests that four East African countries, Kenya, Rwanda, Tanzania and Uganda, are losing up to US\$2.8 billion annually from tax incentives and exemptions. Much of this loss is due to incentives and exemptions aimed at attracting foreign direct investment (Tax Justice Network Africa and Action

¹http://www.realinstitutoelcano.org/wps/portal/riecano_eng/Content?WCM_GLOBAL_CONTEXT=/elcano/elcano_in/zonas_in/sub-saharan+africa/dt1-2009.

Aid 2012).² Proposals for new tax incentives and exemptions should therefore be treated with great caution, even when the intention is to create an incentive to invest. Other factors such as the availability of a trained workforce, or raw material inputs, or transport infrastructure, are typically far more important to investors. Tax incentives carry expenditure costs, which should be carefully evaluated since they involve revenues effectively foregone. They also risk undermining the integrity of the tax system, with knock-on effects on tax legitimacy and market efficiency.

Several case studies have been published in recent years of transfer pricing involving African countries (Christian Aid 2009; Action Aid 2012). But it is important to keep in mind that this problem is systemic rather than a case of a few rotten apples in the corporate barrel. The problems stem from the inherent weaknesses of the guidelines established by the Organisation for Economic Cooperation and Development (OECD) under the rubric of its arm's length method for pricing internal transactions within multinational companies. The practical problems associated with trying to apply the arm's length method are well known to African tax authorities.³ But the intellectual weaknesses of the arm's length method also pose insurmountable challenges, especially in relation to transfer pricing abuses involving provision of management and similar intangible services and to the pricing of intellectual property rights (Sheppard 2012). Practical alternatives do exist, however, that do not involve applying the arm's length method. Many developing countries are experimenting with such alternative ways of tackling transfer pricing abuse (Valadão 2012; Zhang 2012).

The specter of tax havens has loomed large on the global political agenda in recent years. Tax havens are recognized to have played important roles in weakening financial market regulation and enabling

²http://www.actionaid.org/sites/files/actionaid/eac_report.pdf

³http://www.taxjustice.net/cms/upload/pdf/Gerdi_van_der_Westhuysen_1206_Helsinki_ppt.pdf

illicit cross-border financial flows. Some commentators portray tax havens as supply-side agents in providing an enabling environment for corrupt activities: according to their argument the supply of secrecy services from tax havens creates a 'criminogenic' market environment, in which banks, accounting and legal firms, and others are willing to provide support services for illicit financial flows because these services generate highly profitable fee rates (Shaxson 2011; Christensen 2012). In 2009, two years after financial crises hit European and North American markets, the G20 countries agreed in London to tackle tax havens and abolish the banking secrecy that encourages and enables companies and super-rich people—the high net-worth clients so sought after by the offshore wealth management industry—to evade taxes in their normal country of residence. This G20 initiative has had limited success, however. This is due to its reliance on weak OECD standards for tax information exchange between tax havens and other countries, and partly due to the lack of pressure from developing countries, including African countries, to use this opportunity to tackle offshore secrecy. As the British Parliament's International Development Committee notes in its 2012 report on tax and development:

“The capacity of a developing country tax authority to obtain information on the offshore activities of its citizens or corporations (i.e. information from foreign tax authorities) is critical to its ability to curtail illicit capital flight.” (IDC 2012, 23)

While African countries are not members of the OECD, the African Tax Administrator's Forum is well placed to put pressure on the OECD to strengthen its information exchange standards by adopting automatic exchange as the effective global standard and extending it multilaterally rather than through bilateral treaty processes. More importantly, however, African countries as members of the United Nations, are under-represented on the UN's Committee of Experts on International Cooperation on Tax Matters, and few

African countries send representatives to observe that Committee. African countries can use their collective political weight to push UN ECOSOC to strengthen the Committee by granting it inter-governmental status, and push the Committee to create a multilateral system which uses automatic information exchange as the effective global standard.⁴ Significantly, in 2012 the OECD acknowledged that automatic information exchange is effective as a deterrent to illicit financial flows and tax evasion, so the pathway is clear for African countries to require its implementation by offshore secrecy jurisdictions.

