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The Impacts of Illicit Financial Flows on Peace and Security in Africa

STUDY FOR TANA HIGH-LEVEL FORUM ON SECURITY IN AFRICA 2014

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Executive summary

A range of estimates of illicit financial flows confirm that the problem facing Africa is large, and has grown substantially. Annual losses in recent years range as high as $100 billion, and for many countries the long-term average has exceeded 10% of recorded GDP. Even allowing for substantial uncertainty in estimates of flows whose defining characteristic is that they are *hidden*, the order of magnitude is dramatic.

The potential effects, too, are dramatic. Extrapolating from GDP losses to one major dimension of human security, it is estimated that illicit flows are responsible for major delays in regional achievement in child mortality reduction. A two-thirds reduction in under-five mortality from the 1990 baseline (the target of the fourth Millennium Development Goal), in a sample of 34 sub-Saharan countries, could on this basis have been achieved by 2016 rather than the current estimate of 2029 – implying millions of lives may be lost unnecessarily.

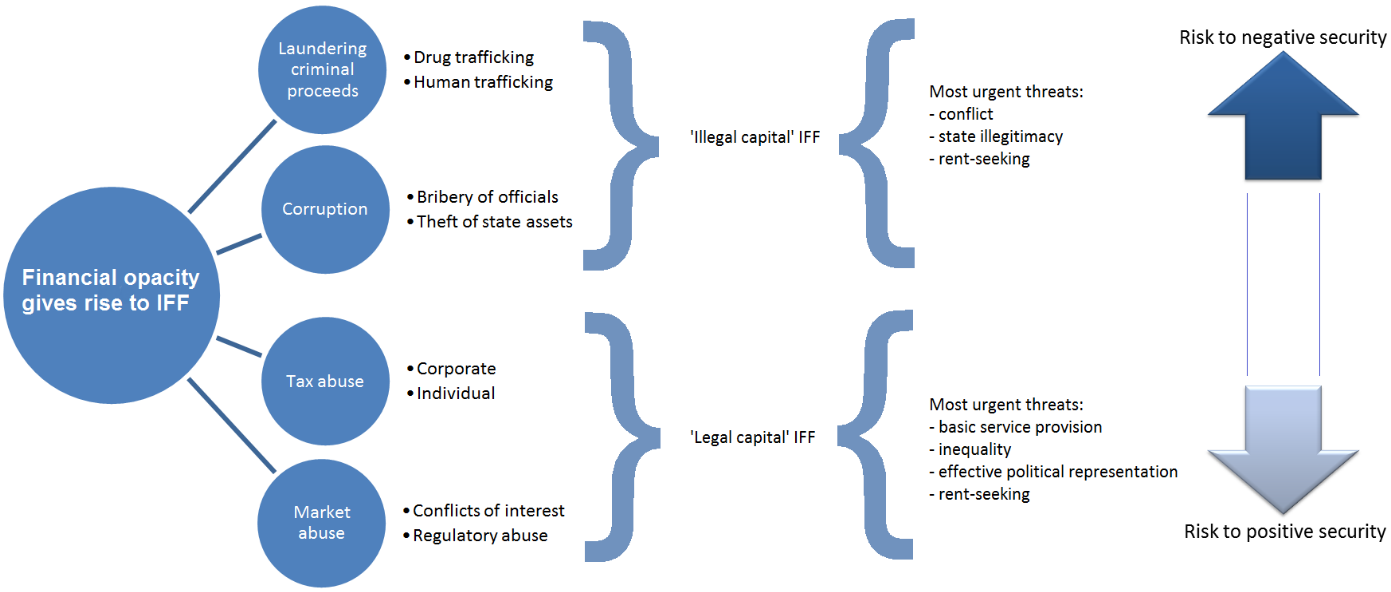
Illicit financial flows (IFF) have four main components (see Figure 1). Two of these involve hidden transactions with illegal capital: the laundering of the proceeds of crime; and corruption and the theft of state assets. The other two involve illicit (and often illegal) transactions, but with legally-obtained capital. These are tax abuse (both corporate and individual); and hidden ownership to hide conflicts of interest and to facilitate market abuse. Together, IFF pose a major threat to effective states.

Greater research and policy effort has thus far addressed the potential linkages between IFF and 'negative security' (that is, the ability of states to prevent insecurity at the personal, community and political levels). A number of important linkages exist here. First, IFF (predominantly of the illegal capital type) will tend to undermine both the immediate effectiveness of institutions, and confidence in them to provide fair and effective rules for markets and for politics – peeling away the layers of institutional resilience that can provide a bulwark against conflict when pressures arise. Second, greater illegal capital IFF characterise an economy in which rent-seeking plays a major part; and conflict can arise over control of the state and the associated (criminality and corruption) rents.

In the other direction, conflict undermines the institutions which can curtail IFF, and drives uncertainty which increases the expected returns to rent-seeking behaviour relative to that of long-term economic investment. These linkages together create the possibility of a vicious cycle, in which IFF exacerbate conflict and vice versa, with institutional state weakness as both cause and effect.

Only recently has focused policy and research attention been paid to legal capital IFF, and here there is a growing base of evidence on the linkages; in particular, to 'positive security' (the ability of states to provide secure conditions in which rapid human development can take place). Again, a vicious cycle is possible: IFF undermine the resources available to states, and their effectiveness (and often willingness) to use resources for broad-based development, undermining human development outcomes; while weak institutions and a lack of confidence in fair political representation encourage further IFF.

Figure 1: Overview of IFF and security linkages



Source: author's elaboration.

Further analysis is needed to understand more about the relative strength and importance of the various linkages in different contexts, but the broad thrust is very clear: policymakers concerned with peace and security should be concerned with IFF. More specifically, since IFF are by definition hidden, policymakers should be concerned with the extent of financial secrecy which is necessary to facilitate IFF: both at the national and regional levels, and globally as it affects Africa.

There are particular risks from relatively financially secretive African jurisdictions such as Mauritius, as well as emerging issues such as the planned Nairobi international financial centre, or Gambia's aggressive entry into the supply of anonymous shell companies.

At the same time, there is great momentum in global processes to promote financial transparency, and this creates a set of important opportunities – not only to commit to particular national and regional measures which will generate benefits directly, but also to act internationally to reduce the possibility that many African countries may be excluded from those global processes.

Table 1 sets out a range of measures according to whether they are applicable at the national level in order to meet international responsibilities; at the national level out of self-interest; at the regional (and sub-regional level); and at level of regional priorities to influence global processes. The measures reflect five areas of concern.

- **Beneficial ownership**. The scope for anonymous ownership of companies, trusts and foundations should be curtailed – in keeping with the developing international norm, and in the national interest – through publication of this information, possibly coordinated at the regional level. With active regional efforts to meet this standard, there will be scope to consider counter-measures against jurisdictions elsewhere that continue to maintain secrecy. The primary responsibility sits with national policymakers: and most pressingly in countries such as Mauritius which are responsible for large cross-border transactions, since a lack of transparency here has the greatest potential to cause damage elsewhere.

- **International information exchange**. Improvements in respect of beneficial ownership information are also necessary to facilitate the automatic exchange of financial information for tax and other IFF purposes. Regional (and sub-regional) agreements on information exchange can not only provide direct benefits but also demonstrate that systems are in place so that African countres are not barred from joining the emerging global exchange instrument that has the potential to end much 'tax haven' secrecy. The African Tax Administration Forum (ATAF) should be tasked with leading the process, and resourced to do so and to help member countries as necessary.

- **Trade**. The majority of illicit flows is estimated to occur through trade mispricing for many countries, so counter-measures here are a clear priority. At the national and regional levels there is scope for better data collation and joint analysis, with the scope for real-time detection of mispricing that could exert a powerful deterrent effect. Regional groupings such as the East African Community should pilot such efforts. At the regional-global level, 'follow the money partnerships' including major trading partners (e.g. the EU) have the potential to protect the integrity of trade pricing. More assertive interventions, which could potentially be led by the African Union or the follow-up process of the UNECA IFF panel, include the possibility of bringing a WTO case against a particularly opaque trading partner such as Switzerland; and the development of a common African position on the extent of commodity trade transparency.

- **Corporate tax**. In respect to transparency, national authorities should require country-by-country reporting from multinational groups to allow easy identification of possible profit shifting. At the (sub-)regional level, pooling of such data would allow both more effective analysis and also the possibility of publication to support external research and to build citizen confidence in fair and effective taxation. Given the extent to which African economic activity may be generating profit elsewhere, however, the question arises of whether policymakers should consider taking a common African position in favour of unitary taxation – which aims to align profits with real economic activity, with potentially dramatic impacts on the corporate tax base. Supporting analysis could be lead by the follow-up process of the UNECA IFF panel, with technical support from UNECA, the African Development Bank and ATAF.

- **International data**. Finally, reflecting that illicit financial flows are driven by a lack of transparency about cross-border economic and financial stocks and flows, there are opportunities at both national and regional levels to improve substantially the collation of information, and the IFF analysis of the resulting data. National policymakers must take the lead, with appropriate regional coordination and support.

African policymakers have the power to take significant steps against IFF domestically, which can also strengthen greatly their ability to ensure that global arrangements reflect African priorities. Decisive action within the next twelve months can ensure that permanent benefits are obtained from the current window of opportunity. Missing the chance will impose long-term costs on states and citizens through unnecessary insecurity.

Table 1: Overview of policy responses to IFF

Level of policy: / Area of policy:	National (minimum standards)	National (own priorities)	Regional and sub-regional (own priorities)	Regional-global (own priorities)
Beneficial ownership	Legislate (and allocate resources) to ensure all company and legal structures require collection of ownership information Publish same (online) in timely fashion		Support all countries to reach minimum standards Develop shared public portal to access ownership information	Promote global minimum standard for publication of ownership information Consider counter-measures for non-compliant jurisdictions
International information exchange	Work towards compatibility with international standards	Promote and adopt simple applications to flag high-risk data (e.g. where inconsistent with domestic tax returns)	Develop and enact regional mechanisms for automatic information exchange Support best practice in use of data to identify risk	Advocate to ensure immediate reciprocity is not entry requirement to global instruments, i.e. that countries can begin receiving data as long as committed to eventual full reciprocity Consider/supporting counter-measures for non-compliant jurisdictions
Trade	Own data collation, publication (e.g. via UN Comtrade)	Real-time analysis of own data	Pooled real-time data analysis (more efficient use of resources and broader dataset to improve quality of assessment and ability to identify abnormal pricing in real time)	Pilot 'follow the money' partnerships to curtail trade mispricing globally Consider counter-measures, including potential WTO challenges, for highly opaque trading partners Develop a common African position on international trade transparency, starting with commodities
Corporate tax		Require combined and country-by-country reporting from multinationals	Publish combined and country-by-country reporting from multinationals Combine resources for regional assessment of multinational tax positions Assess potential for profit allocation methods	Call for OECD to publish Africa-specific assessment of individual BEPS proposals Support assessment of alternatives, including profit allocation methods; and if warranted, develop a common African position in support of unitary taxation
International data	As far as practical, work towards supplying data to international bodies on bilateral trade and investment stocks and flows	Use global datasets to assess and manage risk (exposure to secrecy jurisdictions) in own bilateral relationships	Support all countries to contribute data, and to use	Promote global cooperation and more timely production of bilateral trade and investment statistics, including cooperation of secrecy jurisdictions

Source: author's elaboration.

I. Africa's illicit financial flows, and vulnerability to financial secrecy

The dramatic scale of Africa's illicit financial flows is increasingly widely recognised, including in recent research from the UN Economic Commission for Africa, the African Development Bank and the Africa Progress Panel. As yet, however, there has been less work on the specific channels of impact of these flows.

This study assesses the linkages between illicit financial flows and security, broadly defined, and on that basis identifies specific vulnerabilities and potential policy responses in the regional context. Chapter II addresses the linkages with positive and negative conceptions of security. Chapter III sets out explores a range of components for domestic and regional policy steps, and the potential for a concerted African voice in global policy discussions. First, this initial chapter will set the context for the study, with three main components: a brief overview and typology of illicit flows; a survey of existing illicit flow estimates; and some new findings from a new approach to country risk.

Overview and typology of IFF

There is no single, agreed definition of illicit financial flows (IFF). This is, in large part, due to the breadth of the term 'illicit'. The (Oxford) dictionary definition is: "forbidden by law, rules or custom." The first three words alone would define 'illegal', and this highlights an important feature of any definition: illicit financial flows are not necessarily illegal. Flows forbidden by "rules or custom" may encompass those which are socially and/or morally unacceptable, and not necessarily legally so.

To take a specific example, commercial tax evasion affecting a low-income country where the tax and authorities have limited administrative capacity is much less likely to be either uncovered or successfully challenged in a court of law, than would be the same exact behaviour in a high-income country with relatively empowered authorities. A strictly legal definition of IFF is therefore likely to result in systematically – and wrongly – understating the scale of the problem in lower-income, lower-capacity states.

For this reason, a narrow, legalistic definition of IFF should be rejected.[2] The phenomenon with which we are concerned is one of *hidden flows,* where either the illicit origin of capital or the illicit nature of transactions undertaken is deliberately obscured. The most well-known classification stems from Baker (2005) and disaggregates IFF into three elements: commercial tax evasion (estimated at up to two thirds of the total), the laundering of the proceeds of crime (up to a third), and corrupt payments and the theft of state assets (3-5% of the total). The major addition that has sometimes been suggested is that of illegitimate debt – where an illegitimate state creates a (binding) public liability by using its power to borrow internationally.

