

Profiling Cash Drains in Africa

We present some excerpts from the study "**Illicit Financial Flows from Africa: Hidden Resource for Development.**" released by Global Financial Integrity on March 26. Also included is a short article by Léonce Ndikumana and James K. Boyce, authors of a 2008 report on the same subject.

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Ndikumana and Boyce argue that those who owe Africa's debt are actually those who have illegally transferred wealth overseas, and that African countries should identify debts as "odious" and refuse payment unless the creditors are able to prove that the loans were actually spent for the intended purpose instead of siphoned overseas.,

"Estimates [for the period 1970-2008] show that over the 39-year period Africa lost an astonishing US\$854 billion in cumulative capital flight--enough to not only wipe out the region's total external debt outstanding of around US\$250 billion (at end-December, 2008) but potentially leave US\$600 billion for poverty alleviation and economic growth. Instead, 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." - report by Global Financial Integrity

These estimates based on available data, the report authors also note, are without doubt conservative underestimates. Adjusting for some of the known data flaws, they suggest the figure might be more than double, at \$1.8 trillion. And even this larger figure, they note, does not include proceeds that are never recorded, such as from drug trafficking and smuggling.

Strikingly, the report argues that explicit corruption, such as bribes, account for only a small portion of capital flight. By far the largest component is, instead, generated by commercial tax evasion through trade misinvoicing.

Illicit Financial Flows from Africa: Hidden Resource for Development

Prepared by Dev Kar and Devon Cartwright-Smith

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Global Financial Integrity

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In December 2008 Global Financial Integrity released its groundbreaking analysis of Illicit Financial Flows from Developing Countries: 2002 - 2006. We estimated such flows at \$859 billion to \$1.06 trillion a year.

We are pleased now to release our analysis of Illicit Financial Flows from Africa: Hidden Resource for Development. This study examines the 39-year period from 1970 through 2008. ...we estimate that such flows have totaled \$854 billion across the period examined. This

estimate is regarded as conservative, since it addresses only one form of trade mispricing, does not include the mispricing of services, and does not encompass the proceeds of smuggling. Adjusting the \$854 billion estimate to take into account some of the components of illicit flows not covered, it is not unreasonable to estimate total illicit outflows from the continent across the 39 years at some \$1.8 trillion.

Much attention has been focused on corruption in recent years, that is, the proceeds of bribery and theft by government officials. In the cross-border flow of illicit money, we find that funds generated by this means are about 3 percent of the global total. Criminal proceeds generated through drug trafficking, racketeering, counterfeiting and more are about 30 to 35 percent of the total. The proceeds of commercial tax evasion, mainly through trade mispricing, are by far the largest component, at some 60 to 65 percent of the global total. While we have not attempted in this study to verify these approximate percentages for Africa, we believe that they are likely to be of roughly the same order of magnitude.

This massive flow of illicit money out of Africa is facilitated by a global shadow financial system comprising tax havens, secrecy jurisdictions, disguised corporations, anonymous trust accounts, fake foundations, trade mispricing, and money laundering techniques. The impact of this structure and the funds it shifts out of Africa is staggering. It drains hard currency reserves, heightens inflation, reduces tax collection, cancels investment, and undermines free trade. It has its greatest impact on those at the bottom of income scales in their countries, removing resources that could otherwise be used for poverty alleviation and economic growth.

Addressing this problem requires concerted effort by both African nations and by western countries. The outflow from Africa and the absorption into western economies deserve equal attention. Through greater transparency in the global financial system illicit outflows can be substantially curtailed, thereby enhancing growth in developing countries and at the same time stabilizing the economies of richer countries. ...

Raymond W. Baker Director, Global Financial Integrity

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1. Introduction

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The purpose of this paper is not to explain the factors that drive illicit financial flows or to carry out a series of econometric tests seeking to determine their significance. There is a wealth of existing research on these subjects. Rather, we analyze the long-term evolution of illicit flows from the continent and its various regional and economic groupings. ... we also point out certain common pitfalls in data interpretation.

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2. Models of Illicit Financial Flows

Illicit money is money that is illegally earned, transferred, or utilized. If it breaks laws in its origin, movement, or use it merits the label.

Flight capital takes two forms. The legal component stays on the books of the entity or individual making the outward transfer. The illegal component is intended to disappear from records in the country from which it comes. By far the greatest part of unrecorded flows are indeed illicit,

violating the national criminal and civil codes, tax laws, customs regulations, VAT assessments, exchange control requirements, or banking regulations of the countries out of which the unrecorded/illicit flows occur.

