

ILLICIT FINANCIAL FLOWS AND FOREIGN DIRECT INVESTMENT IN DEVELOPING COUNTRIES

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Abstract

Africa is facing a number of challenges that are negatively affecting socio-economic development at all levels of governments and local governments are expected to play a leading role for Africa's development. One of these challenges are illicit financial flows that are perceived by many as a crime against Africa's transformation. The continent is losing billions of dollars every year because of tax evasion, corruption and inappropriate transfer pricing and maladministration. With tax being one of Africa's main sources of revenue, current and past researches revealed that, illicit financial flows (IFFs) cripple African Governments tax base as a results of capital outflows and lack of good governance. This situation obviously is a challenge for Africa's development as governments struggle to finance structuring projects and this in turn compels these governments to seek funds from international organisations at very high interest rates. It is also important to reveal that Foreign Direct Investment (FDI) rapidly grew after the Second World War with the intention to maximize profit on investment in less developed countries and specifically in the African continent. In competing in Africa, most multinationals main objective is to pay less tax, make extensive profits and transfer the proceeds to their country of origin. This subsequently gave rise to illicit financial flows in Africa where the continent is losing billions of dollars. Past studies equally revealed that, Africa's revenue could increase between 55 and 65%, if appropriate mechanisms of monitoring the flows were in place. This study therefore is based on the premise that, tax evasion, illicit financial flows, corruption and abusive transfers pricing are all factors that affect Africa's development. Using appropriate method of inquiry, this study wants to demonstrate the presence of FDI's in Africa as a modus operandi behind tax evasion. It also using the "Appropriability Theory" to explain the rationale for FDI in Africa.

Keywords: Maladministration, Foreign Direct Investment, Multinationals, Illicit Financial Flows, Tax Evasion, Structuring Projects

1. INTRODUCTION

Report from the Financial Time Journal (2015) revealed that Foreign Direct Investments (FDIs) projects in Africa rose by 6% making Africa the fastest growing region for foreign direct investment. Sub-Saharan Africa investment levels rose from \$42bn to \$61bn. But are these investments benefiting the African continent? However, the rationale for FDI in this current study is driven by the "Appropriability Theory" that encourages the Multinational Companies (MNCs) to invest by putting in place good management instruments, developing efficient information based related to buyers and acquiring excellent technologies as well as developing first class products that will allow the firms to remain competitive in the markets.

The Firms are expected to work towards generating adequate incomes that are set to be reinvested in additional markets locally and abroad. In doing so, the firms keep a close look on products that will allow them to keep its competitive advantage. The Advantage associated with the appropriability theory is that, it is endowed with productive powers that allow it to predict the prevalence and problems linked to high technology industries within FDIs. This theory contributed

immensely to the rapid growth of Foreign Direct Investment (FDI) after the Second World War. This growth in FDIs is strongly correlated to the intention of maximizing profits from direct investment in the African continent. In competing in Africa, most Multinational Companies (MNCs) main objective is to pay less tax, make extensive profits and transfer the proceeds to their country of origin.

This subsequently gave rise to illicit financial flows in Africa where the continent is losing billions of dollars yearly through tax evasion, corruption and inappropriate transfer pricing and maladministration. Past studies have shown that, Africa's revenue could increase between 60 and 65%, if appropriate mechanisms of monitoring the flows were in place. Recent studies also revealed that, Africa is losing approximately \$58 billions of dollars yearly on export and import related activities. Some Multinational Companies (MNCs) through corrupted activities of African government usually benefit from concessional tax. This enables them to maximize profits while destroying Africa's economy through illegal financial transactions. These corrupt activities are some of the reasons why Africa remains very poor and unable to compete with the world best countries.

Even though foreign direct investments have good intention in contributing to Africa's economic growth and creating employment, the experience on the ground has shown that, unemployment rate in Africa remains very high as FDI's are unable to create decent jobs and facilitate the training of young men and women. The presence of FDI's in Africa is therefore justified as the need to penetrate the African markets in order to compete for profits maximization while investing less on Africa's human development.