Catching up on lost opportunities

Increasing tax yields represents a challenge for African tax authorities. But this is a crucial part of mobilizing Africa's domestic resources for development. While aid remains a short-term necessity for some poorer countries, the long-term goal must be to increase the domestic savings rate to reduce dependence on external investment sources. With such a large proportion of Africa's private savings currently being hidden away in secret offshore trusts and bank accounts, the scope for raising revenues in an equitable, pro-poor way is limited. Tackling illicit financial outflows must therefore be seen as a high priority.

Much can be done both to curtail current outflows and encourage repatriation of savings shifted offshore years ago. The most effective way of achieving this lies with strengthening international cooperation on information exchange to deter citizens from holding savings offshore to evade taxes. Once the secrecy incentives to use offshore structures to hold assets offshore and evade taxes are removed, the supply-side attractions of tax havens will diminish significantly. Tackling the offshore issue is a primary concern since the widespread public awareness of how the 1 percent

use offshore accounts undermines tax morale and reduces compliance further down the income scale. Reversing weak tax morale requires strong and high-profile action to convince the 99 percent that taxes aren't just for "the little people."

Once basic confidence in the fairness of the tax system is achieved, the focus can shift to implementing a broader tax-policy mix that is both more equitable and more conducive to pro-poor growth. A key goal at this stage must be to encourage unregistered traders and micro-businesses to join the formal economy and become taxpayers. There is no simple formula for achieving this. But a mix of policies including allowing access to micro-credit, assisting with registration and tax filing, and support with distribution and marketing, might provide an appropriate balance of incentives. It is also crucial that the tax-policy mix covers a wide spread of citizens, and does not fall disproportionately on small and micro businesses. While there is no one-size-fits-all tax-policy mix that suits the needs and circumstances of all countries, certain principles need to underlie the choices that determine the choice of tax regime. These principles include:

- Choosing taxes that contribute to a long-term development strategy, and rejecting taxes that undermine the chosen strategy;
- Recognizing that taxes operate as a package rather than in isolation from each other;
- Creating a balanced tax regime based on a wide mix of taxes, including taxes on income, capital gains, wealth, property, and sales, rather than relying on only one or two sources of revenue income;
- Providing appropriate incentives for environmental protection;
- Avoiding taxes that require a considerable administrative input or are overly complex for micro-businesses.

In addition to the above principles, it is necessary to take account of the imperative to empower African citizens to hold their governments to account on both how taxes are raised and how the revenues are spent. The principles of tax justice require that

⁴http://www.taxjustice.net/cms/upload/pdf/AIE_100926_TJN-Briefing-2.pdf

citizens are actively engaged in tax policy formulation, in budgetary processes, in expenditure monitoring, and in promoting the efficiency, equity, and transparency of revenue collection processes. These are the foundations on which Africans can build a sustainable tax justice consensus.

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Tax Havens: An Emerging Challenge to Africa's Development Financing

Nicholas Shaxson

Nicholas Shaxson is author of *Treasure Islands: Tax Havens and the Men Who Stole the World* (<http://treasureislands.org/>). He writes for the Tax Justice Network.

The term 'tax haven' is a bit of a misnomer because they are not just about tax, but about a whole range of other things too. There is no generally agreed definition of what a tax haven is, but if you drill right down to the core of what these places offer, you end with two words: 'escape,' and 'elsewhere.' Once we understand what this means, it becomes clear why they are such a threat to Africa.

First, escape. Tax havens help wealthy individuals and large corporations escape from criminal laws, from financial regulation, from transparency and disclosure, from inheritance rules, from professional liability, and more. Take your money to a tax haven, and your home rules no longer bind you. In other words, tax havens help wealth elites escape from the rules of civilized society, whether by illegal means or not. The implications for Africa are obvious.

Second, 'elsewhere.' The secrecy facilities or tax loopholes provided by the 600,000-odd International Business Companies in the British Virgin Islands¹ are not for the benefit of local islanders: they are for foreigners, elsewhere. You don't like the rules and laws that apply at home, so you take your money somewhere else. 'Elsewhere' - hence the term 'offshore.' Offshore lawmakers are

¹ http://www.britishvirginislands-ibc-registration.com/BritishVirginIslands_International_trade_and_investment.html

always separated from those people who are actually affected by the laws they write -- so there is *never* proper democratic consultation when these laws are written. This is the whole point. These are laws by insiders, for insiders, and the lines of democratic accountability are deliberately cut. So offshore is, almost by definition, the proverbial smoke-filled room, where decisions are taken behind closed doors, with no public accountability. Once again, the implications for Africa should be clear.

