Illicit Financial Flows: Africa's capital flight under globalisation

Abstract:

This essay will discuss the issues of illicit financial flows, in particular capital flight and the inter-linked issue of tax evasion and tax avoidance by transnational corporations (TNC's) in Africa. Neoliberal globalisation and the financialisation of the world economy has exacerbated and in some cases directly contributed to capital mobilisation out of Africa. Under financial globalisation, capital is highly mobile and will search for ways to maximise returns. One such way has seen increased incidents of tax evasion, tax avoidance and the growth in and use of tax havens by TNC's and wealthy individuals. The magnitude of capital outflows as a result of this has been linked to the continued under-development of Africa, particularly in that it inhibits a states' ability to mobilize domestic resources for economic and social development.

What is capital flight and how has globalisation contributed to it?

Illicit financial flows or capital flight "*is generally described as a form of illegal and is often associated with money that is illegally earned, transferred, or utilized*" (Mbeki Foundation, 2012). It can be generated or "*originate from a multitude of sources including corruption, crimes and tax evasion*" (Massa, 2014, p201). Capital flight is the outflow of money from one state to international institutions. Capital flight from Sub-Saharan Africa (SSA) alone is estimated to be in the region of $814 - $944 billion between 1970 and 2010 (Boyce & Ndikumana, 2011, 2011). Over the same time period, capital outflows exceeded capital inflows of development aid at $650 billion and foreign direct investment (FDI) at $306 billion (Ajayi, 2014). When accounting for debt levels Boyce and Ndikumana (2011) conclude that SSA is a net creditor to the world given its external assets are worth around $767 billion.

Such a magnitude of capital flight is made possible by corrupt governments and wealthy individuals with a preference for foreign asset accumulation (Boyce & Ndikumana, 2011). Motivations for capital flight include concerns over political instability which risks expropriation that could reduce their wealth (Hermes & Lensink, 2014). The domestic

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banking system in Africa is underdeveloped and has weak supervisory and regulatory frameworks and this weakness further facilitates and encourages capital flight (Massa, 2014).

Moreover, key features of neoliberal globalisation as directed by international finance and transnational corporations are free trade, capital mobility (Lesage & Vermeiren, 2011) and time-space compression (Harvey, 1989). In reality this means that Africa's domestic banking system is now characterised by the high presence of foreign banks and the ability to remotely move capital (mobile and internet banking, Massa, 2014). Sub-Saharan Africa now accounts for the second largest proliferation of foreign owned banks (Europe being first, Massa, 2014). This in turn has contributed to the removal of barriers to capital flows, which is a dominant feature of financial liberalisation.

Financial liberalisation is often argued by economists and power elites as the most efficient way to allocate scarce resources and ultimately strong financial markets increase investment and therefore economic development and growth. However, in reality the inherent contradictions of the capitalist global economy - one being competition - distorts the financial system and in turn the allocation of resources and national economic development. Although a simplistic description of inherent contradictions in the capitalist global economy, the outcome of such competition is increased financial de-regulation, increased financial liberalisation, free trade, erosion of the tax base and tax havens. These outcomes in turn support and facilitate capital flight from both developed and developing regions.

In Africa, however, financial globalisation has resulted in increased pressure to remove capital account controls to integrate into the world economy thereby creating economic development (Hermes & Lensink, 2014). However, even during periods of economic growth, some African countries have still experienced increased illicit financial outflows (Ayogu & Gbadebo-Smith, 2014). This haemorrhaging of capital in turn erodes the tax base (Ajayi, 2014) and hinders a state's ability to use domestic capital resources for development.

Tax evasion, tax avoidance and tax havens – vehicles of illicit financial flows.

To date, the issue of capital flight has focused on corruption, bribery of government or theft by government leaders and officials (Boyce & Ndikumana, 2011, 2012). However, globalisation has opened up new opportunities for TNC's to reduce their tax liabilities (Jenkins & Newell, 2013). Money secured through forms of corruption accounts for about 3% of the global total of capital flight (Kar & Cartwright-Smith, 2010). It is the money

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secured through reduced tax payments and commercial tax evasion that accounts for 60% to 65% of all capital outflows from Africa (Kar & Cartwright-Smith, 2010). Advocating neoliberal policies of de-regulation and financial openness (Lesage & Vermeiren, 2011) and the ensuing competition to maximise profits has resulted in a global shadow financial system which facilitates capital outflows (Kar & Cartwright-Smith, 2010). Tax avoidance and evasion are strong motives by which profits can be maximised (Kedir, 2014). Conversely, financial globalisation means most financial flows are global in nature, while taxation remains a feature of the nation state (McNair & Vermeiren, 2010) thereby making it increasingly difficult for states to collect tax revenues (Jenkins & Newell, 2013). Given tax avoidance and evasion's global reach, which can only be controlled at the national level, "*progressive tax policy has become a tremendous collective action problem...at least a large number of jurisdictions have to co-operate, which is extremely difficult because of wide divergence in interest and ideological stance*" (McNair & Vermeiran, 2010, p160).