Table 2 provides a broader overview of the transaction types. It is unlikely to be comprehensive because there is potential to engineer an illicit flow in any transaction, and the range of potential illicit motivations is wide indeed; but nonetheless demonstrates the breadth of IFF phenomena. Clear clusters are captured in the column 'IFF Type', which shows the main illicit motivations: 1 – market/regulatory abuse, 2 - tax abuse, 3 – abuse of power, including the theft of state funds and assets, 4 – proceeds of crime. As the final two columns indicate, all four IFF types are likely to result in reductions in both state funds and institutional strength.

[2] Blankenburg & Khan (2012) provide an interesting, related argument: that in cases of state illegitimacy there may be legal flows which are illicit, and indeed illegal flows which are licit. Where a state is unrepresentative and predatory, its adjudications over legality may be considered illegitimate. A tax evading flow, under such circumstances, could be considered justified – and even, depending on the interpretation o/f 'rules or custom', as licit.

Table 2: A typology of illicit financial flows and immediate impacts

Flow	Manipulation	Illicit motivation	IFF type	Impact on state funds	Impact on state effectiveness
Exports	Over-pricing	Exploit subsidy regime	2	↓	↓
		(Re)patriate undeclared capital	1	↓	↓
	Under-pricing	Shift undeclared (licit) income/profit	2	↓	↓
		Shift criminal proceeds out	4	↓	↓
		Evade capital controls (including on profit repatriation)	1		↓
Imports	Under-pricing	Evade tariffs	2	↓	↓
		(Re)patriate undeclared capital	1	?	↓
	Over-pricing	Shift undeclared (licit) income/profit	2	↓	↓
		Shift criminal proceeds out	4	?	↓
		Evade capital controls (including on profit repatriation)	1	↓	↓
		Shift undeclared (licit) income/profit	2	↓	↓
Inward investment	Under-pricing	Shift undeclared (licit) income/profit	2	↓	↓
		Shift criminal proceeds out	4	?	↓
		Evade capital controls (including on profit repatriation)	1	↓	↓
	Over-pricing	(Re)patriate undeclared capital	1	?	↓
	Anonymity	Hide market dominance	1		↓
	Anonymity	Hide political involvement	3		↓
Outward investment	Under-pricing	Evade capital controls (including on profit repatriation)	1		↓
	Over-pricing	Shift undeclared (licit) income/profit	2	?	↓
		Shift criminal proceeds out	4	↓	↓
	Anonymity	Hide political involvement	3		↓
Public lending	(If no expectation of repayment, or if under-priced)	Public asset theft (illegitimate allocation of state funds)	3	↓	
Public borrowing	(If state illegitimate, or if over-priced)	Public asset theft (illegitimate creation of state liabilities)	3	↓	
Related party lending	Under-priced	Shift undeclared (licit) income/profit	2	↓	
Related party borrowing	Over-priced	Shift undeclared (licit) income/profit	2	↓	
Public asset sales	Under-pricing	Public asset theft	3	↓	
	Anonymity	Hide market dominance	1		↓
	Anonymity	Hide political involvement	3		↓
Public contracts	Over-pricing	Public asset theft	3	↓	
	Anonymity	Hide market dominance	1		↓
	Anonymity	Hide political involvement	3		↓
Offshore ownership transfer	Anonymity	Corrupt payments	3	↓	↓

Note: 'IFF type' is defined as follows: 1 – market/regulatory abuse, 2 - tax abuse, 3 – abuse of power, including theft of state funds, 4 – proceeds of crime.

These in turn allow identification of the major actors in IFF:
- private actors (individuals, domestic businesses and multinational company groups committing tax and regulatory abuse, and the related professional advisers – tax, legal and accounting) – these are the leading actors in IFF types 1, 2 and 3;
- public officeholders (both elected and employed) – these are important actors in IFF types 3 and 4, and may be involved in type 1; and
- criminal groups (a term used here to indicate both those motivated primarily by the proceeds of crime, and those using crime to fund political and social agenda) – the leading actors in IFF type 4.

There is substantial overlap in the mechanisms used for IFF, regardless of motivation. The opportunity to hide, where it exists, is likely to be exploited for multiple purposes. For example then, the legal use by a multinational of highly secretive jurisdictions may both provide cover for illegal use of the same secrecy, and also inadvertently legitimize such behaviour. Identifying illicit flows in a particular mechanism will tend to be insufficient to specify the type of IFF in action.

Table 2 shows a roughly equal number of potential IFF in each of the first three categories, and rather fewer for the proceeds of crime; but this rests on an assumption made for descriptive clarity which is unlikely to hold in practice: namely, that businesses operating internationally are not used to launder the proceeds of crime. This distinction in turns highlights a more important one: namely, that IFF can take place with capital which is anywhere on a spectrum of legality. At one end are criminal proceeds and stolen public funds, with legitimate income and company profits at the other.

A second spectrum exists in relation not to the capital but rather the transaction itself. At one end there are clearly illegal transactions, such as bribery of public officials by commercial interests; at the other end, transactions which are likely to be legal (at least in the sense of not having been challenged successfully in a court of law) but may well be illicit; in this category would be, for example, some of the more aggressive transfer pricing behaviour of multinational companies.

Figure 2: Main IFF types by nature of capital and transaction

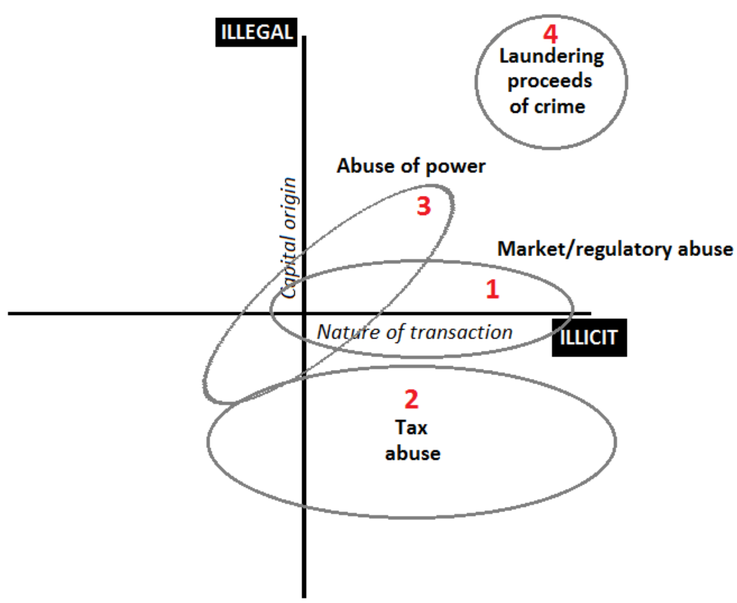


Figure 2 provides a rough plotting of the four IFF types identified, on a quadrant diagram showing the spectra of transaction licitness and capital legality. The historical emphasis of both research and policy has been on those IFF types that are furthest, in general, to the northeast quadrant (i.e. where both the capital origin and the transaction are in question); and least attention to those in southeast (i.e. those where the capital origin is less likely to be in question than the manipulations involved in the transaction.

Most attention, in other words, has been paid to the clusters relating to abuse of power, and more recently to the proceeds of crime – at least in relation to efforts against 'terrorism financing' subsequent to the World Trade Center attacks of September 2001. The areas of market abuse and tax abuse have been relatively neglected in terms of policy focus, with the result that the dominant discourse has largely excluded the role of private sector actors in driving illicit flows – at least until the financial crisis affecting may countries that began in 2008.

It is worth reiterating that in all cases in the typology, the behaviours in question are in some sense reprehensible. They rely on being hidden because there would be substantial negative ramifications to their becoming publicly visible. These ramifications might be legal or social – that is, they may reflect violations of law or of 'rules and custom' – and in each case are sufficiently powerful to justify any costs of hiding.

In subsequent chapters we will refer to the four IFF types, but also make use of the broader distinction outlined between 'legal capital IFF' (tax abuse and market abuse, types 1 and 2) and 'illegal capital IFF' (the abuse of power and laundering of criminal proceeds, types 3 and 4).

Leading estimates

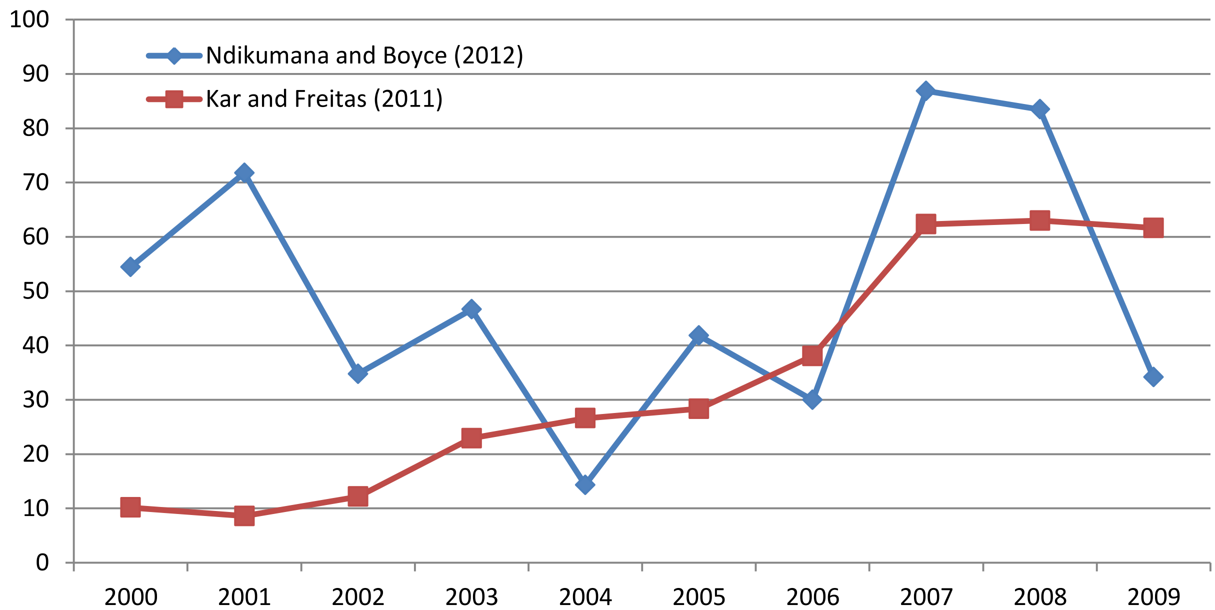
Current approaches to illicit financial flows can be considered together under the heading of 'anomaly-based estimation'. Each approach relies, in one way or another, on exploiting anomalies in public data on economic and financial stocks and flows to generate estimates of the quantum of illicit flows or stocks contained (hidden) therein.

The main IFF analyses for Africa rest on the approaches pioneered by Global Financial Integrity (GFI, e.g. Kar & Freitas, 2011) and by Ndikumana and Boyce (e.g. 2012). In both cases, the authors combine broad trade mispricing estimates (based on the value of total trade) with assessments of unrecorded capital flows (from anomalies in the capital account). The major difference is that Ndikumana and Boyce net off illicit inflows, providing a more conservative (and also more volatile) series; while GFI base a preference for gross flows on the not unreasonable argument that 'there is no such thing as net crime' – if illicit inflows are also damaging, then netting them against illicit outflows will clearly understate the importance of the phenomenon. Figure 3 compares recent estimates for Africa as a whole from the two approaches.

Other approaches which provide less comprehensive results include: analyses of trade pricing at the commodity level (e.g. Pak et al., various; Cobham et al., 2014); country-specific analyses such as the analysis of commodity contracts in DRC by the Africa Progress Panel, 2013); and studies of particular IFF channels (which have the potential to yield more precise but absolute low-end estimates where based on legal findings), for example on the theft of state assets by past public officials (see e.g. Maton & Daniel, 2012) or the extent of bribery revealed in settlements made by multinational groups. In addition, some studies have focused on illicit stocks rather than flows (e.g. Henry, 2012, and Zucman, 2013).