Tax havens respond, in their defense, that they are 'efficient' conduits for capital, helping it flow smoothly around the world, channeling much-needed investment into African and other developing countries. Lots of money does indeed flow into Africa through Mauritius and other tax havens.

But it is important to consider what this 'efficient' money flow means.

Since the 1970s, economists and accountants have fallen in love with a particular notion of efficiency, meaning a lack of friction in economic transactions. Low-tax, low-regulation tax havens epitomize this 'frictionless' finance.

There is indeed a lot of investment in Africa via tax havens—but that may not be such a good thing. Consider the issue of 'round-tripping.' African countries, like many others, offer special tax and other incentives to foreigners, which are not available to locals. They create these incentives in the hope of attracting foreign investment. But what so often happens is that locals take their money offshore, dress up in offshore secrecy and return it back home, disguised as foreign investment, availing themselves of all the perks that are not available to their less wealthy compatriots. It is hard to see what is 'efficient' about this. Meanwhile, academic research suggests that these tax incentives do not seem to promote growth (<http://taxjustice.blogspot.ch/2009/07/imf-lower-corporation-taxes-and-tax.html>).

There is worse. In the book *Africa's Odious Debts*, James Boyce and Léonce Ndikumana estimated capital flight from 33 African countries at an accumulated \$735bn from 1970-2008, worth \$944bn at conservative interest rates; this number happens to tally closely with industry estimates of the holdings of African High Net Worth Individuals at \$800-1,000 billion. Most of this capital flight escaped offshore, and stayed offshore. Compare these numbers to the estimated external debts for these countries of 'just' \$177 billion in 2008 – suggesting that Africa was a net creditor to the world of \$767 billion. The trouble is, of course, that the assets are in the hands of a small, wealthy African elite, while the liabilities are shouldered by the broader African populations in the form of reduced health, education and infrastructure – or higher taxes.

James Henry's 2012 paper *Explaining Capital Flight*, looking at the drivers and effects of these flows, notes how a big share of this capital flight has been actively driven by the borrowing itself, which comes in then is quickly recycled offshore, often with the aggressive intervention of private bankers from London, Geneva and New York.² They have been ruthlessly 'efficient' in shifting the assets to Africa's wealthy elites and the liabilities to the African public.

Consider another aspect of 'efficient' and frictionless finance. To get around a particular annoying regulation; or to get your container quickly through that port; or to get that permit expedited fast, or to skirt that tax – there is an approach that can seem highly 'efficient' from an individual company's perspective. That approach is called bribery. But while bribery can certainly seem efficient for an individual or corporation, a society plagued by bribery is a very different matter. Likewise, tax havens make global financial markets more efficient by removing obstacles. But what are those obstacles? They are tax, regulations,

disclosure requirements and so on—all of which, for all their warts, are put in place for good reasons. It is not immediately obvious why removing them should be 'efficient.'

African countries are relatively powerless in the face of the nebulous, complex, shifting, frictionless world of offshore finance. But in this context it is worth asking the question: rich countries *also* lose billions to the offshore system too, and their economies are the victims of untold financial crimes hidden by offshore secrecy. So why do they tolerate it?

The answers to this question are illuminating.

Start by considering how many Nigerians stash their money secretly in London or Switzerland. There is no hard data available, but there may be hundreds of thousands. Now consider how many British or Swiss residents will choose Lagos or Abuja as the best place to stash their secret, tax-evading wealth? It is hard to imagine many.

The point is this: tax havens are generally located in wealthy, stable countries, and the illicit financial flows head overwhelmingly in one direction: from poor, unstable countries to rich, well-governed ones.

The rich countries like your money, and making financial flows more 'efficient' and more secretive will accelerate this gigantic one-way net flow.

On April 2, 2009, the G20 countries declared in a summit in London that "the era of banking secrecy is over." They promised a crackdown on offshore secrecy, and assigned the task of leading the crackdown to the OECD, a club of rich nations. This sounded exciting – but an examination of what actually happened demonstrates the power and effectiveness of the offshore lobby.