Tax evasion and tax avoidance have distinct differences; evasion being illegal, avoidance is not (Jenkins & Newell, 2013). Tax evasion is deliberate deception – tax avoidance is deliberate 'mitigation' (Jenkins & Newell, 2013, Otusanya, 2011). These blurred lines are easily crossed and brought about by creative accounting measures such as trade mispricing and trade misinvoicing and transfer pricing (Boyce & Ndikumana, 2011, Ayogu & Gbadebo-Smith, 2014, Jenkins & Newell, 2013). Additional mechanism is the use of tax havens or secrecy jurisdictions that "*actively encourage and support corrupt practices by facilitating illicit financial flows through and offshore interface*" (Christensen, 2009). This 'offshore economy' allows '*profits to be moved across space, from country to country, and across time to bring forward book profits while pushing back tax profits'* (Sharman, 2010, p. 7) thus "*making secrecy jurisdictions, not marginal, but central to the global economy*" (Bracking, 2012, p616)

The scale of tax avoidance and evasion - The loss to Africa:

Tax havens have growth in line with the growth of neoliberal financial globalisation. In 1970, 32 tax havens were know to exist, by 2005 this has risen to 72 (Christensen, 2009) which are estimated to house over 2 million international business companies and almost as many trusts, hedge funds and insurance companies (Bracking, 2012). Other estimates suggest that 50% of lending by international institutions in addition to 30% of all FDI are registered in tax

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havens (Bracking, 2012 citing Palan et al, 2010). This institutional capital is joined by about $12trillion of private individual wealth (Bracking, 2012)

For Africa, the under-developed continent where the majority of people live below $2 a day, such vast revenues lost to tax havens by TNC;s and wealthy elites capital flight equates to an estimated loss of $50 billion a year or as Oxfam explained "*six times the estimated annual cost of achieving universal primary education, and almost three times the cost of universal primary health coverage*" (Oxfam, 2000). Another striking description is that from Christian Aid "*it is the equivalent of US$160 billion per year in lost corporate taxes which is more than one and a half times the combined aid budget of US$103.7 billion in 2007, and enough to fund the Millennium Development Goals (MDGs) by 2015"* (Christian Aid, 2008 cited by Bracking, 2012). If the income of wealthy individuals secured in tax havens could be taxed, even at a very low rate, up to $255million could be made available for development in Africa (Tax Justice Network, 2005)

On the tax avoidance and evasion side, 60% of all trade transaction in and out Africa is are estimated to be 'mispriced' about 11% which results in a capital outflow of over $10billion a year (Baker, 2005 cited by Christensen, 2009). Other studies suggest that $12 to $17 billion alone was lost from Sub-Saharan Africa to the USA between 1976 and 1987 as a result of trade mispricing (Boyrie, 2010, citing Chang & Cumby, 1991). A more recent study on trade mispricing between SSA and the USA suggest there has been a 257% increase of capital outflows to the US from 1996 to 2005; that equates to $4.9billion in lost taxable capital to SSA (Christensen, 2009). Trade misinvoicing, whereby TNC's under-invoice exports, saw a total of $32billion of taxable revenue from 1970 to 2008 being lost from Sub-Saharan Africa (Boyce & Ndikumana, 2011). Figure 1 below gives an overview of estimates of lost tax revenue.

TABLE 1. Estimates of tax revenue lost by developing countries through corporate tax avoidance

Study	Tax revenue lost ($billion)
Cobham (2005)	50
Christian Aid (2008)	160 (2008)
Christian Aid (2009)	121.8 (avge 2005–07)
Oxfam (2000)	35 (1998)
Hollingshead (2010)	98–106 (avge. 2002–06)

Fig. 1 Lost Tax Revenues Source: Jenkins & Newell, 2013

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Given the blurred distinction between tax evasion and avoidance it has been a difficult task to measure and fully quantify the degree of lost tax revenue to Africa; very little academic research exists with most estimates coming from the NGO sector (Jenkins & Newell, 2013) leaving room for critical analysis. Nevertheless, evidence exists that shows the scale of tax evasion and tax avoidance by TNC's and wealthy individuals which makes up the bulk of capital flight from Africa and thus have a direct impact on its 'development'.

Examples of globalisation's contribution to capital mobility:

Halliburton West Africa Ltd & Nigeria:

Providing products and services to the energy industry, Halliburton employs 55,000 people across 70 states involved in upstream services to the oil and gas sector (Otusanya, 2011). It operates from four headquarters across the continents and its global revenue for 2008 was $18.3 billion (Otusanya, 2011).