There are two main channels through which illicit capital, unrecorded in official statistics, can leave a country. The World Bank Residual model captures the first channel through which illicit capital leaves a country through its external accounts.

The second type of illicit flows, generated through the mispricing of trade transactions, is captured by the Trade Misinvoicing model which uses IMF Direction of Trade Statistics.

Specifically, the World Bank Residual model compares a country's source of funds with its recorded use of funds. Sources of funds--the countries inflows of capital--include increases in net external indebtedness of the public sector and the net inflow of foreign direct investment. The net external indebtedness is derived by calculating the change in the stock of external debt which was obtained from the World Bank's Global Development Finance database. Use of funds includes financing the current account deficit and additions to central bank reserves. Both these data series along with data on foreign direct investment were obtained from the IMF Balance of Payments database. According to the model, whenever a country's source of funds exceeds its recorded use of funds, the residual comprises unaccounted-for, and hence illicit, capital outflows.

Trade misinvoicing has long been recognized as a major conduit for illicit financial flows. By overpricing imports and underpricing exports on customs documents, residents can illegally transfer money abroad. To estimate trade misinvoicing, a developing country's exports to the world are compared to what the world reports as having imported from that country, after adjusting for insurance and freight. Additionally, a country's imports from the world are compared to what the world reports as having exported to that country. Discrepancies in partner-country trade data, after adjusting for insurance and freight, indicate misinvoicing.

However, note that this method only captures illicit transfer of fund abroad through customs re-invoicing; IMF Direction of Trade Statistics cannot capture mispricing that is conducted on the same customs invoice (for which we make an adjustment in Section IV).

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One should bear in mind that there are a number of limitations underlying the two models used to estimate illicit flows. First, no economic model that relies on official data to estimate illicit flows can capture the effects of smuggling which entirely bypasses customs authorities and their recording systems. Smuggling tends to be rampant when there are significant differences in cross-border prices in certain goods between countries that share a long and porous frontier. The profits from smuggling often end up as part of outgoing illicit flows since smugglers seek to shield their ill-gotten gains from the scrutiny of officials, even as smuggling distorts the quality of bilateral trade. As a result, trade data distortions due to smuggling may indicate that there are inward illicit flows into a country when in fact the reverse is true.

Economic models that rely on official statistics also cannot capture illicit flows generated through transactions in narcotics and other contraband goods, human trafficking, violations of intellectual and property rights, and the sex trade because related financial flows are not recorded in any books. Hence, economic models understate the actual volume of illicit flows to the extent that these types of illegal transactions are significant for both developing and developed countries.

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3. The Pattern and Evolution of Illicit Flows from Africa

Existing research shows that African countries have experienced massive outflows of illicit capital mainly to Western financial institutions. In fact, Ndikumana and Boyce (2003, 2008) among

others find that the continent as a whole has turned into a net creditor to the world. The irony is not lost on bilateral and multilateral creditors who have together provided Africa with substantial and growing amounts of external aid over several decades. Other researchers such as Collier, Hoeffler and Pattilo

(2001) point out that many African investors seem to prefer foreign over domestic assets to the extent that the continent now has the highest share of private external assets among developing regions with serious ramifications for self-sustaining economic growth which allow countries to graduate from aid dependence.

Estimates presented in Table 1 show that over the 39-year period Africa lost an astonishing US\$854 billion in cumulative capital flight--enough to not only wipe out the region's total external debt outstanding of around US\$250 billion (at end-December, 2008) but potentially leave US\$600 billion for poverty alleviation and economic growth. Instead, 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.

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While the overwhelming bulk of this loss in capital through illicit channels over the period 1970-2008 was from Sub-Saharan African countries, there are significant disparities in the regional pattern of illicit flows (Chart 2). For example, capital flight from West and Central Africa, by far the dominant driver of illicit flows from the Sub-Saharan region, is mainly driven by Nigeria which is also included in the economic group "fuel exporters". In fact, the proportion of illicit flows from West and Central African states may be somewhat overstated, given that other regions of Africa include many countries that are poor reporters of data and thereby understate their contributions to illicit flows.

For example, flows from the Horn of Africa (represented by the narrow red sliver in Chart 2) are likely to be understated particularly in the earlier decades due to incomplete balance of payments and bilateral trade data from Eritrea, Somalia, and Sudan, which have been historically unstable and prone to conflict.