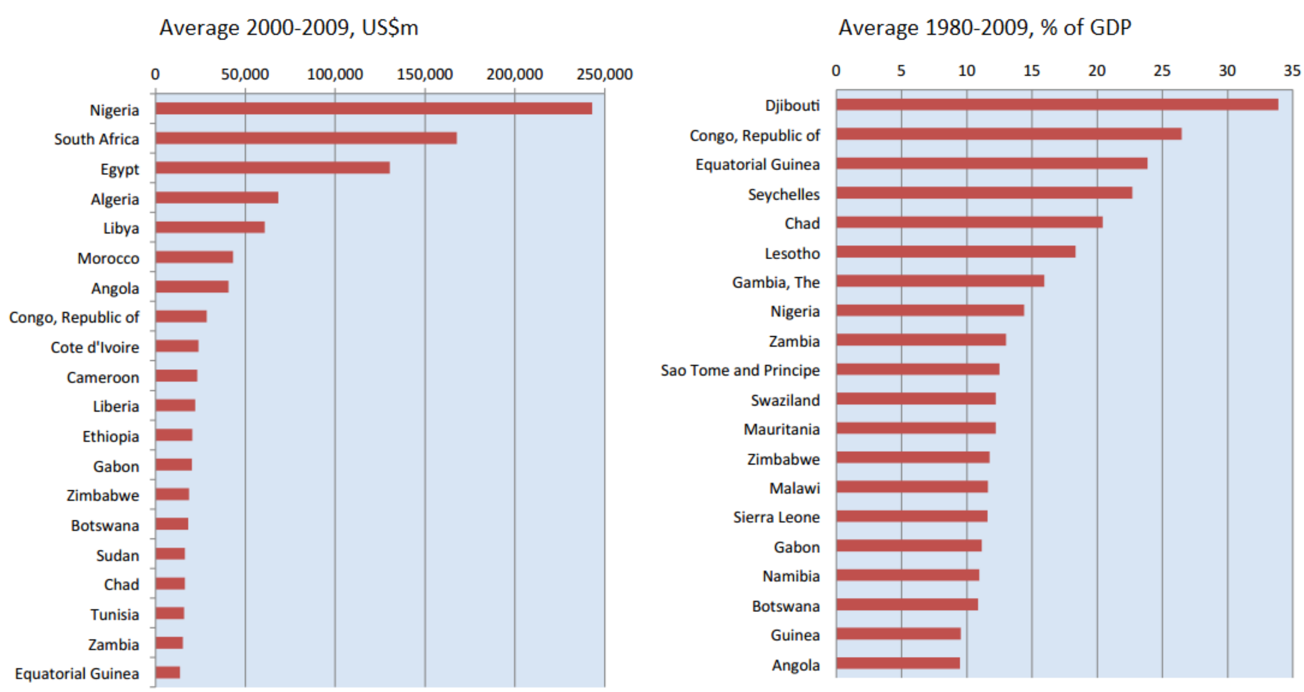
The regional totals in figure 3 hide large variation between countries. Perhaps the most detailed set of African estimates to date is the joint analysis of GFI and the African Development Bank. Kar, Freitas, Moyo & Ndiaye (2013) provide estimates for the period 1980-2009 for nearly all countries in the region. Figure 4 shows the most exposed countries in dollar terms (left-hand panel) and in relation to GDP (right-hand). In dollar terms it is perhaps unsurprising to see the leading regional economies of Nigeria and South Africa at the top. It is, however, striking to find that 18 of the top 20 most exposed countries have lost an average of more than 10% of their GDP each year, for a period of 30 years.

Figure 3: Estimates of African illicit outflows, 2000s (US$ millions)



Source: Author's compilation.

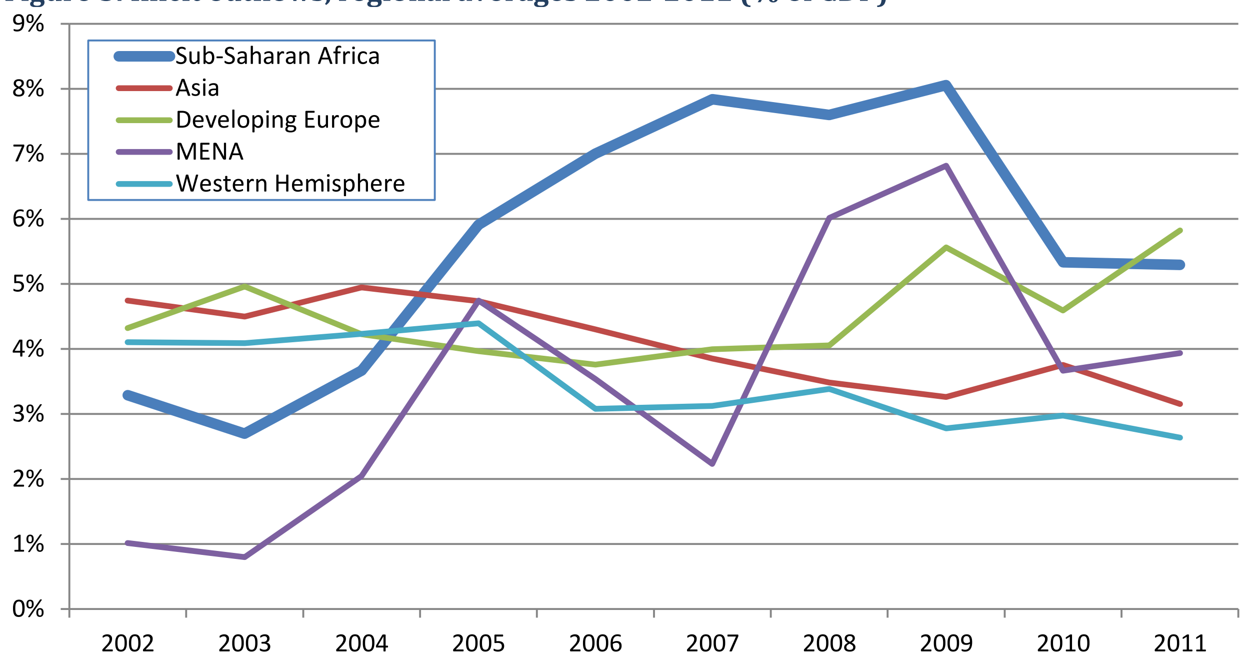
Figure 4: African countries with highest illicit financial outflows, AfDB/GFI study



Source: figures 5a and 5b in Kar, Freitas, Moyo & Ndiaye (2013).

Now per GFI's global analysis for the years 2002-2011 (Kar & LeBlanc, 2013), only Nigeria (9th) and South Africa (11th) feature in the top 15 most exposed countries in dollar terms. However, when we compare exposure in relation to GDP in figure 5, sub-Saharan Africa emerges as the most exposed region to illicit outflows. On average, in 2002-2011, sub-Saharan Africa saw outflows of 5.7% compared to an average for all other developing countries below 4%. In other words, for the most recent ten-year period for which consistent estimates are available, **sub-Saharan Africa saw estimated illicit outflows nearly 50% higher than the average** for all other developing countries.

Figure 5: Illicit outflows, regional averages 2002-2011 (% of GDP)



Source: author's compilation from Kar & LeBlanc, 2013.

Risk assessment[3]

While current approaches focus, as discussed, on anomaly-based estimation of illicit flows, a complementary approach is to assess the risk that illicit components are contained within transactions. There are two reasons to consider additional approaches. First, the existing estimates inevitably attract criticism over the possibility that they may confuse 'innocent' anomalies including data errors and mismatches due to timing and rounding errors with evidence of illicitness, and the sensitivity to some of the assumptions made – see for example the various views expressed in five chapters of the World Bank's illicit flows volume (Reuter, 2012: chapters by Eden; Fuest & Riedel; Leite; Murphy; and Nitsch). As such, while the range of estimates have established the scale of the issue in terms of the broad order of magnitude, the degree of confidence in the estimates may be less suited to specific policy analysis at the level of countries and IFF types.

The second concern relates to the bluntness of the leading estimates. While it is useful to compare the component attributable to trade with that attributable to the capital account, greater specificity would be valuable to support policy prioritisation.

Underlying these issues is the simple fact that flows that are hidden by design do not lend themselves to measurement. However, it is possible to analyse more precisely the risks that any given flow contains a hidden component. The central idea behind the new approach is this: that precisely

[3] This section reflects joint work with Alice Lépissier.

because illicit financial flows are, by definition, hidden, the likelihood of an illicit component will be increasing in the degree of financial opacity in any given transaction. The assumption is this: that all else being equal, **the easier is to hide something, the more likely that something will be hidden**.

To the extent that financial opacity of partner jurisdictions can be measured, this provides the basis to assess the risk of IFF facing a given country or region, according to the pattern of partners in economic and financial cross-border activity. The first step is therefore to create a measure of average Partner Opacity in each stock or flow for which data are available on a bilateral basis. This measure reflects the extent to which countries face a risk of 'hiddenness' in each stock or flow. For example, the IFF risks inherent in a commodity trade with Switzerland will be substantially higher than in the equivalent transaction with Sweden; and similarly, intra-group transactions of a multinational company with its subsidiary in Bermuda contain greater risk than those with its subsidiary in Brazil. The Tax Justice Network's Financial Secrecy Index (2013) calculates a 'secrecy score' for Switzerland of 78 out of 100, compared to the much more transparent Sweden's 32, while Brazil scores 52 compared to Bermuda's 80.[4]

This does not of course imply that all trade with Switzerland is illicit, nor that all multinationals with Bermudan subsidiaries are committing tax evasion. However, the greater is the transparency of the partner jurisdiction in a given bilateral transaction, then the lower, all other things being equal, will be the risk of something being hidden. Not all transactions of a less transparent nature will be illicit; but the likelihood of illicit transactions within a less transparent flow will be higher. The greater the degree of opacity, in other words, the higher the risk of IFF.

Box: Calculating 'Exposure' to IFF risk

Partner Opacity	Scale	Exposure
$V_i = \frac{\sum F_{i,j} \cdot SS_j}{F_i}$	$I_i = \frac{F_i}{Y_i}$	$E_i = \frac{\sum F_{i,j} \cdot SS_j}{Y_i}$

Where:	$\boldsymbol{i}: \{\mathbf{1}, \ldots, \boldsymbol{I}\}$	Country of interest
	$\boldsymbol{j}: \{\mathbf{1}, \ldots, \boldsymbol{J}\}$	Partner country
	$F_{i,j}$	Flow between reporter i and partner j
	$\boldsymbol{Y_i}$	GDP of country of interest
	$\boldsymbol{SS_j}$	Secrecy Score of partner country. Ordinal scale, 0-100.

Multiplying Partner Opacity with 'Scale' (the importance of a given bilateral stock or flow in relation to the GDP of the country of concern) yields values of 'Exposure' (see Box). If all possible partner jurisdictions were either completely transparent, or completely secretive, the Exposure values would simply be the share of GDP involved in transactions with pure secrecy jurisdictions. Exposure scores

[4] The Financial Secrecy Index, published every two years by the Tax Justice Network, is the most common measure of financial opacity and is used widely – for example, it is a component of the Basle Anti-Money Laundering Index, and a recommended risk assessment tool in the OECD's Bribery and Corruption Awareness Handbook for Tax Examiners and Tax Auditors. The Index is based on a 'secrecy score', which is constructed from 48 indicators of transparency, in areas from corporate reporting to banking and beneficial ownership, largely based on the assessment of relevant international and multilateral organisations. The secrecy score ranges in theory from zero (perfect financial transparency) to one hundred per cent ('perfect' financial secrecy); in practice no jurisdiction has scored less than thirty per cent.

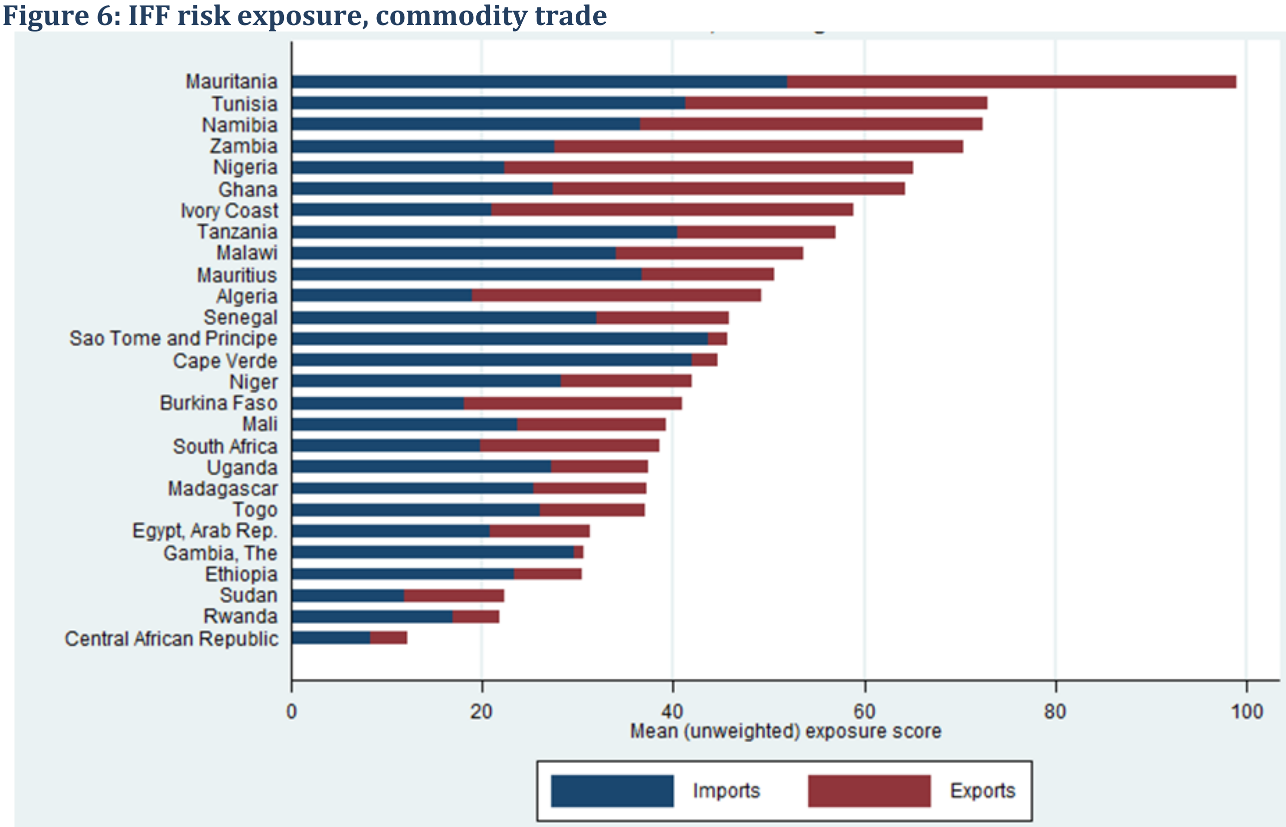
can therefore be interpreted as measures of the overall risk to an economy from financial secrecy, or equivalently as measures of IFF risk.

Exposure scores have been calculated for African countries, subject to data availability, in respect of flows of trade in goods and services (figure 6); stocks of direct investment (figure 7) and stocks of portfolio investment (figure 8). Underlying data are for 2011 and sourced from UN Comtrade, IMF CDIS and IMF CPIS respectively.