The OECD had a black, white and gray list of tax havens – and it is a measure of how serious this initiative was that the blacklist was empty by April

² http://www.taxjustice.net/cms/upload/pdf/APPENDIX_II_-_Price_of_Offshore_Revisited.pdf.

7, 2009 – just *five days* after the G20 statement. Jurisdictions could get onto the white list by signing 12 so-called Tax Information Exchange Agreements (TIEAs) – bilateral agreements by which tax havens are supposed to cough up information about foreign assets stashed in their jurisdiction to the partner in the agreement. The trouble is: these OECD agreements are useless. These agreements prohibit what they call ‘fishing expeditions’ where Ghana, say, could put in a blanket request to the Cayman Islands for all information about Ghanaian citizens’ assets. No, you have to *already* know the information you are looking for about a particular Ghanaian citizen, then ask the Cayman Islands to confirm that! These agreements are slightly better than useless – but not much. The OECD was asked to drain a swamp, but it has been handing out drinking straws.

The tax havens busily starting signing these TIEAS in order to get the 12 agreements, but well over a third of these are with other tax havens or with tiny jurisdictions such as Greenland, Andorra and the Faroe Islands. Worse still, of the over 200 TIEAs signed, just three were with African countries, leaving aside Liberia, which is a tax haven in its own right.³

The rich countries’ big model for transparency is not working. And that is deliberate. Instead of properly cleaning up the tax havens, the world’s rich countries are resorting to the tried and tested palliative: foreign aid. The global rules for taxing multinational corporations are not much better: the basic aim of the OECD-led system is, in the words of international tax expert Lee Sheppard, “to make life comfortable for American, British, German, and French multinationals.”⁴ The rules are clumsy tools that affluent developed countries have used among themselves, to their collective detriment, and seek to impose on developing countries.

It is essential to understand where the tax havens are located. In the popular imagination, they are mostly small, shady islands such as Cayman, or secretive little bolt holes such as Monaco. These jurisdictions are important, but in reality the dictators’ assets tend to get parked in the places where they and their families like to go shopping: that means London, Miami or Geneva.

How are these assets owned? Typically, a super-wealthy African might own a luxury apartment through a multi-jurisdictional structure. One of the simpler structures may involve a Bahamas trust whose trustees are in Jersey; that trust will then hold a company in the British Virgin Islands, which in turn owns the apartment, alongside a bank account in a branch of a Swiss bank in Singapore.

Assuming criminal tax evasion, which is the guilty tax haven here? Nobody and everybody, of course. But that is not the end of the story. Britain (or, to be more economically precise, the City of London financial center) runs a series of satellite tax havens, spread across the world in concentric rings. In the inner ring are Britain’s Crown Dependencies: Jersey, Guernsey and the Isle of Man. The next ring out are the 14 Overseas Territories: the last remnants of the British Empire, which include some of the world’s most important small island tax havens: the Cayman Islands, the British Virgin Islands, Bermuda, Turks and Caicos, Anguilla and Gibraltar. These two offshore networks, which are essentially the last remnants of the British Empire, are partly British, and partly independent.

Each has its own political system with its own independent politics, but each has a Governor (or Lieutenant Governor) appointed by the Queen. Britain is officially responsible for their foreign relations and defense, and for their good governance. The last court of appeal is the Privy Council in London.

Further out in the web are a number of other tax havens with ongoing strong historical or

³ <http://www.oecd.org/ctp/harmfultaxpractices/43775845.pdf>.

⁴ <http://taxjustice.blogspot.ch/2012/08/top-us-tax-expert-in-savage-attack-on.html>.

commercial ties to the UK: Hong Kong, Mauritius, the Bahamas, and others.

From Britain's point of view, this network operates along the lines of a spider's web, with the City of London at the center. Each haven tends to have something of a geographical focus: the Caribbean havens focus most heavily on North, Central and South America, while the Crown Dependencies will focus most heavily on European business, as well as Africa and the Middle East. They capture huge amounts of money (and the business of handling money) up to the City of London. Just in the second quarter of 2009 the UK received net financing of US\$332 billion just from its three Crown Dependencies.⁵ Martyn Scriven, secretary of the Jersey Bankers' Association, describes the relationship: "If I have money to spare, I pass it to the father. Great dollops of money go into London from here." Promotional literature for Jersey Finance, says it plainly: 'Jersey represents an extension of the City of London' (<http://www.jerseyfinance.je>)

My book *Treasure Islands* explores the emergence of the modern City of London from the mid 1950s - - just as the British Empire was crumbling - with the so-called "Eurodollar" markets, which transformed the City of London as the financial engine at the heart of the British Empire to a 'light touch,' deregulated Wild West center, which over time increasingly became fed by the web of British (and other) tax havens around the world. Looking at this from an African perspective, it is not unfair to say that Britain left its colonies by the front door - then stole back in by a side window, retaining a huge influence over, and profiting significantly from, Africa's international money flows.