By the same token, civil strife for some periods in the Democratic Republic of the Congo, Rwanda, and Uganda are reflected in incomplete and poor quality data which likely understate the volume of illicit flows from the Great Lakes region. Hence, the long-term evolution of illicit flows from the different regions of Africa need to be interpreted with caution in light of such data deficiencies.

... the estimates indicate that Africa lost around US\$29 billion per year over the period 1970-2008, of which the Sub-Saharan region accounted for \$22 billion. On average, fuel exporters including Nigeria lost capital at the rate of nearly \$10 billion per year, far outstripping the \$2.5 billion dollars lost by non-fuel primary commodity exporters per year. ...

Table 1 also shows that real illicit flows from Africa grew at an average rate of 12.1 percent per annum over the 39-year period.

Some of the acceleration in illicit outflows was undoubtedly driven by oil price increases and increased opportunities to misprice trade that typically accompany increasing trading volumes due to globalization. The rates of outflow in illicit capital for West and Central Africa (14.5 percent) as well as Fuel-exporters (21.8 percent) over the entire period 1970-2008 reflect substantial outflows from Nigeria and Sudan. The acceleration of illicit outflows in 2000-2008 from both these regions coincide with unprecedented increases in oil prices. This seems to corroborate Almounsor (2005), who found a significant link between oil price increases and capital flight.

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Per capita, the North Africa region (comprising of Algeria, Egypt, Libya, Morocco, and Tunisia) lost \$1,767 in investable capital over the 39-year period with Southern Africa and West and Central Africa following closely behind at approximately \$1,334 and \$1,313 per capita, respectively. Again, except for the dip in the 1990s, the loss of illicit funds per capita has been steadily increasing over the period across most regions of Africa in spite of the high rates of population growth prevalent throughout the continent.

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How do some of these estimates compare with past research? While a number of past studies present evidence of substantial illicit financial flows from Africa, the study by Ndikumana and Boyce (2008; available at <http://www.peri.umass.edu/236/hash/61e07e4377/publication/301/>) is the most recent and comprehensive one on the subject. They estimate illicit flows (or illegal capital flight) for a sample of 40 Sub-Saharan African (SSA) countries over the period 1970-2004 and find evidence of a "revolving door" effect between the contracting of external debt and illicit outflows. Over the 35-year period, real capital flight (in 2004 dollars) from the SSA countries amounted to \$420 billion, which would jump to \$607 billion if one were to include imputed interest earnings.

In contrast, we adopted a conservative approach to estimating capital flight in that we omitted a country from the total if we deemed that its data were unreliable or if some of the data were incomplete. For the same sample size and time period as the Ndikumana and Boyce study, we find that Sub-Saharan Africa as a whole lost US\$282 billion in real 2004 dollars over the period 1970-2004; extending the period to 2008 sharply increased the cumulative total to US\$533 billion.

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On balance, our findings corroborate Ndikumana and Boyce in that the stock of private assets held abroad by Sub-Saharan Africans exceeds the combined stock of the region's external debt, thereby making it a net creditor to the world. This finding is not surprising given that, except for a small decline in the 1990s, average illicit flows from the continent have been ratcheting upwards every decade since the 1970s (Chart 4).

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4. Adjustment for the Underestimation of Illicit Flows

For reasons pointed out in Section II including limitations of economic models, there is no question that illicit financial flows are significantly understated. In this section, we attempt to correct for some of the factors responsible for the underestimation while clearly recognizing the limitations of such methods. It should be noted that adjustments to include illicit flows generated through illegal activities such as smuggling, trade in narcotics and other contraband goods, human trafficking, the sex trade, and other illegal activities, are outside the scope of this paper. Nevertheless, the exercise provides some guide to the margins of error associated with the estimation of illicit flows.

Table 3 (page 20) presents the adjusted estimates in the following sequence of calculations.

...

As a result of these adjustments, total illicit flows from Africa over the period 1970-2008 more than double from US\$854 billion to US\$1.8 trillion. While this is a staggering volume of illicit outflows, it is likely to be still higher if we were to include flows due to other illegal activities.

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V. The Development Impact of Illicit Flows

The enormity of such a huge outflow of illicit capital explains why donor-driven efforts to spur economic development and reduce poverty have been underachieving in Africa. Policy measures must be taken to address the factors underlying illicit outflows and also to impress upon the G-20 the need for better transparency and tighter oversight of international banks and offshore financial centers that absorb these flows.