Note that exposure on investment *stocks* should not be compared directly with that in trade *flows*; and in addition, note from the typology that illicit flows in trade are likely to be a relatively small proportion of the total value (i.e. the mispriced element), while illicit flows in investment may be 100% of the total where ownership is hidden for illicit purposes. Policymakers are likely to have more detailed data with which to carry out this assessment, and should consider carefully the specific circumstances in their country in making decisions to prioritise particular areas.

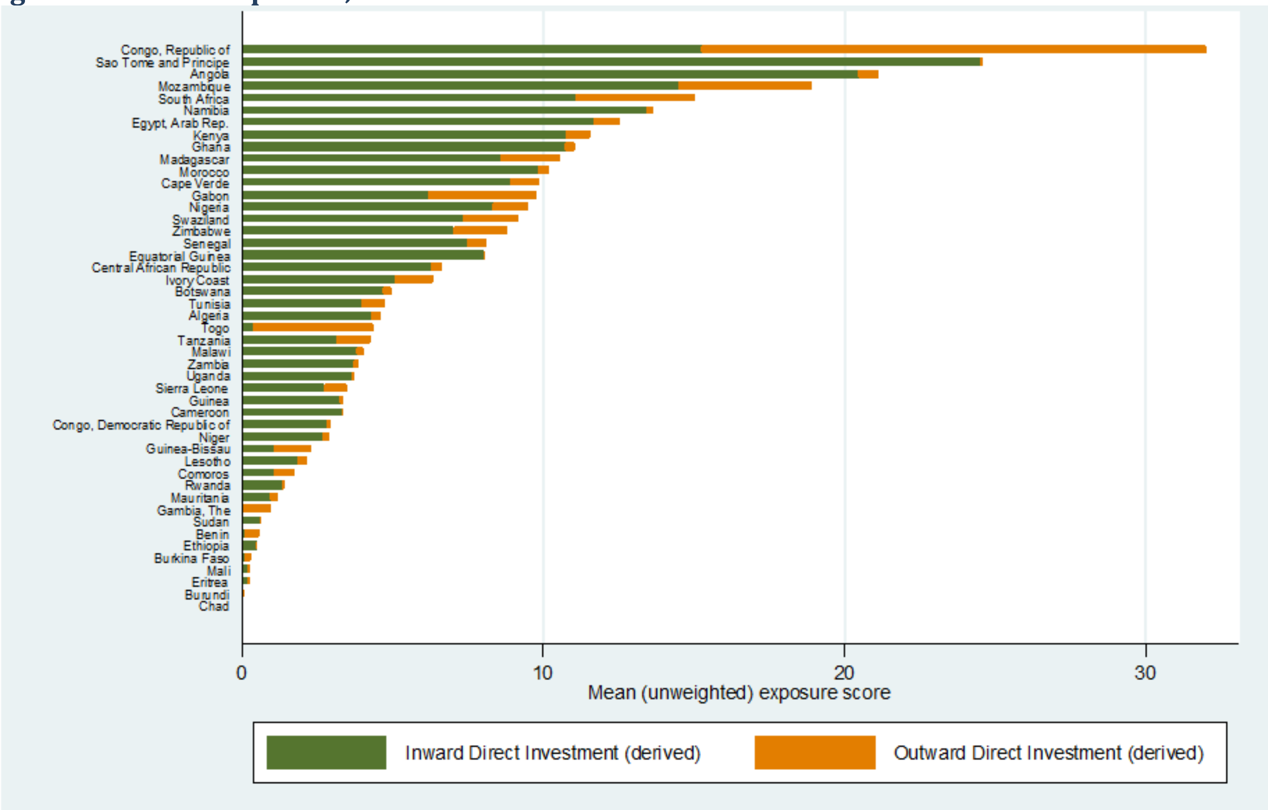
One immediate suggestion of figure 6 is that trade exposure tends to be higher in imports, with the exception of major commodity exporters. Indeed, as would be expected, countries with great natural resource wealth are among the most exposed in all categories. Inward direct and portfolio investment exposure dominates outward, although this in part reflects weaknesses in international reporting of outward positions. In addition, many countries are simply missing altogether. Enhanced regional data collation and reporting would offer clear advantages in terms of policymakers' ability to track and manage IFF exposure in different areas.

Figure 6: IFF risk exposure, commodity trade



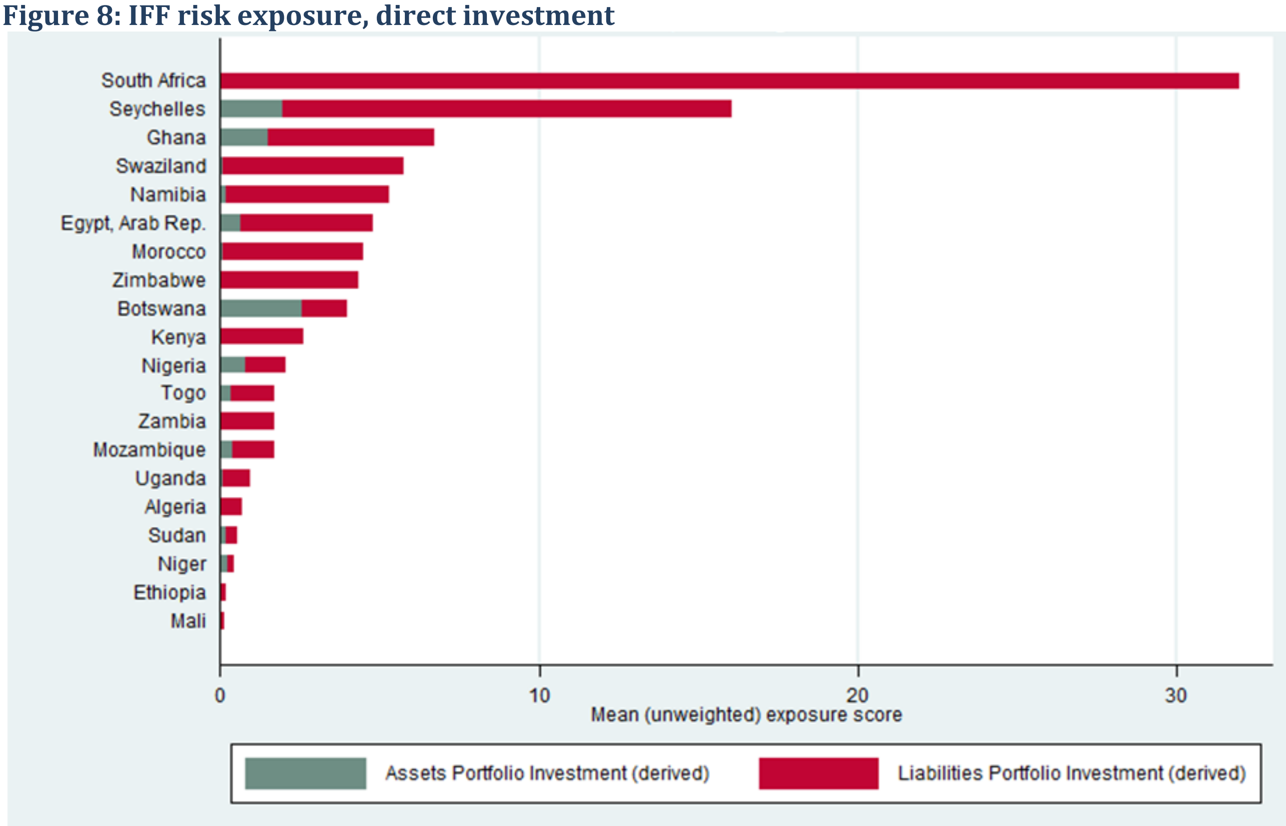
Source: Cobham & Lépissier, forthcoming.

Figure 7: IFF risk exposure, direct investment



Source: Cobham & Lépissier, forthcoming.

Figure 8: IFF risk exposure, direct investment



Source: Cobham & Lépissier, forthcoming.

II. Analytical linkages between IFF and human security

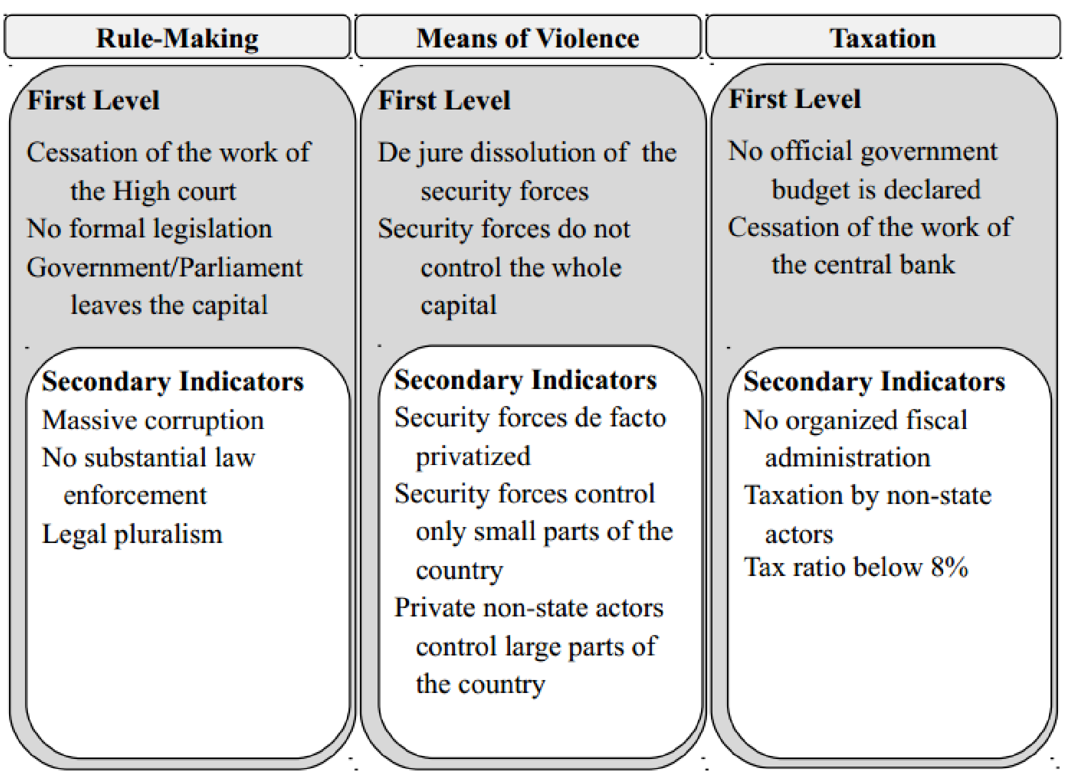
This chapter addresses the potential linkages between IFF, and outcomes relevant to peace and security across Africa. The framing for security follows from the seminal UNDP Human Development Report of 1994's pioneering view of human security as encompassing seven major elements: economic security, food security, health security, environmental security, personal security, community security and political security.

These aspects are considered in two sections, dealing respectively with 'negative' security (issues around the ability of states to prevent personal, community, political and environmental insecurity) and with 'positive' security (issues around the ability of states to provide the conditions for economic, food and health security and progress). In each case linkages in the form of bad security outcomes giving rise to growth in IFF are explored, as well the possibility that higher IFF result in worse security outcomes.

First, however, it is useful to elaborate briefly a conceptualisation of the 'ideal' state, and therefore of what is implied by state collapse. In doing it so it becomes clear that fundamental linkages exist between statehood and IFF, which underpin the security linkages explored below.

An ideal state can be considered to enjoy three monopolies: those on rule-making, which is fundamental to sovereignty; on violence, which guarantees the first; and on taxation, to finance the first two. On this basis Lambach et al. (2012) conceptualise state collapse according to figure 9, where they provide first level and secondary indicators of the collapse of state monopoly power in each of the three areas.

Figure 9: Concept of state collapse



Source: figure 2 in Lambach et al, 2012.

The four major components of IFF can each exert influence. Tax abuse most obviously threatens taxation, while market abuse and the abuse of power threaten the monopoly on rule-making. The monopoly on violence may be threatened when criminal proceeds are used to fund conflict, or simply become such a large component of total economic activity – with their own system of 'legitimate' violence to maintain order – that the state's monopoly is threatened.

Figure 10 presents the threefold monopoly as a pyramid, with taxation supporting both rule-making and violence, and violence underpinning rule-making. The main IFF types which threaten each layer of the pyramid are also shown, as is the broad role of different layers in curtailing each type of IFF. The overall picture is complex but clear. It is one of multiple overlapping and largely reinforcing linkages, creating a powerful circularity in the relationship between statehood and IFF.

Figure 10: IFF and state monopoly powers

Scope for IFF to undermine…		**Threefold monopoly of 'ideal' statehood**	**…Scope to curtail IFF**	
Major	Minor		Major	Minor
Abuse of power Market abuse	Tax abuse Laundering criminal proceeds	Rule-making	All	
Laundering criminal proceeds		Violence		All
Tax abuse	Abuse of power Market abuse	Taxation	Tax abuse	Abuse of power

Source: author's elaboration.

This Weberian ideal state is of course highly stylised, and it is useful to consider the implications for the analysis of allowing a more realistic and nuanced picture of actual states. Where the stylised model in figures 9 and 10 treats the areas of rule-making, violence and taxation as entirely distinct, the reality is that they are intimately related and dependent upon each other, and that these relationships are mediated through political institutions.