This study therefore is based on the premise that, tax evasion, illicit financial flows, corruption and abusive transfers pricing are all factors that affect Africa's development leading to poverty and high inequalities among citizens. Using appropriate method of inquiry, this study tries to demonstrate the presence of Foreign Direct Investment in Africa as a cause behind tax evasion (Edoun & Essome, 2015). Past studies revealed that, Illicit financial flows (IFFs) activities are growing and undermining Africa's efforts to drive socioeconomic development in Africa as the continent is losing billions of dollars yearly. IFFs are funds that are illegally earned, utilised or transferred out of a country in contravention of national or international laws (AU/ECA, 2015; OECD, 2014c).

2. REVIEW OF LITERATURE

The rapid growth of FDI's in Sub-Saharan African is the result of perfect competition where a number of firms have activities in more than one country. It is important to emphasize that, as the FDI's presence increases in the countries where they operate, efforts is strongly deployed by these FDI's to avoid taxation. In doing so, these firms negotiate with governments to pay lower tax rates in order to maximize their profits. This obviously has a negative impact on government revenue for the coming financial year taking into consideration that, tax is one of the major sources of revenue for many countries including those in Africa. Also besides, the multinational aim to push governments to lower tax rates in their advantage, the issue of transfer pricing is also to be taken seriously in this article as it is viewed as a strategy used by multinational accountants to insure that, more funds are generated from cross-border transactions. Lindert and Pugel (1996, 2000) argued that, multinational firms can use transfer pricing for reporting a chunk of their profits in lower countries even though the profits were generated in higher tax countries. Lindert and Pugel (1996, 2000) convincingly inferred that:

To lower its corporate income taxes, the firm can have its unit in the high-tax country be overcharged or underpaid for goods and services that unit buys from or sells to the less taxed affiliate. They argued that, in that way, the unit in the low-tax country shows high profits. Profits are clandestinely transferred from the unit in the high tax country to the unit in the low tax country. As a result from these transactions, there is a net tax reduction for the multinational firm in question. It is therefore clear that, if African countries continue to be victim of these kinds of international financial corrupted activities, it will lose billions of dollars as a result of this.

The current study therefore is based on the premise that, tax evasion, corruption and abusive transfers pricing are all factors that affect Africa's development. Edoun (2012 and 2015) convincingly argued that, corrupted activities are the reasons why many countries in Africa failed to achieve socio-economic development for instance by building proper infrastructures and creating decent jobs for local citizens.

The High Level Panel Report on illicit Financial Flows from Africa (2015) spearheaded by the former South African president Thabo Mbeki revealed that IFFs from Africa should be taken seriously because they are increasing fast and negatively affecting Africa's economy base. In conducting their study, the panel was able to establish that, illicit financial outflows from Africa had subsequently increased from about \$20 billion in 2001 to \$60 billion in 2010 and this is subsequently very damaging for Africa's development. The Global Financial Integrity on the other hand conducted a study and projected the trend growth of IFFs from Africa over 2002-2011 at 20.2 percent a year. This prompted experts in the field to ascertain that, the issue of IFFs is critical and damaging, therefore appropriate measures are required to curb this organize crime that cripple Africa's economies.

Findings from the review of literature revealed that Dev Kar and Devon Cartwright-Smith of *The Global Financial Integrity* conducted a study and presented an analysis on illicit financial flows from African countries over a 39-year period from 1970 to 2008. From the above table, one could see that over a period of 39-years, Africa lost an estimated US\$854 billion as a result of IFFs and other related financial mal practices. These findings also revealed that, these funds if appropriately managed, would have contributed in settling the region's total external debt outstanding of around US\$250 billion and the proceeds could have contributed in maintaining infrastructures and creating new one for socio-economic development. This study was equally able to establish that, cumulative illicit flows from the continent increased from about US\$57 billion in the decade of the 1970s to US\$437 billion over the nine years 2000-2008. ¹

Table 1. Africa: Illicit Financial Flow, 1970-2008

Group	Total IFFs				
	1970s	1980s	1990s	2000-2008	1970-2008
Africa	57291	203859	155740	437171	854061
North Africa	19161	72020	59813	78742	229737
Sub Saharan Africa	38130	131839	95927	358429	624324
Horn of Africa	2354	14131	5108	15603	37197
Great lakes	6925	16079	4978	10285	38267
Southern	5894	20581	31447	116828	174751
Western and Central	22956	81047	54394	215712	374109
Fuel Exporters	20105	67685	48157	218970	354917
Non Fuel Exporters	7867	26517	22375	23342	80102