Research at Global Financial Integrity shows that the massive outflows of illicit capital are not just due to sub-optimal policies in individual developing countries but rather that such policies find synergy in deep flaws within the global financial system. ...

So long as illicit capital continues to hemorrhage out of poor African countries over the long term at a rapid pace, efforts to reduce poverty and boost economic growth will be thwarted as income distribution becomes ever more skewed leading to economic and political instability.

The current global financial crisis, which has generated a world-wide public backlash against the lack of transparency and excesses of financial institutions, offers both African and rich donor countries an historic opportunity to address the problem of illicit flows and absorption of such flows in the world's shadow financial system. The existing global financial system shaped by liberalization and deregulation of financial markets have instead ended up generating ever-rising illicit flows and loss in government revenues. ...

The time is right for African countries to not only implement strong economic and governance measures to curtail illicit flows but to impress upon the G-20 the need to correct their failures in oversight and regulation that have facilitated the absorption of illicit flows and contributed to the current economic crisis.

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CAPITAL FLIGHT FROM SUB-SAHARAN AFRICA

Léonce Ndikumana & James K. Boyce

Tax Justice Focus, 2008, v. 4, #1

<http://www.peri.umass.edu/215/>

"The real counterpart of many assets on the balance sheets of creditor banks is private deposits in many of the same banks by individuals belonging to Africa's political and economic elites."

Capital flows between sub-Saharan Africa and the rest of the world present a striking paradox. On the one hand, African governments are heavily indebted and have been forced by external debt burdens to undertake painful economic adjustments in recent decades, curtailing the provision of vital social services to their populations while devoting scarce foreign exchange to debt-service payments. On the other hand, sub-Saharan African (SSA) countries have experienced massive outflows of private capital to Western financial centres. Indeed, these private assets surpass the subcontinent's foreign debts.

In the 35-year period from 1970 to 2004, total capital flight from 40 SSA countries amounted to \$420 billion (in 2004 dollars), compared to a total external debt at the end of this period of

\$227 billion. If we impute interest earnings on flight capital, the accumulated stock of capital flight at the end of 2004 was even greater at \$607 billion.

Sub-Saharan Africa in this sense is a net creditor to the rest of the world: the region's external assets exceed its external liabilities. But there is a crucial difference between the two: the subcontinent's external assets belong to private individuals, whereas the external debts are borne by the governments, and through them by the African people as a whole.

Adding to the irony of SSA's position as net creditor is the fact that a substantial fraction of the money that flowed out of the country as capital flight appears to have come to the subcontinent via external borrowing. Part of the proceeds of loans to African governments from official creditors and private banks has been diverted into private pockets - and foreign bank accounts - via bribes, kickbacks, contracts awarded to political cronies at inflated prices, and outright theft. Some African rulers, like Congo's Mobutu and Nigeria's Sani Abacha, became famous for such abuses.

This phenomenon was not limited to a few rogue regimes.

Statistical analysis suggests that across the subcontinent the sheer scale of debt-fueled capital flight has been staggering.

For every dollar in external loans to Africa in the 1970-2004 period, roughly 60 cents left as capital flight in the same year.

The close year-to-year correlation between flows of borrowing and capital flight suggests that large sums of money entered and exited the region through a financial "revolving door." This implies that the real counterpart of many assets on the balance sheets of creditor banks is private deposits in many of the same banks by individuals belonging to Africa's political and economic elites.

Our analysis of African capital flight in this period also reveals a "debt overhang" effect, whereby increases in the accumulated stock of external debt spurs further capital flight in subsequent years. Rising debt may induce residents to shift liquid assets abroad in anticipation of currency devaluation and other macroeconomic problems. In the region as a whole, a one-dollar increase in the debt stock on average triggered an additional 3 to 4 cents of capital flight per year. In other words, debt-driven capital flight over the medium-to-long term exacerbated the short-term hemorrhage caused by debt-fueled capital flight.

Efforts to identify, recover and repatriate illicit private fortunes held abroad are one way African people and their governments can try to repair the damage. This is difficult, however: it places the burden of proof on African governments to locate and reclaim the money. The Stolen Asset Recovery (STAR) initiative, launched last September by the World Bank and the United Nations Office of Drugs and Crime, may help improve the prospects. But forcible repatriation offers only limited possibilities for easing SSA's debt burden.