Binary distinctions of 'collapsed' states or otherwise, or 'fragile' states, may as a result be unrealistically stark, in a way that actually hinders understanding. As the High Level Panel on Fragile States puts it in their report, 'Ending Conflict and Building Peace in Africa' (2014, p.8):

> *We do not find it helpful to approach 'fragility' as a category of states. Rather, it is a risk that is inherent in the development process itself... Fragility comes about where [pressures such as those stemming from inequality and social exclusion, or from new resource rents and resource scarcity] become too great for countries to manage within the political and institutional process, creating a risk that conflict spills over into violence – whether interstate or civil war, ethnic or tribal conflict, widespread criminality or violence within the family. Countries that lack robust institutions, diversified economies and inclusive political systems are the most vulnerable. In the most acute cases, violence has the effect both of magnifying the underlying pressures and eroding the institutions needed to manage them, creating a fragility trap from which it is very difficult to escape.*

The Panel argue that the quality of institutions of political processes to manage change are the 'pivot' that determine whether pressures lead to conflict, and confirm the importance of the three monopoly powers above for the building of the necessarily resilient institutions to avoid it. None of the three, however, are simply achieved. The World Bank's World Development Report 2011 on 'Conflict, security and development' addresses similar themes, and also stresses the importance – and the difficulty – of developing institutional resilience.

Political settlements have two dimensions: establishing power relations between different groups, and (re)setting relationships between state and citizens. The resilience of such settlements, from which states derive their rule-making power, is not simply created but rather built up over time "through the gradual layering of practices of compromise and accommodation among different groups in society, through a process of 'political sedimentation'" (High Level Panel on Fragile States, 2014, p.16).

In relation to the monopoly on violence, the High Level Panel's "second lesson on state-building is that establishing security and justice is a precondition for progress in all other areas" (p.16); while "Other key lessons on state-building include the importance of revenue collection and public financial management, which underpin the state's ability to re-establish its core structures, pay civil servants and deliver public services. Tax collection gives the state an interest in promoting economic development, to broaden its tax base, while giving tax payers a stake in how the state uses their taxes – a potential virtuous circle that helps rebuild the capacity and legitimacy of the state" (p.17).

This potential virtuous circle is mirrored by a potentially vicious one, in which the failure to tax fairly and effectively undermines state legitimacy, and the weakly legitimate state is unable to tax effectively – with tax abusing IFF a key link in the chain. In fact, the more that the simple stylised model is unpicked, the more clearly does the potential threat of IFF and related rent-seeking emerge in each area. As the following sections explore, linkages between IFF and both negative and positive security create the possibility of vicious cycles, in which conflict and insecurity exacerbate IFF and vice versa, with institutional weakness both cause and effect.

Negative security

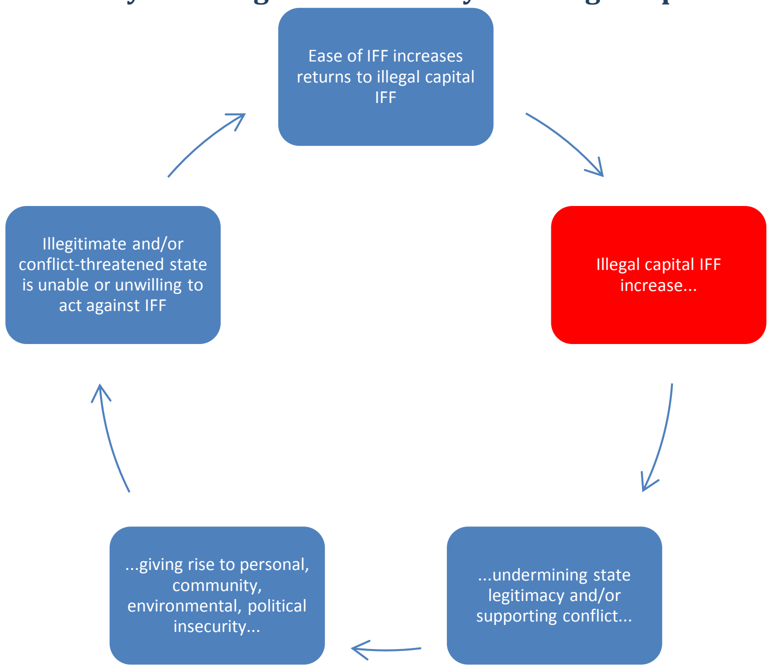
This section focuses on linkages between IFF and issues around the ability of states to prevent, or to negate, insecurity at the personal, community, environmental and political levels: more specifically, the ability and willingness of states to act to reduce the risk of violence against the person, the risk of insecurity due to tensions between groups, the risk of environmental degradation and the risk of political rights violations.

This is the area in which IFF linkages have been most commonly asserted, although there are reasons to be cautious about some of these. Figure 11 shows the broad outline of a vicious cycle that can be hypothesised between negative (in)security and illegal capital IFF in particular (that is, IFF associated with abuse of power and laundering criminal proceeds - similar though probably weaker arguments may exist for legal capital IFF but we do not focus on these here).

Consider the possible starting point – marked in red – of an increase in illegal capital IFF. Where this derives from abuse of power – say, for example, the extreme behaviour of a kleptocratic leader – the cycle follows almost tautologically. The nature of the IFF itself undermines the state legitimacy and directly reflects the state's capacity and interest to provide security, or indeed to act to curtail IFF.

When the rise in IFF reflects laundering of the proceeds of crime, it is the underlying crimes where the linkages are likely to emerge. Drug and human trafficking were highlighted in chapter I as major areas of underlying criminality, and to these can be added piracy, environmental crime and arms dealing.

Figure 11: The vicious cycle of negative insecurity and illegal capital IFF



Source: author's elaboration.

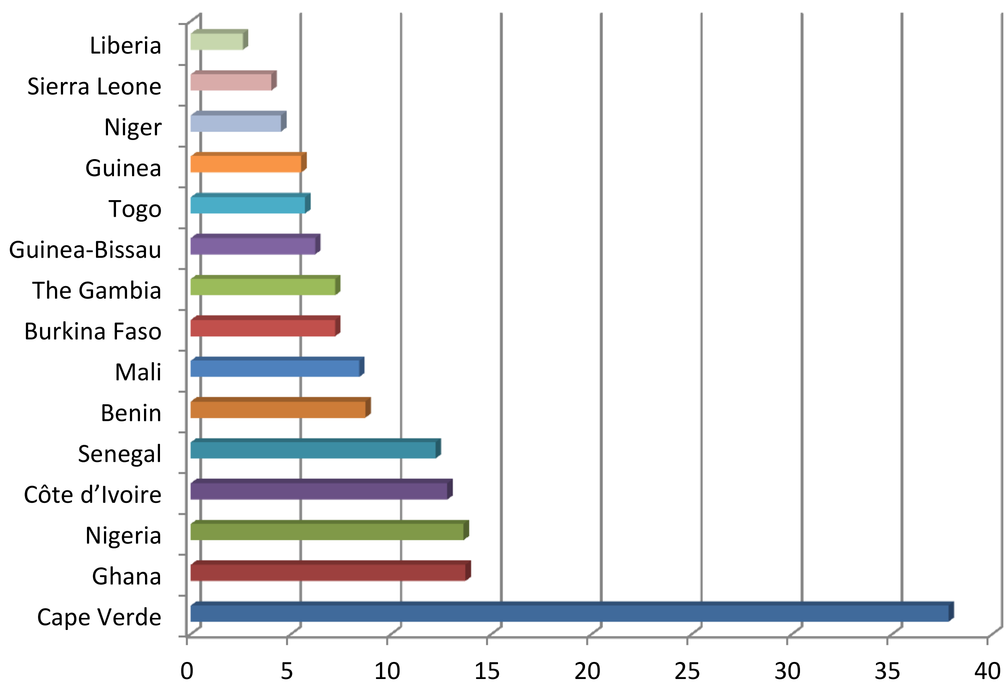
For Cockayne (2011), drug and human trafficking has led to little less than the criminalisation of governance itself in West Africa and the Sahel. He identifies two hubs that grew strongly after Caribbean counter-narcotics efforts in the 1990s pushed the trade elsewhere: one around the Gambia, Guinea and Guinea-Bissau, and the other around Benin, Ghana and Togo. In addition, Cockayne highlights important services provided in other states – namely money laundering in Senegal, and transit in Mali, Mauritania and Niger.

The evidence of political influence seems clear in a number of cases – as former UNODC director Antonio Mario Costa put it in 2008, 'Drug money [in West Africa] is corrupting government officials, army and navy officers, even the security services. Drug money is not only buying real estate and flashy cars: it is buying power' (quoted in Cockayne, 2011). In addition, pre-existing weakness of states seems in a number of cases to have contributed to their attraction to the drug trade.

The question for the current study, however, is whether there is a specific role of illicit *financial* flows, over and above the initial criminal activity. The answer must be in the affirmative. Figure 12 shows the fundamental driver, namely the difference between average economic expectations within the official economy and the potential of cocaine. For this to be the driver, however, reliable means area needed of returning some of the (criminal) proceeds of sales in Europe to West Africa: that is, the incentives only align when IFF are functioning 'well'. The IFF link is supported by USAID's (2013) position that focusing on money laundering is valuable because it targets those higher up the chain and also does not increase drug prices.

The scale of the issue is reflected in UNODC estimates that West African crime networks made $1.8-$2.8 billion from cocaine sales in 2009, compared to regional GDP of around $5 billion. This in turn demonstrates the potential for political influence. In Guinea-Bissau the assassination of President Joao Bernardo Nino Vieira and Chief of Defence Staff General Batista Tagame Na Wai in March 2009 was believed to be linked to the drugs trade. In 2011 a coup was attempted by Bubo na Tchuto, ex Navy chief, already considered a drug kingpin by the USA and later arrested in 2013 by the US Drug Enforcement Agency. A successful coup in April 2012 also appear to have been related to control of the drug trade as trafficking has increased since it took place. In 2010 the EU pulled out if a security sector reform programme as considering that the absence of the rule of law meant it was doomed to fail (BBC, 2014).

Figure 12: West Africa: Per capita GDP equivalent in grams of cocaine (2010)



Source: author's elaboration from data compiled by Cockayne (2011), from IMF World Economic Outlook, September 2011 and 2011 UNODC World Drug Report. Cocaine priced at prevailing western European wholesale prices.

The most dramatic linkages to security are those asserted between drug trafficking and terrorism or insurgency – but these may also be the least robust to closer inspection. Lacher (2013) writes scathingly of "the alleged involvement of al-Qaeda in the Islamic Maghreb (AQIM) and the Movement for Monotheism and Jihad in West Africa (MUJAO) in drug smuggling". In particular, Lacher (p.3) claims that claims of a drug-terrorism nexus in the Sahel are misleading for a number of reasons:

> *First, much of the evidence presented as basis for such claims can either be easily debunked, or is impossible to verify. Second, rather than the two extremist groups as such, involvement in drug trafficking appears to concern individuals and groups close to, or within, MUJAO and AQIM: within both groups, members are driven by multiple and, at times, conflicting motivations. Third, numerous other actors are playing an equally or more important role in drug smuggling, including members of the political and business establishment in northern Mali, Niger and the region's capitals, as well as leaders of supposedly 'secular' armed groups. Fourth, the emphasis on links between drug trafficking and terrorism in the Sahel serves to obscure the role of state actors and corruption in allowing organized crime to grow. Fifth, the profits derived from kidnap-for-ransom played a much more significant role in the rise of AQIM and MUJAO.*

Bourne (2011) goes further and argues that a great deal of the international security discourse on the convergence between illicit (non-financial) flows and 'failed' states is characterised not by supporting evidence but quite the reverse: "this asserted convergence is not a reflection of the globalisation of transnational threats but rather an evolving set of assumptions about the origin and nature of threats" (p.490). Bourne argues that the reality is inevitably more complex.

Similar critiques might well apply to claimed causal links between piracy out of Somalia and insurgency, despite documented links to Al Shaabab; and the role of IFF appears even more tenuous if ransom payments are not themselves considered illicit.

The joint World Bank-UNODC-Interpol (2013) study uncovered much about the role of IFF. Ransoms payments are often made in cash on board ships although some have been made by wire transfer. Cross-border cash smuggling and trade mispricing are understood to be used to move ransom money, along with money value transfer services which are an important part of the financial architecture in Somalia. Law enforcement agencies have found ransom money from the Somali piracy in bank accounts in Africa, North America, Europe and Asia and investigations are underway into Somali pirate financiers in Africa, North America and Europe. Some of these proceeds are ploughed back into criminal activity including migrant smuggling. Meanwhile, the (legal) khat trade provides a major route for laundering the money, in crops exported from Kenya into Somalia.

Recommendations of the study include the development of anti-money laundering frameworks which are non-existent or new in the region, and for capacity building support for central banks in Somalia and Somaliland to monitor financial transactions. On the whole, however, it remains unclear that IFF play a direct causal role in piracy or related national security threats.

Similar critiques might be made in relation to environmental crimes. These may occur in the form of external extraction – for example, under-reporting of fishing of West Africa is estimated at around 40%, in a problem that is estimated to cost developing countries in total $4.9bn to $11.3bn a year (Haken, 2011); or through abuse of power – for example, Charles Taylor used a number of shell companies and foreign bank accounts to profit from the large scale deforestation of Liberia which in turn was used to finance arms purchases (Global Witness, 2007). In the latter case the role of IFF is clearer, but arguably still falls short of the burden of proof to suggest IFF causality for the resulting environmental or other insecurity. Nor is it necessarily clear that elimination of underpricing of timber exports from DRC (Greenpeace, 2008) would have caused less environmental damage (incentive effects of lower net profits could potentially have led to more or less intensive logging).