> *"This case involved a tax scheme whereby a MNC was able to establish affiliates incorporated in a particular jurisdiction in order to shelter foreign-source income, thereby enabling that income to benefit from a lower tax rate." (Otusanya, 2011, p 326)*

The corporate structure and creating 'shell companies' or subsidiaries in tax haven can be used to reduce tax liabilities, simply by transactions between the parent company and its operations side (Jenkins & Newell, 2013). Other mechanisms include the use of holding companies in low-tax states who own a subsidiary in a high-tax state which doesn't make a profit but pays a loan to its parent company often means the holding in the high tax state can avoid paying tax. Headquarters can be set-up in low-tax states thereby reducing tax liabilities on profits originated somewhere else (Jenkins & Newell, 2013). Halliburton West Africa Ltd (HWAL) operations in Nigeria are an example of such mechanisms facilitated by globalisation that resulted in a major loss of taxable revenues. The example is best explained by Otusanya (2011);

> "*For the period 1996–1999 HWAL was purported to have filed a self-assessment return with its tax liabilities arising from the tax return duly paid. However, the independent audit investigation into the accounts of HWAL revealed that a total of $109.69 million was claimed as recharges and $1.75 million was unreported profit, which reduced the tax payable by $6.97 million. The loss of tax revenue*

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and the accompanying flight of capital was the legal basis for raising the 'additional assessment of tax' (AAT) of $6.7 million against HWAL28 in 2002 (Otusanya, 2011, p 327)

Based on the incorrect self-assessment returns, the Federal Inland Revenue Service (FIRS) investigation and the conviction that TNCs use subsidiaries and;

"*complex corporate structures to shift profits and legal pronouncement on 'deemed profit', the Body of Appeal Commissions (on 15 March 2005) ordered HWAL to pay the disputed tax purported to have been avoided through recharges and unreported profit, but HWAL appealed against this decision to the Federal High Court......the Federal High Court judge held that HWAL could not be taxed for the total amount it had received under the contract...The Judge therefore ruled that the judgment of the Body of Appeal Commissioners should be set aside, that the additional tax raised by the FIRS to HWAL for the years 1996 to 1999 were invalid, null and void and should therefore be set aside, and that that FIRS should refund to HWAL the sum of $6,686,381"*(Otusanya, 2011, p327).

Federal Inland Revenue Service (FIRS) has since appealed the case however to date it has not been resolved. Profit shifting through tax havens and creative corporate restructuring is facilitated by financial globalisation. This has resulted in billions of taxable revenues being lost to tax avoidance mechanism representing a 'lost opportunity' for domestic utilization of resources for Nigeria's economic development.

SABMiller in Ghana:

Through transfer pricing, SABMiller subsidiaries like Accra Brewery in Ghana pay or move money to SABMiller parent companies in tax havens, reducing or removing all profits and thereby reduce or remove tax liabilities in Ghana (ActionAid, 2010). Payment to parent companies in low-tax staes is done through, loan repayments 'thinly capitlaised', management fees and processing orders through subsidiaries in Mauritius, a know tax haven (ActionAid, 2010). The magnitude of the revenue lost is best illustrated below;

"Accra Brewery controls more than 30% of Ghana's beer market, yet it is remarkably unprofitable. Between 2007 and 2010, Ghanaians poured £63.3 million (Gh¢131 million) into the company's coffers. Yet over this period it managed to make an overall pre-tax loss of £3.07 million. Even before the costs

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of financing the business it registered a mere £525,000 (Gh¢906,000) operating profit, representing just 0.69% of its income. Unsurprisingly, Accra Brewery's tax bills for the four years amounted to a derisory £216,000 (Gh¢423,000). For three of these four years it paid no income tax at all" (ActionAid, 2010, p12)

Again the loss of taxable revenue through transfer pricing, is yet another vehicle through which capital flight is mediated out of Africa and into international institutions an opportunity presented by financial globalisation.

Conclusion - the damaging effect of tax evasion

Tax evasion or tax dodging by TNC's equate to large losses by African Governments and is damaging to their economy (Kedir, 2014). Estimates suggest that over $150billion per year outflows from Africa, 80% makes its way to international financial centres and another 30% of Sub-Saharan Africa's GDP is relocated to tax havens (Ajayi, 2014). Illicit financial flows of capital are "*a major constraint to development financing in Africa, a continent that continues to lag behind in most measures of human development*" (Boyce & Ndikumana, 2011). Capital flight is most severe in Africa and hinders its ability to utilized domestic resources for economic or social development. Worse still, capital flight is exacerbated by TNC's tax planning that involves tax evasion, tax avoidance and the use of tax havens to maximise profits (Kedir, 2014). The causes are twofold, both weak domestic institutions from government to banking and external elements that facilitate capital flight (Boyce & Ndikumana, 2011). Nevertheless it is the dominant force of neoliberal financial globalisation that has exacerbated the 'bleeding of a continent' (Boyce & Ndikumana, 2011, p55).

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