A complementary strategy would be for African countries to repudiate debts that financed the accumulation of private assets on the grounds that these debts are odious. This is equivalent to asset repatriation: it blocks the final spin of the "revolving door." For Africa, the net capital loss from debt-fueled capital flight comes not from the initial two-way flows but from the resulting debt-service payments in subsequent years. African countries cannot close the stable door after the horse has bolted, but they can cut their losses because they haven't yet paid for the horse. In addition, repudiating odious debt would help deter future capital flight fueled by irresponsible lending.

In international law, a country's debts can be considered "odious"

if three conditions hold: (1) absence of consent: the debts were incurred without the consent of the people, which is typically the case when debts were borrowed by undemocratic regimes; (2) absence of benefit: the borrowed funds were used not to benefit the people, but instead

benefited the rulers, possibly including for repression against the people; and (3) creditor awareness:
creditors were aware or should have been aware of (1) and (2).

It is hard to distinguish, however, between legitimate debts and odious debts. Putting the burden of proof on debtor countries to establish the "odious" nature of debts could often impose insuperable transaction costs. Another way would be to put the burden of proof on the creditors to demonstrate the legitimacy of the debts contracted by previous regimes. Sub-Saharan African governments would tell their creditors that outstanding debts will be treated as legitimate if, and only if, the real counterparts of the debts can be identified and shown to have benefited the people of the country. If the creditors can document where the money went, and show when and how it benefited citizens of the borrowing country via investment or consumption, then the debt would be regarded as a bona fide external obligation of the government (and hence an external asset of the creditor bank or government). But if the fate of the borrowed money cannot be traced, then the present African governments must infer that it was diverted into private pockets associated with the former regimes, and possibly into capital flight. In such cases, it can be argued that the liability for the debt lies not with the current government, but with the private individuals whose personal fortunes are the real counterpart of the debt.

One possible objection is that lenders may retaliate and refuse to lend to countries whose governments opt to repudiate odious debts. But this concern may be exaggerated. Many African countries currently receive little new net borrowing; indeed many today experience negative net transfers, paying more in debt service than they receive in new money. Such debtor countries can easily endure the "punishment" of credit rationing. Moreover, invoking the odious debt doctrine is not equivalent to across-the-board debt repudiation. Legitimate creditors have no reason to fear, given that legitimate loans will be duly repaid. Indeed the prospects for their timely repayment will be enhanced if countries now longer face the additional burden of servicing illegitimate loans.

This strategy would also enforce and reward responsible lending practices by western financial centres as well as transparent and responsible debt management by African leaders. It could yield a win-win outcome for lenders and borrowers. There is certainly a risk that debtor countries would be overly expansive in defining what constitutes "odious debt" if they could repudiate such debt unilaterally, without recourse to legal proceedings to assess the merits of the case. To address this concern, it would be useful to establish an international institution to adjudicate questions of debt legitimacy in developing countries, especially postwar countries - a move that the Norwegian government proposed in October 2005.

As Africa searches for ways to reach financial stability and to increase resources for development financing, we believe that addressing the problem of capital flight ought to feature prominently in debates at the national level as well as in the international development assistance community.

Total capital flight from selected African countries, 1970-2004 (million 2004 US \$ and as % of external debt)

[Columns in the table represent:

Country

Cumulative capital flight (\$ million)

Capital flight stock with imputed interest earnings (\$ million) Capital flight stock as % of external debt]

| | | | |
|--------|--------|--------|--------|
| Angola | 42,179 | 50,951 | 535.2% |
|--------|--------|--------|--------|

| | | | |
|---------|-------|-------|--------|
| Burundi | 2,074 | 2,567 | 185.3% |
|---------|-------|-------|--------|

| | | | |
|---------------|---------|---------|--------|
| Cameroon | 18,379 | 27,288 | 287.4% |
| Chad | 1,338 | 2,346 | 137.9% |
| Congo, D. R. | 19,572 | 36,738 | 310.3% |
| Cote d'Ivoire | 34,349 | 54,001 | 460.0% |
| Ethiopia | 17,031 | 22,526 | 342.6% |
| Kenya | 2,665 | 6,369 | 93.3% |
| Nigeria | 165,697 | 240,781 | 670.9% |
| South Africa | 18,266 | 17,492 | 176.0% |
| Uganda | 4,982 | 6,854 | 142.1% |
| Zimbabwe | 16,162 | 24,556 | 511.9% |

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