Source: www.gfip.org

Table 2. External financial flows and tax revenues for Africa (\$billion), 2004-2016

		2004-08	2009	2010	2011	2012	2013	2014	2015	2016
Foreign	Private Inward foreign direct investments (FDI)	42.8	55.1	46.0	49.8	49.7	54.2	49.4	57.5	66.3
	Remittances	36.7	44.9	52.5	57.0	61.9	61.2	63.8	64.6	66.4
	Commercial Bank Credit	0.5	-1.3	1.7	0.8	1.8	4.5	3.8	0.5	1.2
	Porto Folio Investment	7.5	1.2	32.7	21.0	32.3	22.8	23.1	13.4	15.2
	Public Net official bank credit flows(bilateral & multilateral)	-1.0	11.0	14.8	14.5	14.0	23.3	17.8	16.0	21.0
	Official development assistance (net total, all donors)	39.0	48.0	47.7	51.5	51.1	56.7	54.2	56.4	58.7
	Total foreign flows	125.5	158.9	192.0	194.8	210.7	222.8	212.2	208.3	226.5
Domestic	Tax revenue	281.0	302.9	367.8	453.2	458.8	468.5	461.2		

Source: African Economic Outlook (2016)

The African Economic Outlook (AEO, 2016) accordingly using the IMF figures argued that, Africa faces volatile FDI inflows. Foreign investment into Africa increased by 16% to USD 57.5 billion in 2015, these certainly are confusing figures taking into consideration that, Africa is seriously struggling to ignite socio-economic development as a result of illegal activities from Multinational Companies (MNCs). The High Level Panel (2015) spearhead by Thabo Mbeki found evidence that abusive transfer pricing was increasing exponentially in Africa, crippling as the result, most of Africa's countries tax base. The panel further acknowledged that, in a particularly telling example, an African President informed the Panel that a multinational corporation in his country had never paid taxes over a 20-year period because it consistently reported making losses.

On the other hand, the AEO (2016) posits that, Official development assistance in grants and concessional loans increased in 2015, after a small drop in 2014. Are these really having an impact on Africa's transformation and why is the continent remained trapped under abject poverty?

The AEO (2016) further argued that African countries' total domestic public revenues are down. This is mostly due to a fall in taxes on resource revenues. This should be absolutely so as a result of tax dodgers. For instance the High level panel (2015) was informed by the South African authorities that a multinational corporation avoided paying \$2 billion in taxes arguing that most of its operations were active in the United Kingdom and Switzerland".²

The above will certainly have a negative impact in government's revenue as a result of price falsification to evade customs duties and domestic levies. Multinational corporations in Africa should not infringe Africa's code of trade as this is negatively affecting government's tax base. If governments in Africa are unable to generate funds from tax, this could lead to a number of consequences that can affect the entire social construct as well as social cohesion. Many countries in Africa remain very poor and highly indebted. Money lost through illegal financial activities could have assisted the continent to pay its debt and use the proceeds to build appropriate infrastructure where citizens will have access to basic services such as water and electricity.

3. FINANCING AFRICA'S DEVELOPMENT THROUGH DOMESTIC RESOURCES MOBILISATION

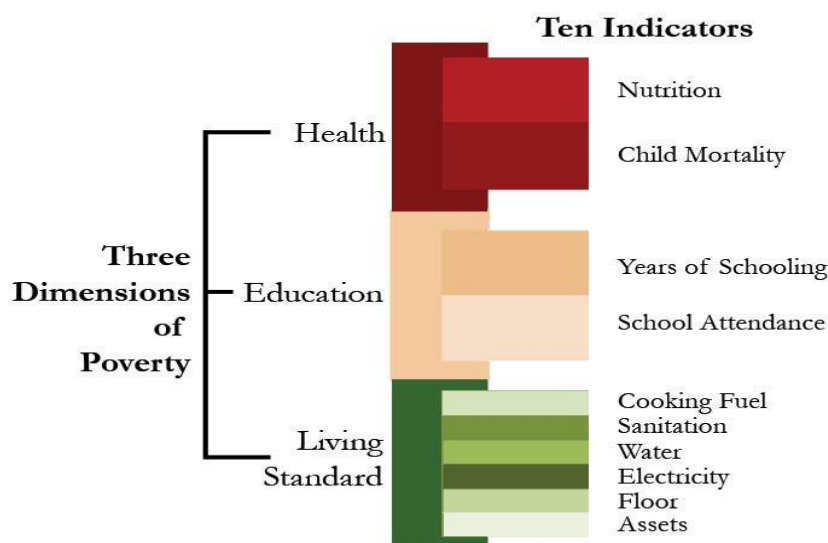
Past experiences have shown that Africa over the years has always been depending on foreign debt to finance its development projects. The continent as a result of high interest rate attached to the debt has not achieved much in terms of development. Africa therefore is still trapped in extreme poverty as indicated by Duncan Green who is the strategic advisor at Oxfam.