It may surprise some people to discover that the United States is also a gigantic tax haven (or secrecy jurisdiction, a term that some of us prefer,) in its own right, thanks to state-level laws that allow the formation of anonymous corporations providing

bullet-proof secrecy, and federal laws that for decades have deliberately turned a blind eye to dirty foreign money, often fed into Wall Street by foreign 'feeder' tax havens. Bain capital, the private equity firm formerly run by current U.S. presidential candidate Mitt Romney, is one of many that has solicited potentially tax-evading (and perhaps other criminal) money from foreigners, who have typically invested in the United States via funds based in the Cayman islands. Although U.S. taxpayers suffer greatly from offshore tax havens, Wall Street benefits from the offshore inflows—and it is increasingly Wall Street that calls the shots in Washington.

The biggest tax havens, it turns out, are not the small islands of the popular imagination, but the world's biggest economies. The Tax Justice Network's Financial Secrecy Index or FSI which combines a jurisdiction's secrecy score with a weighting for the size of its offshore financial sector, reckoned in 2009 that the world's five most important providers of offshore financial secrecy were the United States, Luxembourg, Switzerland, the Cayman Islands and the United States, in that order.⁶ The subsequent 2011 FSI, which mathematically emphasized the secrecy score than the 2009 index did, gave Switzerland the top rank, followed by the Cayman Islands, Luxembourg, Hong Kong, and the USA.⁷ In both cases, however, Britain would have ranked head and shoulders above the others if TJN had, as one might reasonably do, included the British Overseas Territories and Crown Dependencies as part of Britain.

With this short history and analysis, it becomes easier to see why rich countries tolerate tax havens, and why they will be so hard for Africa to confront. We like the money, so we create the secrecy, and we tolerate the tax havens. It is little wonder that the OECD's efforts to crack down have been such a charade.

⁵ http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/d/foot_review_main.pdf.

⁶ <http://www.financialsecrecyindex.com/2009results.html>.

⁷ <http://www.financialsecrecyindex.com/2011results.html>.

But one thing is now changing. Civil society and the public in Britain and other countries are at last waking up to the importance of tax havens, and are no longer content to argue simply that the answer to Africa's ills is more aid. It is important – essential

that African voices also start to become more vocal about tax havens.

Plundering a Continent

Raymond W. Baker, Director, Global Financial Integrity

Raymond Baker is the Director of Global Financial Integrity and a Senior Fellow at the Center for International Policy in Washington, D.C., researching and writing on the linkages between corruption, money laundering, and poverty. He is the author of Capitalism's Achilles Heel: Dirty Money and How to Renew the Free-Market System. In 2011 he was named to the High Level Panel on Illicit Financial Flows from Africa, chaired by former President of South Africa, Thabo Mbeki.

In 1961 I arrived in Lagos, Nigeria, to take over the management of a company. One of the early conversations I had was with an “old coaster,” a British gentleman who was managing director of a UK-based trading company that had been active along the west coast of Africa since the late 1800s. I asked him, “How do you do business in Africa?” He looked me skeptically up one side and down the other and wasn’t very forthcoming. I got the distinct impression that he did not like Americans showing up in his former British colony so soon after independence. But I pressed on as is my American manner and asked further, “Well, okay, tell me, how do you price your imported cars and textiles and building materials to sell in the Nigerian market?” He answered, “Price? Price is not a problem. I’m not trying to make a profit.”

Imagine my surprise. I had just finished Harvard Business School learning all about how to make a profit and here in Africa one of the first persons I encounter tells me he’s not trying to make a profit. What could be going on here?