Overall, it seems likely that the ease with which IFF occur may be an exacerbating factor in criminal activity and abuses of power that undermine negative security; but they are unlikely to be the driving factor in many cases. Similarly, insecurity will contribute to create the conditions for IFF, but broader context may well be more important – for example, the depth of poverty and the existence or otherwise of other economic opportunities.

The linkages that seem most clear are less direct – but perhaps also more powerful.[5] Much of the problems of conflict and negative security arise in countries characterised by low levels of institutionalisation of authority, a heavy reliance on patronage politics and an accordingly high level of allocation of state rents to unproductive activities (patronage, to maintain the political machine). For a rent-seeking patronage order to function, it must resist or evade the pressures to institutionalise state finance – through, for example, an incentive structure in which senior officials have a personal interest in financial opacity and the misuse of public funds, and fiscal policy is subordinated to the "political budget" (the state allocation for patronage purposes). Major sources of funds such as natural

[5] I am grateful to Alex de Waal for this exposition.

resource companies may be rewarded through the opportunities to evade tax with impunity, and may maximise net profits through bribery.

In turn this kind of state structure creates structural incentives for violence. Kleptocracy will tend to require violence to protect the position of privilege; those outside may resort to force to extort rents from those in power, or to challenge for the prize of (illegitimate) power itself.

Financial secrecy facilitates the abuses of power, the accumulation of assets overseas, the non-payment of tax and payment of bribes: so that IFF are central to the range of incentives that bend the state towards insecurity and conflict.

From a policy perspective, greater financial transparency in key areas will weaken the ease with which IFF occur. In addition, there will be clear cases of particular criminality where counter-IFF instruments may prove to be important tools - – for example by eroding the realisable returns to drug trafficking. Such specific measures should be based on careful, contextual analysis. The existence of broader linkages between IFF and negative (in)security, however, contribute to the case for a broad set of measures to be enacted. These are discussed in chapter III after we consider the linkages between IFF and 'positive' security.

Positive security

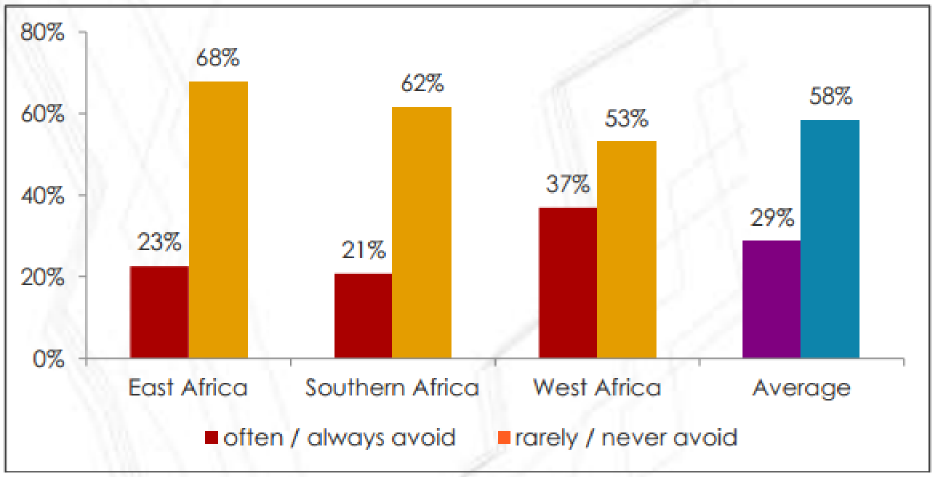
This section focuses on linkages between IFF and issues around the ability of states to provide, to positively construct, secure conditions in which rapid human development can take place. This relates to economic opportunity and freedom from extreme economic inequality; and to the security of basic human development outcomes related to health and nutrition.

In terms of IFF and the role of the state here, it is tax (and its abuse) which is fundamental. Effective taxation provides 4 Rs: not only revenue, and the opportunity to reprice social goods and bads, but redistribution and political representation (Cobham, 2005). Taxation should provide both the funds and the means to redistribute in order to address important deficits in positive security. In addition, however, taxation provides a critical link to effective political representation and wider standards of governance.

The act of paying tax provides an important accountability link (Brautigam et al., 2008; Broms, 2011). Empirical studies suggest the higher the share of tax in government spending, the stronger the process of improving governance and representation (Ross, 2004); while direct tax – taxes on income, profits and capital gains – appears to play a particularly strong role (Mahon, 2005).

The most recent Afrobarometer survey (Aiko & Logan, 2014) confirms the widespread citizen recognition in the region of importance of tax for countries to develop (66%), and of states' right to levy tax (70%, and on a rising trend since 2002). At the same time, however, more than a third of those surveyed think most or all tax officials are corrupt, and these views are correlated with lower self-reported tax compliance. As figure 13 shows, there is a clear regional aspect to the issue: while West Africans expressed the greatest commitment to tax in principle, they confirmed a much higher level of avoidance.

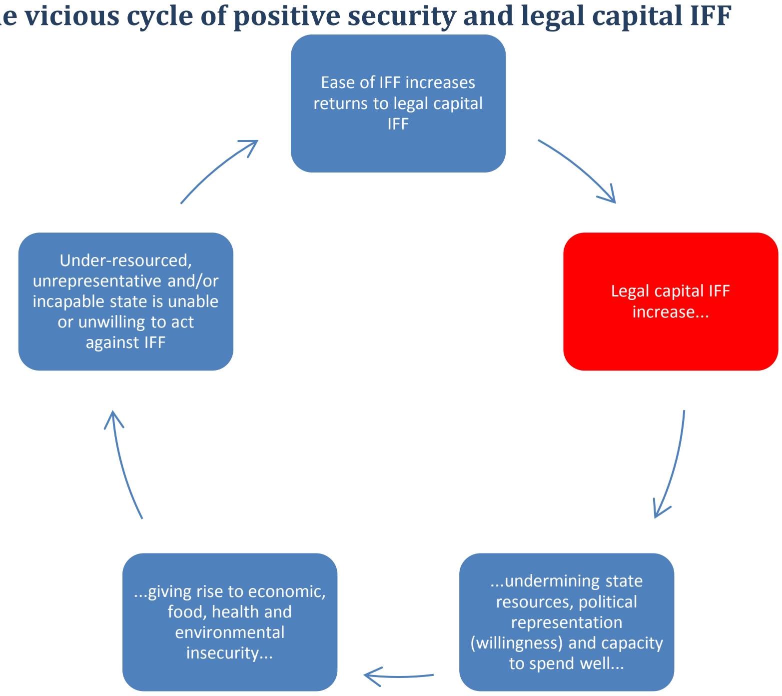
Figure 13: Self-reported tax compliance by region (29 countries, 2011-2013)



Source: figure 10 in Aiko & Logan (2014).

Figure 14 shows the potential vicious cycle that could arise with respect to legal capital IFF and positive (in)security. If the starting point is taken as an increase in legal capital IFF, the risks are of undermining both the available revenues to provide positive security, but also the political responsiveness to be willing to do so. The resulting insecurity and inequalities have the potential to further weaken both the capacity and the willingness of the state to fight IFF, reinforcing the cycle.

Figure 14: The vicious cycle of positive security and legal capital IFF



Source: author's elaboration.

There are a range of options open to states with failing tax systems, and the relative success of Burundi's OBR is heartening (Holmes et al, 2013); as is the growing willingness of aid donors to support capacity in this area. But where there are major international obstacles, there are clear limits to what can be achieved domestically. We return to these in chapter IV, but here note that estimates of the total developing country tax losses due to IFF range from $100 billion to $160 billion

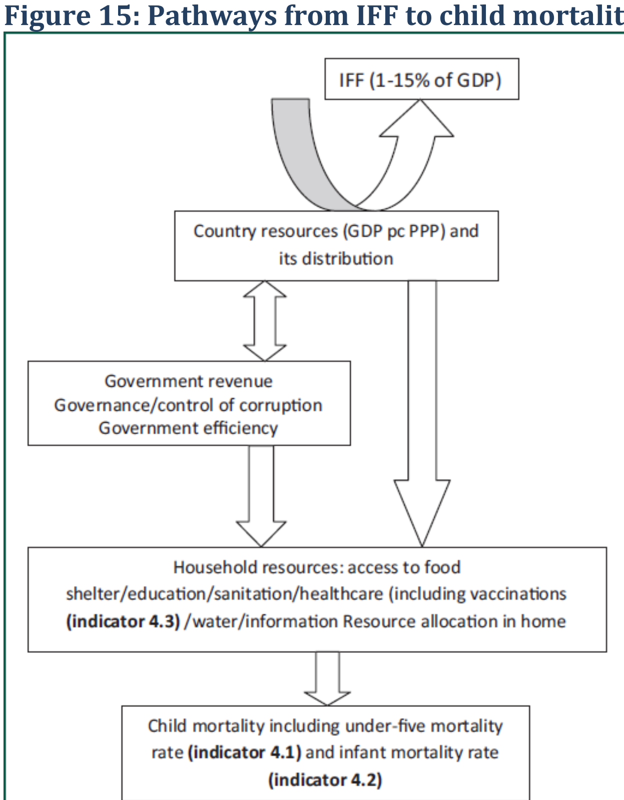
(Hollingshead, 2010; Christian Aid, 2008, 2009). Even allowing for substantial uncertainty, the scale is significant.

The simplest way of conceiving health and nutritional security in relation to IFF draws on a recent paper by O'Hare et al (2013), who consider under-five mortality in sub-Saharan Africa. Figure 15 shows the potential pathways from IFF to mortality: lost revenue and lost national resources (GDP), combined with losses in state capacity, result in worse household access to basic necessities, and this – mediated through the resource allocation within the household – gives rise to worse child health outcomes, including higher mortality rates.

O'Hare et al. (2013) draw upon a previous meta-analysis of studies of the relationship between GDP and mortality rates, to establish a baseline for the impact of GDP losses in sub-Saharan Africa. These are then applied to GFI estimates of IFF, to establish how much quicker progress towards Millennium Development Goal 4 (two thirds reductions in under-five mortality against a 1990 baseline) would have been if IFF were eliminated. The results are shown in table 3, with the last two columns showing the number of years required to reach the target, with and without IFF.

Some reductions are striking – e.g. in Swaziland, the projected reduction is from 155 years at current progress, to just 27, or in Mauritania from 198 to 19 years. Others are more modest, e.g. Mozambique which falls from 16 to 11 years. The regional picture lies in between, of course: with the projected date to reach MDG 4 coming forward from 2029 to 2016. In other words, on these projections, Africa as a whole would very nearly meet MDG 4 in time had IFF been eliminated; whereas the current position is that it will take nearly twice as long.

Figure 15: Pathways from IFF to child mortality



Source: O'Hare et al. (2013).

Table 3: Potential reduction in years required to reach MDG4 if IFF were eliminated

Country	2000 under-five mortality rates (per 1000)	MDG 4 target (under-five mortality rate)	Actual annual reduction in under-five mortality rates (2000–2011)	Illicit financial flows (% of GDP)	Overall potential annual reduction in USM in the absence of IFF	The number of years from 2000 to reach MDG at current rates of decline	The number of years from 2000 to reach MDG if 'IFF/GDP' curtailed
Angola	200	87	2.0	7	4.66	41	17
Botswana	96	17	10.4	10	14.20	16	11
Burkina Faso	191	67	2.0	3	3.14	52	33
Burundi	164	63	1.5	6	3.78	63	25
Cameroon	148	50	0.8	6	3.08	135	35
Central African Republic*	176	59	0.5	5	2.40	218	45
Chad	190	67	1.0	20	8.60	104	12
Congo, DR	181	66	0.7	3	1.84	144	54
Congo, Rep	104	35	0.9	25	10.40	120	10
Cote d'Ivoire	148	51	1.7	6	3.98	62	26
Ethiopia	141	70	5.3	6	7.58	13	9
Gabon	88	31	2.1	11	6.28	49	16
Gambia	128	55	2.6	14	7.92	32	10
Ghana	99	39	2.2	2	2.96	42	31
Guinea	175	76	2.8	9	6.22	29	13
Guinea Bissau	177	80	1.3	7	3.96	61	20
Kenya	111	35	4.0	1	4.38	28	26
Lesotho	127	34	2.8	15	8.50	46	15
Madagascar	102	56	4.8	6	7.08	12	8
Malawi	167	75	6.2	10	10.00	13	8
Mali	213	83	1.8	3	2.94	52	32
Mauritania	116	43	0.5	12	5.06	198	19
Mozambique	177	83	4.7	5	6.60	16	11
Niger	218	102	5.0	3	6.14	15	12
Nigeria	186	77	3.8	12	8.36	23	10
Rwanda	177	58	11.1	5	13.00	9	8
Senegal	119	50	6.4	1	6.78	13	12
South Africa	78	19	4.2	4	5.72	33	24
Sudan	114	41	1.7	3	2.84	60	35
Swaziland	114	28	0.9	11	5.08	155	27
Tanzania	130	52	5.7	2	6.46	16	14
Togo	124	50	1.4	6	3.68	64	24
Uganda	144	62	4.1	3	7.52	20	16
Zambia	157	57	5.6	9	5.60	18	11
Total	146	56	3.3		3.31	29	16

Source: O'Hare et al. (2013).