This situation is strongly affecting local governments that are expecting to be seen as the driving forces of local economic development. As results therefore the continent remained trapped in extreme poverty as explained by Duncan Green (2016) who used the 10 indicators of multidimensional index (MDI) to assess the level of poverty in 46 African countries.

In considering the above indicators (Duncan, 2016) argued that the deprivations affecting the highest share of MPI poor people in Africa are cooking fuel, electricity and sanitation. He further inferred that, the number of poor people went down in only 12 countries. In 18 countries, although the incidence of MPI fell, population growth led to an overall rise in the number of poor people. It has now become imperative that, Africa relies on domestic resources mobilisation to finance development initiatives as advocated by institutions such as African Capacity Building Foundation (ACBF) and the African Union.

² High Level Panel Commissioned by the AU/ECA Conference of Ministers of Finance, Planning and Economic Development . Addis Ababa Ethiopia 2015

Figure 1. Ten indicators of Multidimensional poverty index (MPI)



Source: Duncan Green (Oxfam Blogs, 2016)

4. LESSONS LEARNED, FINDINGS AND WAY FORWARDS

Local governments in Africa are democratic agents that are expected to drive local economic agenda. With the above in mind, it is imperative that, central governments in Africa should start thinking of using domestic resources mobilisation as a tool to finance local economic development. For this to become effective there is a need for local governments in Africa to have access to financial resources as well as the human capacity to manage these resources. Local governments should be equipped with well modernised accounting systems that will assist in carrying out all financial activities in a transparent manner. Accountability systems and measures should be put in place to hold local authorities accountable.

All listed foreign companies should be compelled to pay taxes in the areas where they operate. The lack of legislative frameworks is a weakness in many African countries where the financing of local governments is not well regulated. It is therefore important, that countries in Africa must reinforce the process of decentralisation.

Decentralisation is viewed as the transfer of powers from the upper to the lower level of government. In reviewing the literature on decentralisation, Edoun (2012) quoted Christopher Pollit and Geert Bouckaert (2009) who argued that, decentralisation reforms should take into account legal acts and administrative measures that facilitate the transfer of responsibility in the form of authority, resources (human and financial) and rules (institutions) from central to local authorities. From the above definition, many others acclaimed academics provided very solid definitions and argued that decentralisation could take various forms depending on the context in which it is used. These forms of decentralisation are clearly explained by Oluwu and Wunsch (2004) and related authors who provided a clear difference between them. Oluwu and Wunsch (2004) argued that, when

responsibility or authority is transferred, but not resources or local accountability, this is referred to as de-concentration. When responsibility, authority and resources are transferred, but accountability still resides in the centre, there is delegation. When there is transfer by law and other formal actions, of responsibility, resources, and accountability, this is viewed as devolution (Smith, 1985) and (Adamolekun, 1999).

It is therefore imperative that, to avoid the embezzlement of funds at all levels of government in Africa, the devolution of powers should be taken into account because as Edoun (2011 and 2012) argued, it creates an efficient and reliable administration, intensifies and improves local development, better ensures the rights of the local population to have a voice in government, and better protects minorities. If devolution of power is applied, this study believes that, local authorities will be vested with the necessary powers to fight illicit financial flows that may be organised from the central governments as results of corrupt relation that may have been established between MNCs, FDIs and the States.

5. CONCLUSIONS

Illicit financial flows are disastrous for Africa's development and Africa is still struggling from dictatorship, maladministration, civil wars and the Boko Haram Factor. Edoun and Essome (2015) inferred that, illicit financial flows are linked to illegal financial activities such as tax evasion including trade mis-invoicing and abusive transfer pricing, money laundering, bribery and corruption by MNCs with the help corrupt officers who may enter into tax concessional agreements with these foreign companies whose initial objective to maximise profits. Compared with their local competitors, many MNCs pay lower tax in African countries and this has a negative implication on domestic resources mobilisation strategy.