It took me a while to realize that what he was talking about was transfer pricing. Everything he imported was priced at such a high level that, indeed, the Nigerian subsidiary was not supposed to make a profit. It was only supposed to pay the bills for its imports, with all potential profits shifted back to the UK within the invoices of what was being purchased for resale locally. It took me some time longer to realize that most foreign companies were doing similarly and a bit longer still to figure out that many Nigerians involved in foreign trade were doing the same thing—overpricing imports and underpricing exports in order to shift money out of the continent and into foreign bank accounts. Thus began my education in unrecorded, hidden, usually illegal financial flows and the harm they do to developing countries.

The 1960s marked the takeoff point in developing the structure that facilitates such cross-border illicit financial flows. There are two reasons that account for this. First, the 1960s was the decade of independence. Between the late 1950s and the end of the 1960s, 48 countries gained their independence from colonial powers.¹ Some of the political and economic elites in these countries wanted to take their money out by any means possible, and western financial institutions and even governments serviced this desire creatively and effectively.

The 1960s also marked the decade when multinational corporations accelerated their expansion across the world. There were already a handful of international oil and trading companies with operations in perhaps a dozen countries, but the thrust to expand globally took off simultaneously with the decade of independence and has continued since. Many multinational corporations utilized a practice continuing today—aggressive transfer pricing and money laundering schemes to shift profits from countries where they are in business into locations where they are often not in business.

¹ <http://www.un.org/en/members/growth.shtml>

How is this possible? How do you lose money or operate at little or no profit in countries where you are heavily invested and make money in countries and enclaves where you are not invested? Quite simply, you use the global shadow financial system to shift your revenues and profits across borders at will.

This system comprises a number of elements. Tax havens, rising from four or five in the 1950s, now number upwards of 60 situated all around the globe. Most of these tax havens operate as secrecy jurisdictions, meaning that you can establish entities behind nominees and trustees such that no one can find out who are the real owners and managers of these entities. The most popular form—disguised corporations—now number in the millions around the world, more in the United States than in any other country. Anonymous trust accounts are part of this structure. Fake foundations are available, enabling you to donate money to your own foundation and then designate yourself the beneficiary of the distributions. Trade mispricing is the most commonly used device in the global shadow financial system, accounting for more than half of illicit cross-border financial flows. And then there are many specialized forms of money laundering available, so that capital movements can be facilitated through interest payments, derivatives, swap contracts, entirely fake transactions, barter, and more. This global shadow financial system was built by those who live in the countries into which the money arrives, not by those who live in the countries out of which the money comes.

At Global Financial Integrity, we estimate that the shift of laundered money out of Africa over the last 30 years is very roughly on the order to US\$1 trillion (Kar and Cartwright-Smith 2010). It could be half that and it could easily be twice that, depending on what cannot be seen in our analyses. Whatever the proper figure, we are dealing with an order of magnitude resulting in a devastating impact on the poorest continent and its one billion-plus people.

For many well meaning observers, including the authors of the Washington Consensus promoting unfettered international trade, the only concern here is the loss of tax revenues. Important as this is, the larger impact is the loss of capital to the economies of the continent. Retaining resources in countries has a multiplier effect on domestic activity. Losing resources drains bank accounts, curtails investment, worsens poverty and inequality, and contributes to political instability.

For a half century the western media has focused attention on corruption in Africa. Much of this attention is well deserved. I lived 15 years in Nigeria and retained business interests there until three years ago, so I am not unfamiliar with the reality. But in our analysis of global cross-border illicit financial flows, we think that the corrupt component, stemming from bribery and theft by government officials, is only about three percent of the total. The criminal component arising from drugs, human trafficking, counterfeiting, illegal arms trading, and more is about 30 to 35 percent of the global total. Trade mispricing, in which multinational corporations are heavily involved, is about 60 to 65 percent of the global total. We have not made a separate analysis of these percentages for Africa. The corrupt component may well be higher, and then again the trade mispricing component may also be considerably higher. But the ranking of the three is no doubt correct.

What is missed by most development experts and economic and political analysts is the systemic nature of this problem. Drug trading is approached as a problem to be fought largely through eradication and interdiction. Human trafficking is basically conceived of as a problem of immigration and border control. Corruption is fought from the bottom up more often than from the top down. Money laundering is a matter of know your customer and suspicious activities reports. What we do not want to admit to ourselves is that all three forms of cross-border illicit financial flows utilize the same shadow financial system to shift their

revenues and profits. The key fallacy in global anti-money laundering efforts is the idea that commercial interests can hold on to their use of the shadow financial system to move commercially tax-evading money and at the same time make others give up their use of the shadow financial system to move corrupt and criminal money. This is not possible. It is the facilitating system itself that must be changed.