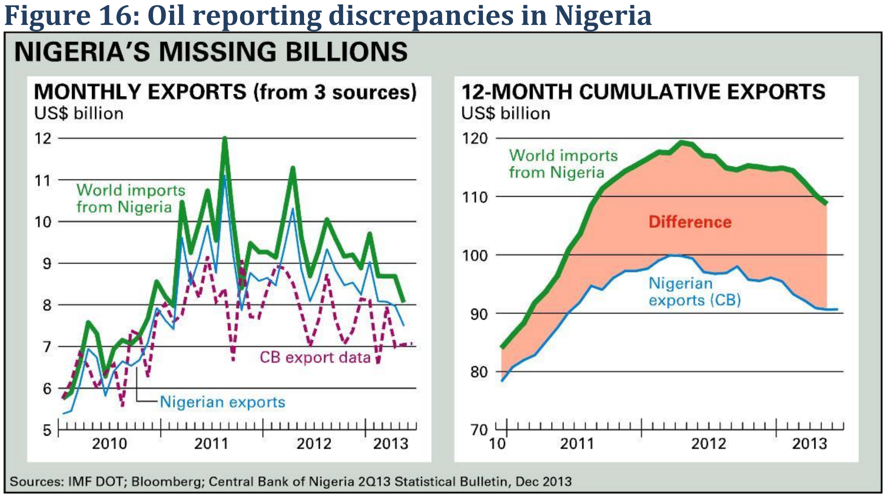
While no similar results yet exist for other aspects of human security, the likely scale simply through the channel of IFF as lost GDP is likely to be substantial in a number of areas. If benefits of better tax spending through stronger representation were to be realised, the potential is greater still.

In terms of economic security beyond lost GDP, it is instructive to consider the case of Nigeria. The recent suspension of central bank governor Lamido Sanusi brought attention to the central bank's calculation of differential between the domestically declared oil exports, and the rest of the world's apparent imports (figure 16). Systematic differences are thought to be due primarily to misappropriation of revenues of the state oil company.

Without implying direct causation, it is suggestive to consider the consumption growth of Nigeria's population, compared to that of sub-Saharan Africa as a whole (excluding Nigeria and South Africa). Figure 17 shows the patterns of consumption growth by decile from 1990-2010. Despite – or perhaps because – of Nigeria's oil-driven boom, the vast majority of citizens saw their consumption fall. Only those in the top few percent did better than the average elsewhere.

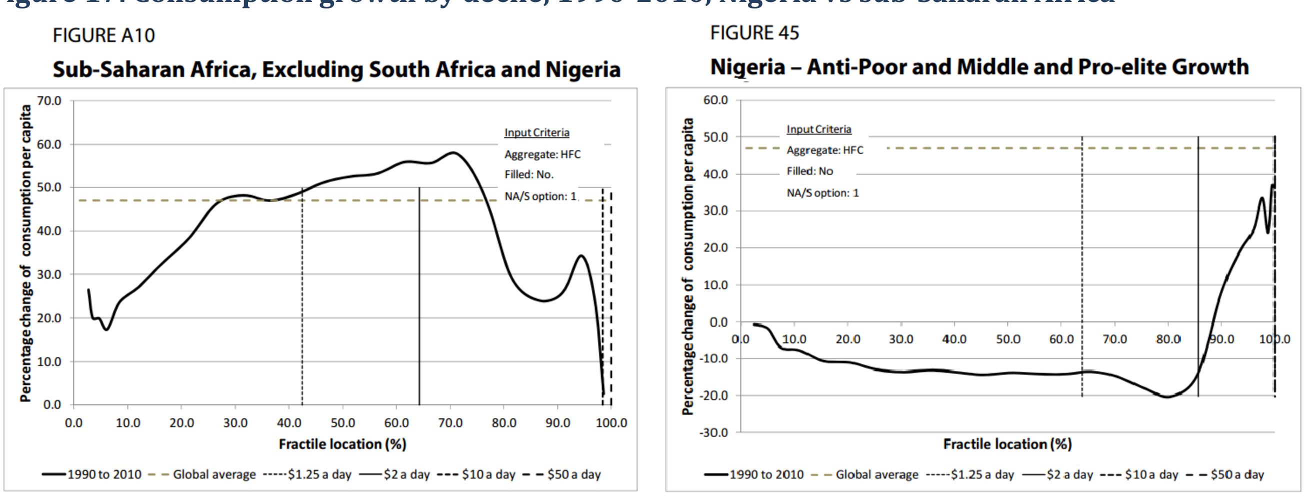
Between 1986 and 2010, Nigeria saw a 75% increase in the concentration of income in the country (Christian Aid, 2014). The Boko Haram group regularly cite inequality as a motive for their violence, and Olokooba et al (2013) argue progressive taxation and redistribution is urgently needed to reduce violence in Nigeria. They further consider inequality between groups and regions as leading to tension, using the example of Oodua People's Congress in the western part of Nigeria have stated that one of the reasons they took up arms was the capture of much of the country's wealth by certain regions. The broad literature on group (horizontal) inequalities finds a link to conflict is common, and also highlights the potential for tax policy responses (Stewart et al., 2007).

Figure 16: Oil reporting discrepancies in Nigeria



Source: Africa Confidential (2014).

Figure 17: Consumption growth by decile, 1990-2010, Nigeria vs sub-Saharan Africa

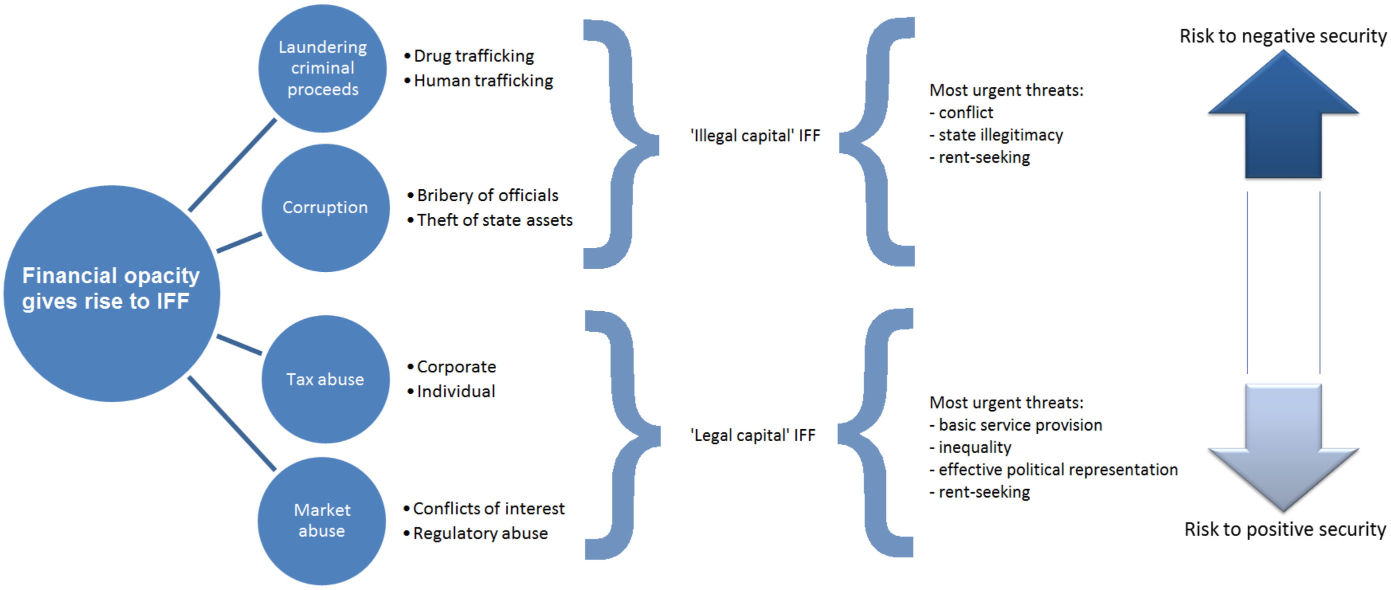


Source: Edwards & Sumner (2014).

As in the area of negative security, there are clearly multiple channels at work between IFF and positive security. However, the direct nature of the link between tax abuse and diminished state capacity to respond to economic, health and nutrition security – even before considering the scope for the same channel to diminish state willingness – may support an even stronger conclusion here about the likely causal link from IFF to insecurity. Insecurity can also support the emergence of IFF issues, but the first channel is by far the clearest.

Figure 1 in the Executive Summary, reproduced here, provides a simple overview of the arguments put forward thus far. IFF can usefully be split into four types, and then into two: illegal capital IFF and legal capital IFF. The former is most closely related to negative security risks, and the latter to positive security. Chapter III considers the range of potential policy measures, and the responsibilities of relevant policymaking bodies.

Figure 2: Overview of IFF and security linkages



Source: author's elaboration.

III. A regional policy agenda

The previous chapters have highlighted that illicit financial flows have important linkages to insecurity (chapter II); and that their common feature is that they rely on financial secrecy to remain hidden (chapter I). For policymakers concerned with security, it follows that financial transparency measures will be central to the response.

Table 1 sets out a range of measures according to whether they are applicable at the national level in order to meet international responsibilities; at the national level out of self-interest; at the regional (and sub-regional level); and at level of regional priorities to influence global processes. The measures reflect five areas of concern: transparency about the ownership of assets and income streams; international exchange of this and related information; the transparency of trade and trade pricing, where so much IFF risk occur; the transparency and also the underlying rules for international corporate taxation; and the broader collation and publication of data on economic and financial stocks and flows.

Beneficial ownership[6]

The legal title to companies is not always the same as the name of the people who actually control it (the 'beneficial owners'). For example companies can be listed under the name of 'Nominee' shareholders, or be held in the name of another company (or trust or foundation), or anonymous 'bearer shares' may be used, making it impossible to trace relationships.

As the World Bank study *Puppet Masters* showed (van der Does de Willebois et al, 2011), anonymous ownership of companies, trusts and foundations is often the central element of financial secrecy in illicit financial flows. Sometimes this occurs within a country – for example, law enforcement in the USA has long struggled with the problem of individual states allowing anonymous company formation (GAO, 2006).

Often, anonymous vehicles are formed in foreign jurisdictions, adding to the problems since this compels authorities to engage in the complicated and often difficult process of a cross-border investigation. Jurisdictions such as Luxembourg or Mauritius, which are commonly used as 'conduits' to invest elsewhere, have therefore a particular responsibility to others in respect of providing transparency.

The Financial Action Task Force (FATF) recommends that countries ensure that information on the real, beneficial owners of companies, trusts and foundations are available to the authorities in an adequate, accurate and timely manner (Recommendations 24 and 25). The G-8 group of countries highlighted the issue at their summit last year, and the UK and a number of its territories with financial centres have since committed to a public registry of beneficial ownership of companies.

Making such registries public, rather than only being accessible to the police or other law enforcement authorities, not only enables law enforcement authorities in other countries to access information without having to resort to the cumbersome, expensive and time-consuming process of mutual legal assistance, but also allows citizens, journalists and civil society to hold companies (and their owners) to account for their actions and provides useful information for banks, customers and suppliers in assessing potential business partners (Open Societies Foundation, 2013).

National policymakers should consider the following actions, in the interests both of domestic security and to avoid undermining security in other countries. First, authorities should require that the

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[6] This sub-section draws on material prepared for Cobham (2013).

national corporate registry obtains identification documents of the beneficial owners of all types of company, and of all parties to trusts and foundations that they create, including prohibiting the issue of bearer shares. To the extent reasonable, the national corporate registry (or a third party) should carry out due diligence to verify that the beneficial ownership information provided to them is correct, using a risk-based approach based on anti-money laundering (AML) systems. Authorities should also impose serious penalties, such as the removal of limited liability, for provision of false information or failure to provide legally-required information.

In addition, authorities should regulate company service providers under AML laws, with significant efforts to ensure that these standards are enforced. All these steps will require provision of the appropriate resources, capacities and legal mandate to corporate registries to carry out verification and apply sanctions. Finally, the full national company registers should be published online, available to search without charge or registration, including a list of company directors and significant shareholders for each company, and statutory filings (e.g. Annual Reports and accounts).

International information exchange

A crucial element of efforts to fight IFF (hidden, cross-border flows) is the international exchange of financial information. The standard for multilateral, automatic exchange of information is the OECD's (2014) Common Reporting Standard, the CRS (emphasis in original):

> *To prevent circumventing the CRS it is designed with a broad scope across three dimensions:*
>
> - *The financial information to be reported with respect to reportable accounts includes all types of* ***investment income*** *(including interest, dividends, income from certain insurance contracts and other similar types of income) but also* ***account balances and sales proceeds*** *from financial assets.*
> - *The financial institutions that are required to report under the CRS do not only include* ***banks*** *and* ***custodians*** *but also other financial institutions such as* ***brokers, certain collective investment vehicles and certain insurance companies****.*
> - *Reportable accounts include accounts held by* ***individuals*** *and* ***entities*** *(which includes* ***trusts and foundations****), and the standard includes a requirement to look through passive entities to report on the individuals that ultimately control these entities.*

An 'early adopters' group has now begun the process to pilot the standard. Encouragingly, this involves a number of traditional 'tax haven' jurisdictions, such as Jersey, Cayman and the British Virgin Islands, which have typically resisted such information exchange. However, only one African country (South Africa) is included among the 44 members. This is likely to reflect two main issues: first, the CRS includes a broad requirement for reciprocity; and second, concerns have been expressed about the ability of lower-income countries to guarantee confidentiality of information received.

There is an obvious solution to both issues: for African countries to establish regional agreements to exchange information amongst themselves, on the basis of the CRS or similar. This would ensure countries had systems in place to be able to reciprocally provide information as well as receive it. It would also provide countries with the incentive to adapt systems as required to be able to make effective use of information received. Success in detecting IFF would not only mark direct progress, but would also have powerful deterrent effects on others. Finally, a regional agreement would provide a direct demonstration to observers outside the region of the ability to use and to safeguard such information.