If MNCs failed to pay tax to governments as a result of corrupt activities entertained by few governments' elites, this will without doubt have a negative implication on Africa's development as governments may run out of funds to finance infrastructures, and failing to provide basic services such as water and electricity. African countries should put in place the system of monitoring and evaluation in order to track down corrupt activities that should be punishable by a strong and free judiciary system. There is a need for joint efforts to curb IFFs at country and regional levels. Because of corrupt relationships between the central and MNCs, these MNCs are provided advantages of paying lower taxes in African countries and the initial findings from Edoun & Essome (2015) concluded that, this may have a negative effect on domestic resources mobilisation strategy.

Domestic resources mobilisation requires that, governments should broaden their tax base. If the MNCs are given some advantages because of their connection with the elite in central governments, local authorities may not be able to collect the necessary tax revenues to finance local structuring projects.

In conclusion therefore, African countries should adopt the principle of devolution that is a total transfer of powers as initially defined by Christopher Pollit and Geert Bouckaert (2009). From the devolution perspective and context, local authorities should put in place the system of monitoring and evaluation in order to track down corrupt activities that should be punishable by a strong and free judiciary system (Essome & EDOUN, 2015). For local governments in Africa to achieve developmental results, Domestic Resource Mobilisation should be considered as the tool to drive the African Union agenda 2063 which is a holistic approach of developing the continent through long terms infrastructural and social investments for Africa's transformation. This could therefore only be possible through political commitments and the fight against corruption and the consideration of ethical leadership that is the backbone for any development initiative. Africa is in dire need of ethical leaders to transform the continent and this should be driven by local authorities who understand the problems of the poor at grass root levels.

6. RECOMMENDATIONS

Since IFFs are the main causes related to the inability of Africa to achieve the MDGs, it has now become imperative that, African governments adopt a set of strategies that should strongly discourage the evil activities of these IFFs. Regional Economic Communities (RECs) should adopt common policies related to punishable measures on money laundering by MNCs and FDIs. RECs should also have a common position on reporting by MNCs that should be requested to disclose a number of information for transparency sake. This information should be translated into annual reports on sales and profits made in a specific country and region. Regional bodies working for regional integration should timeously record this information and share it among country members.

All MNCs should register in the countries where they operate and their bank accounts should be known to monitor transactional activities linked to the accounts. This will certainly reduce tax avoidance and money laundering. In this way African countries could recover more funds from Domestic Resources Mobilisation to finance structuring projects for Africa's transformation.

IFFs in Africa are perceived as one of the reasons why Africa is lagging behind the world best economic countries. This is so because, Africa is losing close to 58 billion of dollars yearly as a result of illegal financial activities related to financial outflows. Decentralisation policy through the devolution of powers is therefore proposed as a strategy to undermine IFFs activities at local levels. Local governments in Africa have the responsibility of providing a number of services at local levels. Local governments should be equipped with powers that allow them to generate income from tax revenue. The Central governments at this stage should only play an oversight role. Mechanisms should be put in place to track tax dodgers; hence an audit of listed MNCs and FDIs is important. With the adoption of devolution strategy the central governments should be prohibited of interfering with local authorities activities.

As local governments are strongly advised to register and audit all MNCs and FDIs operating in their areas of jurisdiction. They should equally work closely with local banks in order to track and monitor transactional activities linked to the accounts. Local government financial information systems should be able to provide local authorities with the necessary information related to financial status of these MNCs that should be compelled to pay tax. In this way local governments in Africa will be able to fight IFFs in their own capacity. By adopting the above approach, more funds will be made available through domestic resources mobilization.

Good governance and sound regulatory framework should promote best practices to fight IFFs in Africa. Accountability and transparency should be the foundation to support democratic institutions. Corruption should therefore be fought as it undermines any development initiative. IFFs are contributing factors to social unrest because as Ndung'u (2007) put it, capital flight has had adverse welfare and distributional consequences on the overwhelming majority of poor in numerous countries in that it heightened income inequality and jeopardized employment prospect.

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