How? Two guidelines are important. Recognize, first of all, that the goal is to curtail illicit financial flows rather the impossible one of stopping them. And second, encompass both rich and poor countries in accomplishing the necessary reforms.

Broadly speaking, the answer is to replace the shadows with transparency. This means a number of steps.

First, banks and other financial intermediaries should be required to know the natural persons owning and managing all financial accounts. This proposal elicited a response from a Wall Street banker who asked, “Do you have any idea how much it would cost us to know the beneficial owners of all our accounts?” The answer is it costs nothing. You put the shoe on the other foot. You the banker sends a letter to each of your non-personalized account holders requesting within six months the name(s) of the natural person(s) owning the account. You advise of the penalties of making a false declaration to a bank. And you advise that if you subsequently find that the information given is incorrect you will have no choice but to block the account pending disposition according to law. Immediately you the banker will get correct information on probably upwards of 99 percent of your accounts. Hopefully the holders that do not want to respond are the accounts that you would prefer not to have anyway. To put it simply, there is no argument in favor of not knowing with whom you are doing business. This is an issue of huge significance in the fight against corruption, crime, terrorism, and tax evasion, and it is the element of

the shadow financial system that is the easiest to curtail.

Second, adopt consistent anti-money laundering (AML) policies across the globe. AML has been important on the world scene for two decades. And for two decades money laundering has been growing. How can this be? Very simply, our efforts are more geared to looking for the money after it has passed from one party to another instead of curtailing the flow before it begins. The shadow financial system defeats AML efforts. The Arab Spring is informative. The Mubaraks, the Ben Alis, and the Kaddafis were found to have large deposits abroad, as yet untallied. But with revelations pouring out of these countries, banks were quick to freeze these accounts, pending further determination of their disposition. Of course, the question is, “Why did you take the money in the first place?” And the reason is because vast gaps are left in global AML efforts, with a decided bias toward easily accepting the money and asking questions only later, if at all. The United States and Europe are replete with laundered money scandals and will continue to be so until AML regulations are tightened and sanctions against sheltering ill-gotten gains are stronger.

Third, automatic exchange of tax information needs to be implemented globally. The argument that African nations and other developing countries cannot deal with the volume of data that would be produced through automatic exchange does not stand up to scrutiny. Any nation can deal with the 10 names or 100 names on their tax rolls with the largest incomes. Automatic exchange has been a reality in the European Union for years. It has existed between the United States and Canada for decades, yet remains to be implemented between the United States and Mexico. Prime Minister Manmoham Singh of India called for automatic exchange at the Cannes G-20 summit in 2011. India is certainly an example of an emerging market country with billions spirited abroad, billions on which tax information should be provided.

In relation to this point, note that all the available measures of global inequality are decidedly underestimates, because they do not include earnings on capital deposited by citizens outside their countries. Those incomes from interest, dividends, and rents pile up abroad and largely slip through the global accounting net, meaning that the rich in many developing countries are far richer than they appear to be. The global gap is wider than income statistics show and getting wider every year. Poverty appears to be declining, but inequality is rising and that poses the greater problem in the long run to reconciling democracy and capitalism. Automatic exchange of tax information is a key toward fighting money laundering and its impact on income inequality.

Fourth, trade mispricing, moving more illicit money across borders than all other methods combined, has to be curtailed. And this is the toughest to accomplish. Fortunately, there is a growing set of data on world market pricing that can be accessed online. Customs officers could compare prices on an invoice to world market data to quickly and fairly check for discrepancies. Customs declaration forms that had a statistically significant deviation from market prices would then be pulled out for further review. Use can be made also of pricing declarations backed up by the signatures of importers and exporters. Both can be asked to sign a statement saying that “The transaction herein is priced at world market norms with no element of mispricing for the purpose of manipulating VAT taxes, customs duties, or income taxes, and the transaction conforms to all exchange control regulations, banking statutes, anti-money laundering laws, and terrorist financing prohibitions in the countries of origin and destination.” Certainly, some exporters and importers will readily violate such a clause. But there are not many multinational corporations that will run such transactions through their tax planning departments for the prohibited tax manipulations and then ask their people to sign a statement saying they did no such thing. Remember, what we are trying to accomplish here is to curtail—not eliminate but curtail—illicit cross-

border financial flows. This issue of trade mispricing needs to be addressed now and cannot wait for a perfect world decades down the road.