Where the OECD has led the technical process thus far, it seems appropriate that the African Tax Adminstration Forum (ATAF) would lead a regional process here – with support, where required, from the OECD itself and from South Africa as the 'early adopter' group member. If broad regional engagement is likely to be unduly slow, then there is a strong case for sub-regional groupings such as the East Africa Community to work with ATAF to implement automatic exchange of information. At the same time, ATAF and others should push for the immediate inclusion – even without immediate reciprocity – of African states in global information exchange.

Trade

The majority of illicit flows is estimated to occur through trade mispricing for most countries, so counter-measures here are a clear priority. Again, transparency is the first step; and again, the scope for detection of IFF and wider deterrent effects is clear.

For national policymakers, there are two priorities: improvements in the collation and publication of trade data, and its real-time analysis. With detailed commodity-level data comes the possibility to run relatively simple software, both to explore the potential for abnormal pricing in past transactions, and also to allow customs officers to query pricing claims in real time.

Such analysis becomes more powerful with a wider dataset to draw on, and with data from both ends of some transactions. For this reason there is value in cooperation at the regional and sub-regional level, in the EAC or SADC for example, to pool data and reduce costs by sharing analysis. In addition, demonstrated success in such areas would provide the basis for requests to major trading partners such as the EU to cooperate in the same process – thereby powerfully increasing the scope of the exercise, and the volumes of trade at IFF risk.

Two additional measures should be considered at the regional level, with the potential for the African Union, for example, to lead. First, policymakers should develop a common African position on international trade transparency, starting with commodities. It is clear that a great share of African commodity exports, whether copper, oil or rice, are at risk of abnormal pricing hiding illicit outflows. There is substantial scope for global measures to improve the transparency and traceability of commodity trade, in a way that is likely to reduce IFF risk significantly.

Second, policymakers should assess the case for counter-measures, including potential WTO challenges, for highly opaque trading partners. Where the evidence suggests trade with particular trading partners may be at disproportionately high risk of IFF, there may be a case to answer that the latter's actions are preventing African countries from enjoying the full benefits of trade – the denial of which to a fellow WTO member is a breach of membership articles.[7]

Corporate tax

The potential scale of corporate tax abuse in IFF is large, as are the implications for positive security in particular. Here once more there are actions in the area of transparency and of detection; but in this case there is a more radical possibility also, which could provide a powerful alternative to seeking 'fixed' in the current, failing system.

In respect to transparency and detection, national tax authorities should require country-by-country reporting from multinational groups to allow easy identification of possible profit shifting. This

[7] Cobham et al. (2014) identify potential IFF losses in the billions of dollars a year from commodity trade with Switzerland, while Bastin (forthcoming) analyses a potential WTO challenge on the basis of that evidence.

reporting, long proposed by critics of the OECD's transfer pricing approach, allows a tax authority to compare easily the relative shares of economic activity and of profit that local subsidiaries of each multinational have in the country. A red flag is raised if, for example, local subsidiaries account for half of the economic activity but only 5% of the declared profit; while a subsidiary in Luxembourg, for example, is in the opposite position. Publishing this information allows analysis and comparison between countries, and also contributes to public confidence in fair tax being applied. Publication of 'tax expenditures' – the costs of tax incentives and tax holidays given to companies – will play the same role, and help to guard against abuses of the process as well as ensuring only economically valuable costs are imposed.

While greater transparency of country-by-country can help tax authorities to limit the most egregious abuses, and citizens to hold tax authorities and companies to account, there are serious limits on the extent to which transparency alone can change outcomes. There are long-standing concerns over the manageability of current tax arrangements, not least in respect of transfer pricing, even for the most highly resourced tax authorities (Picciotto, 2013). As a result, the OECD's Base Erosion and Profit Shifting (BEPS) initiative – at the behest of the G20 and G8 – takes as its aim to better align corporate profits and actual economic activity.

The BEPS Action Plan (OECD, 2013) declares that "A realignment of taxation and relevant substance is needed" (p.13), and takes as its aim that it "should provide countries with domestic and international instruments that will better align rights to tax with economic activity" (p.11). This is striking, since alignment of profit and economic activity is not the aim of the current arrangements. Under the 'separate accounting' approach, individual entities are taxed rather than the corporate group as a whole, and so misalignments will reflect not only tax motivated 'profit shifting' but also differences in the actual profitability of different entities within a particular multinational group.

The problem, of course, is that the complexity and room for manoeuvre within transfer pricing guidelines – and the ability of major multinationals to bring teams of economists, accountants and tax lawyers to argue their case against tax authorities with limited capacity – can result in major misalignments entirely within the rules.

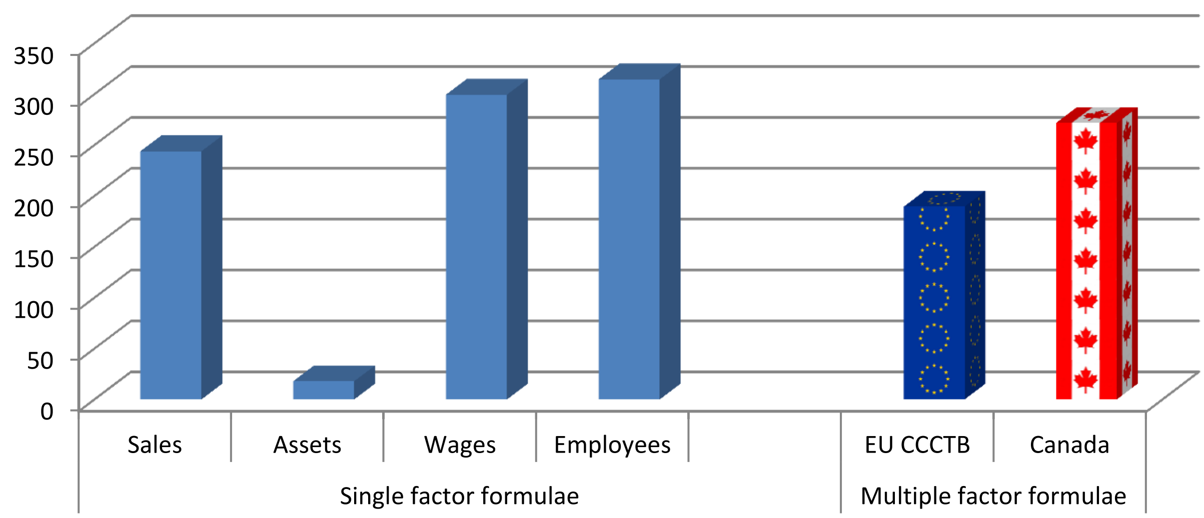
Given the extent to which African economic activity may for this reason be generating profit *elsewhere*, the question arises of whether policymakers should consider taking a common African position in favour of unitary taxation. Unitary taxation is the main alternative approach, and is currently used to apportion profit between states of the USA, cantons in Switzerland and provinces in Canada, and is under active consideration for use to apportion profit between countries of the European Union.

By taxing multinationals at the unit of the group, the aim is precisely to align profits with real economic activity. Analysis of current profit distribution shows that a switch to unitary taxation could have potentially dramatic impacts on the corporate tax base. Figure 18 uses data on US-headquartered multinationals' affiliates overseas, and considers the effect on the tax base attributable to South Africa, compared to the current situation, of apportioning profit according to different formulae intended to capture economic activity. As is clear, most of the obvious possibilities – including the existing European and Canadian formulae – result in a doubling, or even a tripling, of the tax base attributable to South Africa.

A number of potential policy options should be considered. First, a process to consider the implications of a move to unitary tax should be conducted – assessing the potential impact at the level of individual countries, sub-regional groupings and for the region as a whole. Such a process could be pursued within the follow-up process of the UNECA IFF panel chaired by H.E Thabo Mbeki, with technical support from UNECA, the African Development Bank and ATAF. Subject to the findings of this exercise, ideally published within 2014 while the BEPS process is still ongoing, consideration should be given to the agreement of a common African position in favour of a switch to unitary taxation.

In addition, the OECD should be requested to publish Africa-specific assessments of individual BEPS proposals, to highlight whether and to what extent these measures are expected to benefit African countries (as opposed to OECD members, for example); and within the context of BEPS Action Point 11, to publish data on the extent of profit misalignment for African countries, and progress made over time through BEPS.

Figure 18: Increase in tax base under unitary taxation (% of declared profit), South Africa 2011



Source: Cobham & Janský (forthcoming), using US Bureau of Economic Analysis data.
Note: Figure shows potential increase in taxable profit from US-headquartered multinationals, if unitary taxation were applied, instead of the current system of separate accounting and (arm's length) transfer pricing. Single factor formulae show the effect of allocating profit across the group on the basis of the location of, respectively, sales, assets, wages and number of employees. Multiple factor formulae show the effect of allocating according to the European Union's Common Consolidated Corporate Tax Base (an equally-weighted three-part formula between sales, assets and an equal split between wages and employee numbers), and the Canadian formula (equal weighting of sales and wages).

International data

The final area of policy relates to the generation and provision of data on international economic and financial transactions. As far as possible, national policymakers should work towards supplying data to international bodies on bilateral trade and investment stocks and flows. Analysis such as that presented in figures 6-8 is hindered by the absence of self-reported data for many African countries, resulting in a reliance on partner jurisdictions – which in some cases are themselves highly secretive. Even with current data, however, that analysis provides a starting point for countries to identify – and hence to manage – their exposure to financial secrecy, and the risk of IFF, in their bilateral relationships. Sub-regional groupings should support all member countries to contribute data and to use existing data for such analysis, as well as carrying out pooled analysis to reduce costs.

With ongoing efforts to improve data collation and use, there will be an opportunity to promote global cooperation and more timely production of bilateral trade and investment statistics, with the further cooperation of others including secrecy jurisdictions.

Conclusions

This paper has presented, in chapter I, a definition and typology of illicit financial flows, highlighting their hidden nature and the resulting reliance on financial secrecy.

Chapter II set out the linkages between IFF and security, showing in particular the linkages between:

i. 'illegal capital IFF' (driven by corruption and criminality) and 'negative security' (states' ability to prevent, or to negate, insecurity at the personal, community, environmental and political levels); and
ii. 'legal capital IFF' (driven by tax abuse and market regulation abuse) and 'positive security' (states' ability to provide, to positively construct, secure conditions in which rapid human development can take place).

This chapter has outlined a set of responses for national and regional policymakers, in five areas of financial transparency and rule changes.

African policymakers have the power to take significant steps against IFF domestically, with direct benefits for security, which can also strengthen greatly their ability to ensure that global arrangements reflect African priorities. Decisive action within the next twelve months can ensure that permanent benefits are obtained from the current window of opportunity. Missing the chance will impose long-term costs on states and citizens through unnecessary insecurity.

Finally, the UN process to identify and agree a post-2015 successor framework to the Millennium Development Goals creates one further opportunity. The high level panel advising the Secretary General has recommended a target to reduce IFF and tax evasion, and to recover stolen assets, but greater political support could be critical in ensuring the eventual inclusion of a specific measure requiring meaningful commitments from financial centres among others. A strong African position here could be pivotal.

Table 2: Overview of policy responses to IFF

<table>
<tr><th>Level of policy:

Area of policy:</th><th>National (minimum standards)</th><th>National (own priorities)</th><th>Regional and sub-regional (own priorities)</th><th>Regional-global (own priorities)</th></tr>
<tr><td>Beneficial ownership</td><td colspan="2">Legislate (and allocate resources) to ensure all company and legal structures require collection of ownership information

Publish same (online) in timely fashion</td><td>Support all countries to reach minimum standards

Develop shared public portal to access ownership information</td><td>Promote global minimum standard for publication of ownership information

Consider counter-measures for non-compliant jurisdictions</td></tr>
<tr><td>International information exchange</td><td>Work towards compatibility with international standards</td><td>Promote and adopt simple applications to flag high-risk data (e.g. where inconsistent with domestic tax returns)</td><td>Develop and enact regional mechanisms for automatic information exchange

Support best practice in use of data to identify risk</td><td>Advocate to ensure immediate reciprocity is not entry requirement to global instruments, i.e. that countries can begin receiving data as long as committed to eventual full reciprocity

Consider/supporting counter-measures for non-compliant jurisdictions</td></tr>
<tr><td>Trade</td><td>Own data collation, publication (e.g. via UN Comtrade)</td><td>Real-time analysis of own data</td><td>Pooled real-time data analysis (more efficient use of resources and broader dataset to improve quality of assessment and ability to identify abnormal pricing in real time)</td><td>Pilot ‘follow the money’ partnerships to curtail trade mispricing globally

Consider counter-measures, including potential WTO challenges, for highly opaque trading partners

Develop a common African position on international trade transparency, starting with commodities</td></tr>
<tr><td>Corporate tax</td><td></td><td>Require combined and country-by-country reporting from multinationals</td><td>Publish combined and country-by-country reporting from multinationals

Combine resources for regional assessment of multinational tax positions

Assess potential for profit allocation methods</td><td>Call for OECD to publish Africa-specific assessment of individual BEPS proposals

Support assessment of alternatives, including profit allocation methods; and if warranted, develop a common African position in support of unitary taxation</td></tr>
<tr><td>International data</td><td>As far as practical, work towards supplying data to international bodies on bilateral trade and investment stocks and flows</td><td>Use global datasets to assess and manage risk (exposure to secrecy jurisdictions) in own bilateral relationships</td><td>Support all countries to contribute data, and to use</td><td>Promote global cooperation and more timely production of bilateral trade and investment statistics, including cooperation of secrecy jurisdictions</td></tr>
</table>

Source: author’s elaboration.

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