Finally, country-by-country reporting is an important step leading toward greater integrity in the global financial system. Discussed in another paper in this bulletin, efforts are underway to require extractive industries to report on their payments to governments, vitally important to Africa. But this merely begins what needs to be accomplished, which is full financial reporting in each country, so that corporations cannot continue this process of losing money where they are in business and making money where they are not in business.

Africa has taken a major step on the road toward curtailing cross-border illicit flows. The United Nations Economic Commission for Africa has named a High Level Panel to research how this phenomenon affects the peoples of the continent and what can be done to surmount the problem. Led by former President of South Africa Thabo Mbeki, the panel constitutes the first effort by a continent-wide organization to come to grips with the reality of massive flows shifting money from poor to rich countries.

Above all else, this is a problem requiring concerted effort by both sides of the equation—those in the countries out of which the money comes and those in the countries into which the money arrives. The solutions are not technically difficult. The issue is a matter of political will.

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Organizations and websites

Political Economy Research Institute, University of Massachusetts Amherst
<http://www.peri.umass.edu/300/>
Publications and data on capital flight from African countries.

AfricaFocus Bulletins with Material on Debt, Corruption, & Illicit Financial Flows
<http://www.africafocus.org/debtexp.php>
Documents from wide variety of sources, 2003-present.

African Forum and Network on Debt and Development (AFRODAD)
<http://www.afrodad.org/>
A regional platform and organization for lobbying and advocating for debt cancellation and addressing other debt related issues in Africa.

Eurodad: European Network on Debt and Development
<http://eurodad.org/>
Eurodad a network of 50 non-governmental organisations (NGOs) from 19 European countries working on issues related to debt, development finance and poverty reduction.

Global Financial Integrity

<http://www.gfintegrity.org/>

Global Financial Integrity (GFI) promotes national and multilateral policies, safeguards, and agreements aimed at curtailing the cross-border flow of illegal money.

Global Witness

<http://www.globalwitness.org/>

Global Witness investigates and campaigns to prevent natural resource related conflict and corruption, and associated environmental and human rights abuses.

Jubilee USA Network

<http://www.jubileeusa.org/home.html>

Jubilee USA Network is an alliance of more than 75 religious denominations and faith communities, human rights, environmental, labor, and community groups working for the definitive cancellation of crushing debts to fight poverty and injustice in Asia, Africa, and Latin America.

Publish What You Pay

<http://www.publishwhatyoupay.org/>

Publish What You Pay (PWYP) is a global network of civil society organisations that undertakes public campaigns and policy advocacy to achieve disclosure of information about extractive industry revenues and contracts.

Stolen Asset Recovery Initiative (StAR)

http://www1.worldbank.org/finance/star_site/

The Stolen Asset Recovery Initiative (StAR)--is a partnership between the World Bank Group and the United Nations Office on Drugs and Crime that supports international efforts to end safe havens for corrupt funds.

Task Force on Financial Integrity & Economic Development

<http://www.financialtaskforce.org/>

The Task Force on Financial Integrity and Economic Development, a consortium of governments and research and advocacy organizations, focuses on achieving greater transparency in the global financial system for the benefit of developing countries.

Tax Justice Network

<http://www.taxjustice.net>

The Tax Justice Network promotes transparency in international finance and opposes secrecy. We support a level playing field on tax and we oppose loopholes and distortions in tax and regulation, and the abuses that flow from them.

Tax Justice Network USA

<http://tjn-usa.org/>

The Tax Justice Network USA promotes tax justice and tax cooperation, including policies to address tax avoidance, tax evasion and the lack of financial transparency in our government, corporations and financial institutions.

Tax Research Blog

<http://www.taxresearch.org.uk/Blog/>

Blog by Richard Murphy.

U4 Anti-Corruption Resource Center

<http://www.u4.no/>

U4 is a web-based resource centre for development practitioners who wish to effectively address corruption challenges in their work.